

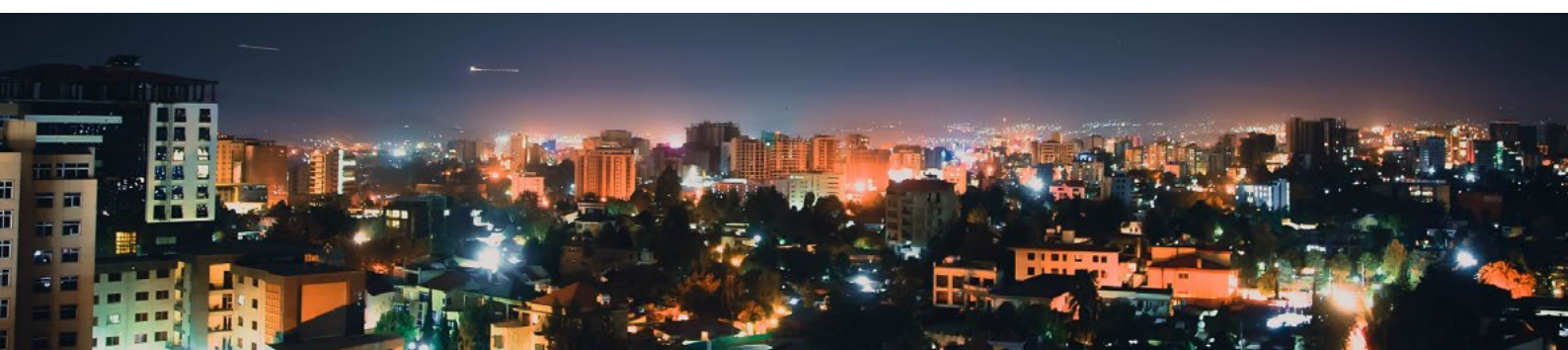


Local Financial Arrangements

edited by

Francisco Velasco Caballero, Universidad Autónoma de Madrid

Karl Kössler and Theresia Morandell, Eurac Research





Foreword

LoGov aims to form a global research and training network and to provide **solutions for local governments** in order to address the **changing urban-rural interplay** and to manage its impacts. As a consortium composed of 10 European and 8 non-European partners, we seek to achieve the following specific objectives:

- to identify, evaluate, compare and share practices in five major local government areas: local responsibilities and public services, local financial arrangements, structure of local government, intergovernmental relations of local governments and people's participation in local decision-making;
- to encourage the effective application of these practices by local governments;
- to strengthen international and intersectoral collaborative research on local government;
- to enhance the skills and career perspectives of the staff exchanged between the project partners.

LoGov's methodological approach relies on a comprehensive comparative analysis that draws on findings from **15 countries** or wider regions on six continents, the extensive **involvement of local policy-makers** through local government associations and a multi- and interdisciplinary approach that is facilitated by the Consortium's expertise in four disciplines: public law, political science, public administration and economics.

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The LoGov consortium is pleased to present this document which summarises the output of the research conducted regarding the identification, evaluation, and comparison of practices in the local government area of local financial arrangements.



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1. Summary of the Evaluation of Practices on Local Financial Arrangements

Francisco Velasco Caballero, *Instituto de Derecho Local, Universidad Autónoma de Madrid*

In the initial guide for the selection of the relevant practices of LoGov's Work Package 2, the sources of financing, the management of the income, and the management of the public expenditure were proposed as a focus of attention. As can be seen, most of the relevant practices in the different countries have focused mainly on the sources of financing, and very secondarily on planning and execution of public expenditure. In the latter area, there are only a few national practices regarding participatory budgeting ("The Importance of the "Village Fund" for the Mobilization of Rural Residents to Civic Participation" [Poland]) and budget transparency ("Budget Transparency with Open Spending Austria" [Austria]; "Metro Open Budget Survey" [South Africa]).

Based on this selection of practices by the different LoGov research groups, we suggest that the comparative phase of the project focuses on the three issues most present in the national dossiers, and in which the rural-urban interplay is most clearly observed: (1) the equalization of income among the different municipalities through transfers, present in almost all national dossiers; (2) the investment in infrastructures and local development (considered in the national dossiers from Italy, Spain, Poland, Austria, Germany and Argentina); (3) and the budgetary participation of citizens (Austria, South Africa, Poland).

In general terms, and as various OECD comparative studies also show, local financial systems are easily comparable because almost all of them have the same sources of income: revenue of their own taxes; supra-municipal transfers; fees and charges; and borrowing. Within each source of revenue, the differences are noteworthy. In many countries, own tax revenues come mainly from either the property tax or a commercial tax, more or less complemented by other less relevant local taxes. Transfers are diverse within each country. In all of them there are both conditional (earmarked) and unconditional transfers. The conditional ones are analyzed as a problem of local autonomy in several dossiers (for example, in "Effects of the Intragovernmental Transfer System on Financial Strength" [Austria]). In many countries, local governments receive a part of the returns from national or regional taxes collected in their territory (shared taxes), which actually act as transfers, because municipalities in these cases lack any taxing power. Fees and charges are very diverse in the different countries. Along with the classic fees for the provision of local services (such as garbage collection or water supply) in some countries, there are more ambitious fees or charges (such as to finance roads ("Trust Fund UniRSE, Santa Cruz" [Argentina]) or to finance urban development ("The Formalization of Development Charges in South African Municipalities" [South Africa])). On occasions, charges complement some non-basic or insufficiently funded municipal services (such as in the case of "Municipal Day-Care Facilities" [Germany] and "Financing of Inter-Connected Transport Services or Linked Transportation Authorities" [Germany])). Finally, loan financing has a complementary and progressively restricted function in all countries, and it is generally oriented towards long-term investment, rather than to finance current spending.



Although the sources of local financing of the different countries are substantially common and comparable, the relative weight of income sources varies across countries. There are countries where financing through own taxes is relatively small, with regional, national or even international grants gaining relative importance (such as European grants, in the case of Poland). In other cases, financing through taxes, in addition to fees and charges, is an important phenomenon, with transfers having a complementary position.

But even within each country, the relative weight of the different sources of financing is different for small municipalities (usually rural) and large municipalities (usually urban). In general terms, urban municipalities (especially the very large ones) are financed to a greater extent with their own resources (taxes and fees), and even through credits. On the other hand, rural municipalities need grants to a greater extent, for three reasons: because the tax bases of local taxes (on the property or various economic activities) are fewer and with relatively low amount; because the cost of providing public services is higher (and therefore, more difficult to cover through user fees); and because there is no real possibility of issuing public debt. In some countries, such as South Africa, India, Malaysia, or Ethiopia, the relative importance of own sources and grants radically differentiates urban and rural municipalities, RLGs being much more dependent on state or regional transfers.

1.1 Income Equalization

Given that own sources are normally insufficient for rural municipalities, it makes a lot of sense, from the perspective of rural-urban interplay, how each country regulates state or regional transfers to the different municipalities. In particular, the existence and form of equalizing elements are especially important in supra-municipal transfers. Precisely because of its relevance to the rural-urban interplay, it is proposed that the coming comparative stage of the project focuses on the more or less equalizing function of state and/or regional transfers. Talking about the equalizing effects of transfers only makes perfect sense when municipal financing with own sources is relatively important. If this is not the case, the transfers have nothing to level: they may pay more or less attention, when allocating resources to each municipality, to the relevant factors of each one (metropolitan character, rurality, aging), but they will not be properly equalizing, because they do not try to compensate for the financial insufficiency of own resources.

Based on the different country reports and from the perspective of equalization between ULGs and RLGs, two broad types of transfers are observed *prima facie*: vertical transfers (national or regional financial resources are allocated to municipalities) and horizontal transfers (a part of the income of some municipalities – the richest ones – goes to the municipalities with less income). Vertical transfers can be to a greater or lesser extent equalizing; horizontal transfers are essentially leveling, although it depends on the specific legal design to what extent they equalize.

In most of the countries considered, the national and regional transfers are not of a single type, but rather a combination of different types. What is relevant then, if we would like to analyze the greater or lesser equalizing effect of the different transfers, is the weight or relative amount of each type of transfer. Countries or regions with strong leveling objectives use various types of leveling transfers (vertical and horizontal). A good example of this is the



horizontal and vertical equalizing fund of the province of Trento (object of RP 2 of the Italian Dossier) or the equalizing transfers of the Canton of Vaud (RP 1 of the Swiss Dossier).

In a global overview of financial grants to municipalities, it is observed that some have equalizing effects, but others do not. A distinction of grants is made below between non-leveling vertical transfers, vertical transfers with equalizing effects, and horizontal transfers (which always produce equalizing effects).

Non-leveling Vertical Transfers

In the countries analyzed there are two fundamental types of national or regional grants that lack equalizing effects. There are, in the first place, transfers based on the number of inhabitants of each municipality. This distributive criterion does neither address the fiscal capacity of each municipality nor the higher or lower costs of providing services nor the demographic or geographic singularities of each municipality. In Spain, for example, most unconditional transfers lack an equalizing effect, because they are based only on population (“Financing Rural Local Governments Faced with Depopulation, Ageing and Dispersion”).

The municipalities' shares in income from national or regional taxes are a second type of transfers that lack leveling effectiveness. These shares are normally based on the tax revenue directly collected by the national government or the region in each municipality with municipalities having no regulatory power over the elements of the tax (tax base, rates, abatements). This happens in Spain, Croatia, Argentina, India, or Poland. In these cases, the income of each municipality is a function of its fiscal capacity (measured in its contribution to national taxes) and, consequently, large urban municipalities usually obtain more income, since these cities have a greater economic activity, higher wages, and higher personal income, and all these factors are determining factors in the collection of Personal Income Tax and indirect taxes related to consumption. A financial system for local governments that gives a lot of prominence to shares in national or regional taxes is therefore, in principle, hardly equalizing.

Vertical Transfers According to Formulas that Include Equalizing Elements

In some cases, vertical transfers (from the national government or the corresponding region) are distributed among the municipalities with some attention to the special needs of the different municipalities. This consideration of special needs occurs in two basic ways: introducing some weighting or correction factor on a basically demographic distribution criterion (so in Albania “The Allocation of the General-Purpose Unconditional Grant and Fiscal Equalization” [Albania] or in South Africa) or creating specific funds of unconditional financing for the municipalities that have specific needs. There are countries, such as Ethiopia (“The Fiscal Equalization Scheme for Woredas in Ethiopia”), where large cities do not receive unconditional or general transfers so that the general transfer system always has an equalizing function. Specific financing funds in favor of municipalities with special financial needs can be found, for example, in Malaysia (balancing grants) and in Canada. In particular, in the Canadian province of Ontario, the so-called Municipal Finance Partnership is made up of four



equalization funds (each based on a different criterion of financial need): The Assessment Equalization Grant; the Northern Communities Grant; the Rural Communities Grant; and finally, the Northern and Rural Fiscal Circumstances Grant.

Horizontal Transfers

In comparative terms, horizontal transfers, which are essentially equalizing, are less frequent. In this case, the municipalities with more tax revenues (usually large cities) transfer a part of their own revenues to the smaller municipalities (usually rural). This kind of equalization can be managed either by a supra-municipal authority (which receives income from some municipalities, to transfer it to others with less income) or directly by the municipalities concerned. In general, the national or regional authorities execute or at least collaborate in the application of horizontal equalization. In the first case (that of a national authority taking revenue from rich municipalities to improve the fiscal situation of poorer ones), we have in Italy the Fund of Municipal Solidarity. This fund is resourced by a share in the collection of the property tax of each municipality and is redistributed by a public-private state company (SOSE) according to criteria of financial need. In Croatia, when allocating to each municipality the income generated by the Personal Income Tax in its territory, a part of the total income (the “Financial Equalization Fund”) is destined to compensate the municipalities in which the collection is below the average. In Moldova, municipalities are financed through a share in the income tax collected in their territory, but a part of these returns adds up to a common fund that is distributed according to criteria of necessity and does not provide any resources to the two large cities: Chisinau and Balti (“General Purpose Transfers as a Key Feature of the Local Financial System” [Moldova]). There is also a horizontal equalizing fund, managed by a supra-municipal authority, in the Canton of Vaud (“The Intercommunal Equalization System in the Canton of Vaud” [Switzerland]) and in the Canton of Fribourg (“The Intercommunal Equalization System in the Canton of Fribourg” [Switzerland]).

Central issues of horizontal equalization are the maximum input caps and the maximum reception caps (for example, both caps are in the Canton of Fribourg). These caps serve to avoid the outright rejection of redistribution by the richest municipalities (usually urban ones) and to stimulate the fiscal co-responsibility of the poorest (which cannot give up optimizing their financing with their own resources).

1.2 Investment in Infrastructure and Local Development

The analysis of the set of best practices shows that, on many occasions, the funding obtained by local entities through financial sources such as own revenue, transfers, fees and charges, as well as borrowing is insufficient to cover the existing public spending needs. At this point, two aspects should be considered.

The first one is a growing demand to local authorities to provide a wider range of public services (in areas such as security, education, or social services). This factor is a constant in the different countries analyzed and is due, to a large extent, to the proximity of the local



government to the citizen. This is reflected in multiple relevant practices, among others in Financial Assistance to Municipalities with Structural Deficit (Italy), Municipal Day-Care Facilities (Germany), and Local Government's Taxing Power and Financing School Canteens to Fight Child Malnutrition in Urban and Rural Chaco (Argentina).

The second aspect to be considered is that the different financial sources for local entities are largely determined and/or limited by the national and regional governments, which makes it difficult for local governments to autonomously increase their income levels. In this sense, the local tax system is designed essentially in the supra-municipal spheres and frequently revolves around relatively stable taxable matters, such as the ownership of land / real estate (through real estate taxes). Transfers and equalizing mechanisms, as we have analyzed in the previous sections, are also quantified using a set of criteria that remain stable over time (unless these are subject to reform or updating, which does not usually happen frequently); consequently, transfers generate a relatively stable, but often insufficient, volume of income to local authorities.

Lastly, access to borrowing, for a period longer than the current annuity, is largely limited by the national or regional authorities (except for some large cities with greater ability to access credit). These limitations on indebtedness are pointed out, among others, in the Thematic Introduction to Local Financial Arrangements of South Africa, Ethiopia, Malaysia, Croatia, and in the practice of Investment Spending of Local Entities in Italy.

In this context, characterized by the increase in the demand for public services and the limitation of the income of the local government, there is, in a wide set of relevant practices, a growing tendency towards the search for alternative financing formulas for infrastructure and public services. These additional financing formulas can be categorized into two main types:

- Fees paid by the user for the provision of services or the development of infrastructures by the local administration.
- Public-private partnerships mechanisms (PPP) through contractual and institutional formulas.

New Approaches to Payments by the User

Concerning tax formulas, as is widely known, the use of user payments (fees) has traditionally allowed the financing of local public services. In fact, fees have a significant weight in the financing of local governments as a whole, being a key element of the local revenue system. By way of example, fees constitute 10% of the income of local authorities in Germany (Thematic Introduction to Local Financial Arrangements in Germany), or 20% in Austria (Thematic Introduction to Local Financial Arrangements in Austria).

Now, alongside with the traditional use of fees, different relevant practices reveal the generalization of new types of payments by the user to obtain the necessary resources to finance a certain infrastructure or public service. Two practices clearly reflect this trend:

The first one is the introduction of so-called “development charges” in South Africa (“The Formalization of Development Charges in South African Municipalities”). Development charges are specific levies created to finance the costs of infrastructures linked to a particular urban



project by their builders/promoters. Through development charges, the aim is to cover the costs of new investments, in fact, the financing of operating, repair, or maintenance costs are expressly excluded. From this perspective, these taxes are similar to the special contributions in Spain, which are considered a tax. Currently, although the introduction of development charges in South Africa is in the draft bill phase, similar measures have already existed in the same country. The existing practices reflect that in order to mitigate the differences between ULGs and RLGs the new law would have to adopt a differential approach, which would encourage builders/developers to carry out projects in RLGs. A trend that, for the moment, has not occurred, with ULGs being the ones that have introduced development charges to a greater extent, as they are magnets of investment, unlike their rural counterparts.

The second relevant practice of Argentina ("Local Government's Taxing Power") analyzes the introduction by local entities of some fees for services that had important similarities with provincial or federal taxes. The fact that these fees concerned similar taxable matters and local authorities were unable to assert precedence of their levies proved problematic. This type of fee for services has also led to disparate judicial decisions by the Courts in favor and against their consistency with the Constitution. Therefore, finally, the Argentine Supreme Court has ruled that local governments should merely establish fees for services effectively provided by them.

For the comparative analysis of the next phase of the project, it is considered interesting to examine whether the introduction of new user payment formulas has become widespread in other countries too and to explore their characteristics and the possible singularities of these taxes in rural local entities.

Public-private Partnerships

Regarding the introduction of collaboration systems between the public and private sectors, different best practices (such as Public-Private Partnerships (PPP) in Germany and Urban Cleansing and Privatization in Malaysia) point out that public-private partnerships are a general phenomenon not only to finance transport infrastructures but also for other types of infrastructure such as in the sector of education (Public-Private Partnerships (PPP) in Germany). PPPs have often been established for accounting reasons, insofar as, depending on the distribution of risks, the investment channeled through them does not affect the levels of public deficit and debt. However, the accounting benefits cannot be the main reason for the introduction of a PPP formula which should rather be based on "best value for money" grounds. If they are only initiated for accounting reasons they may result in a lower initial impact on public deficit and debt levels (to the extent that gross fixed capital formation is not recorded in the public balance sheet), but higher public expenditure in the medium and long term (due to, among other reasons, the cost of private finance). Generally, the question whether a PPP makes sense must be evaluated in terms of efficiency, against the traditional formulas for the development of infrastructures or the provision of services. The efficiency of a PPP must derive from the potential greater knowledge (know-how) of the private sector in the matter, especially in the case of infrastructures or services in smaller municipalities.

The relevant practices indicated analyze key elements for evaluating the suitability of a PPP. Among these are the fair distribution of risks between the public or private sector. In this



regard, the Public-Private Partnerships (PPP) practice in Germany indicates that the transfer of risk to the operator will be more complex when there is no payment by the user, that encourages the correct provision of the service by the operator, concluding in these cases that most of the risk is borne by the municipality. Another central element when considering the development of a PPP is to determine who owns the asset both during the development phase of the PPP contract and at the time of completion.

Regarding the results derived from the introduction of PPP formulas, the best practices identify some of the deficiencies that, in general, have been noted in the PPPs. These are, in particular, the increase in the final costs of the project compared to those initially planned and the excessive transfer of risks to the public sector. These controversial aspects of PPPs have led to a significant increase of new formulas of public-public institutional collaboration to solve the problems of rural local entities in carrying out certain infrastructures or providing certain services.

For the comparative examination, it would be interesting to determine to what extent local entities have introduced PPP mechanisms, the characteristics of PPP projects, especially highlighting the singularities of their use by rural local entities, and the results achieved.

Finally, some relevant practices reflect on how financing deficiencies, especially to carry out investment, have also been covered through specific funds (such as European Funds, in the practices: "The Role of EU Structural Funds for Austrian Local Governments and its Contribution to the Urban-Rural Interplay" in Austria; "The Local Recovery Plan to Overcome the Effects of Covid-19" in Spain, and "Investment Expenditure of Local Governments - the Role of European Funds in the Financial Strategies of Rural gminas" in Poland) and, exceptionally, through funds based on private financing (as in the relevant practice "Trust Fund UniRSE, Santa Cruz" of Argentina, of highly questioned suitability).

1.3 Participation of Citizens in the Budget Process

The relevant practices analyze different formulas (of a disparate nature) through which citizen participation in the budget process has been promoted.

In the case of Austria, citizen participation is promoted through the creation of a portal (www.offenerhaushalt.at) in which the budgets of local authorities are made public. This portal provides transparency in the execution of local public spending and improves the understanding of municipal budgets by citizens. The practice has been a clear success, internationally recognized, as a large number of local entities participate in the platform, especially those of larger size. The latter are more familiar with the publicity of budget data and, unlike what happens in small municipalities, the publicity of sensitive data, such as the salaries of civil servants, does not affect the right to privacy of the latter ones.

In the case of Poland, citizen participation is promoted through the creation, by state law (a top-down process of citizen participation), of the so-called "Village Fund". To access the additional state funding that the "Village Fund" entails, the local entity has to create a separate fund in its budget to finance initiatives designed in a participatory way by its citizens.

Finally, in the practice "Metro Open Budget Survey" of South Africa, a specific mechanism for promoting citizen participation in the budgetary sphere is not analyzed, but rather the



availability of budget information (transparency), the opportunities for citizen participation and the strength of budget oversight in five urban municipalities in South Africa. These three elements (transparency, citizen participation, and supervision) are considered the pillars of budget responsibility. In most of the metropolitan areas surveyed, transparency is best ensured in the budget approval and audit phases. In the area of supervision, this is weak during the formulation, approval, and execution of the budget, but not during the audit. Finally, in terms of citizen participation, an important finding is that, in general, there is a greater presence of it when the budget is approved and audited, while citizen participation is almost non-existent during the phase of budget formulation and that of budget implementation.

From the above best practices, it can be concluded that, in order to carry out a comparative analysis of a global nature, the different research groups should examine, on the one hand, whether their urban and rural municipalities have introduced mechanisms to promote citizen participation in the budgetary field; and, on the other hand, determine the scope of transparency, public participation and budget supervision in their respective states.

1.4 Conclusion

Comparative research on financial equalization between ULGs and RLGs could focus on several selected issues: the relevance of the diverse municipal equalization schemes in the various countries or regions; the type of equalization (vertical or horizontal); the authority that executes the leveling (directly the municipalities or a supra-municipal authority); the criteria considered for the equalization (population density, aging, orography, cost of public services, school population, etc.) and the very effectiveness of the leveling system as a whole.

Regarding alternative financing formulas for investment in infrastructure and local development, the different research could analyze whether new user payments have been introduced, as well as their characteristics and the differential features that they may have in RLGs. Similarly, research should examine the state of play of public-private partnerships (or public-public collaboration) as an alternative financing mechanism of infrastructure or public services; in particular, they might consider the special features of PPP in the rural and urban local sphere. It would also be interesting to observe whether both types of mechanisms act jointly, i.e. through PPPs financed by user payments with distinct characteristics.

Finally, reference should be made to the introduction of a systems of citizen participation in the budgetary sphere, assessing the levels of transparency, public participation and budgetary oversight achieved in their respective countries analyzed by the LoGov project.



2. Local Financial Arrangements in Italy

2.1 The System of Local Government in Italy

Greta Klotz and Karl Kössler, *Eurac Research*

Types of Local Governments

In Italy, there are three main types of local governments which are recognized under Article 114 of the Constitution as making up, together with the 20 regions¹ and the State, the Italian Republic. These are the municipalities (*comuni*), 14 metropolitan cities (*città metropolitane*) and 83 provinces (*province*). The basic units of local government throughout the country are the 7,914 municipalities (*comuni*). However, in order to facilitate the social and economic integration of urban agglomerations, there are the metropolitan cities (*città metropolitane*). While their establishment had been discussed time and again at least since the 1950s, fierce resistance, especially from the regions, had made their actual creation impossible. Only the constitutional reform of 2001 introduced the metropolitan cities into the Constitution. Then it took over a decade to clarify how they would actually operate and to overcome resistance from other government levels. The Ordinary Law no 56/2014 ('Delrio Law') finally established the metropolitan cities.² The third type of local governments that is recognized under Article 114 as a constituent unit of the Italian Republic are the provinces. They are umbrella entities between the regions and municipalities. Similar to second-tier local governments in other countries the main function of the provinces is the coordination of policies and public services.

Apart from these three main types enshrined in the Constitution, the Legislative Decree no 267/2000 mentioned some more types of local governments. The unions of municipalities (*unioni di comuni*) are composed of two or more municipalities and are an institutional form of cooperation in order to jointly exercise certain functions.³ A similar rationale is behind specific local government entities for particular geographical areas, namely the mountain communities (*comunità montane*) and the island communities (*comunità isolane*).

Legal Status of Local Governments

According to the above-mentioned Article 114 of the Constitution, '[t]he Republic is composed of the Municipalities, the Provinces, the metropolitan cities, the Regions and the State. Municipalities, provinces, metropolitan cities and regions are autonomous entities having their

¹ There are 15 regions with ordinary statute and five regions with special statute, recognized under Article 116 of the Constitution, namely Sardinia, Sicily, Trentino-South Tyrol, Aosta Valley and Friuli-Venezia Giulia.

² Giovanni Boggero, 'The Establishment of Metropolitan Cities in Italy: An Advance or a Setback for Italian Regionalism?' (2016) 8 Perspectives on Federalism E-1, E-5.

³ Italian Constitutional Court, Judgment no 50/2015.



own statutes, powers and functions in accordance with the principles laid down in the Constitution'. Even if this provision seems to suggest that the constituent parts of the Italian Republic are on an equal footing, the Constitutional Court soon emphasized the special role of the state vis-à-vis the other government levels.⁴ While Article 114 ensures that the three main types of local government enjoy autonomy within constitutional principles, it does not go any further in regulating them.

Article 117(2)(p), however, determines that national government shall establish the rules regarding the 'electoral legislation, governing bodies and fundamental functions of the municipalities, provinces and metropolitan cities'. The relevant law consolidating pre-existing rules is the above-mentioned Legislative Decree no 267/2000. The regional legislator can only become active in a complementary manner on the basis of the residuary power under Article 117(6). This is true, however, only for the 15 regions with ordinary statute (hereinafter, ordinary regions). The five regions with special statute (hereinafter special regions) are allowed to regulate their local governments in their autonomy statutes (e.g. Article 4(3) and Article 61-65 of the Statute of Trentino-South Tyrol) and, more in details, through ordinary regional legislation.

(A) Symmetry of the Local Government System

There are certain types of local government with special status that take into account different realities in urban and rural areas, like the above-mentioned metropolitan cities, unions of municipalities, mountain communities and island communities. Certain variations follow from Italy's system of asymmetrical regionalism, more concretely, from the different regulatory regimes concerning ordinary regions and each of the five special regions.

Nonetheless, the local government system is quite symmetrical. This is because the system is rooted in ideas of municipal organization from the French Revolution and Napoleonic times. These ideas were supported by the House of Savoy and after their founding of the Kingdom of Italy in 1861 extended to the whole country by enacting the laws of administrative unification in 1865. This explains adherence, in principle, to the French model of uniform municipalities, which are supposed to carry out the same functions irrespective of territorial size, demography, economic power, as well as urban or rural character.

Political and Social Context in Italy

The political situation at the national government level and, to a lesser extent, in the regions has in recent years witnessed profound changes of the party system. At the national level, a coalition government formed by the Five Star Movement and the League came to power in 2018 and was replaced by a coalition between the Five Star Movement and the Social Democratic Party (PD) in 2019. As for the regions, candidates from the League over the last decade have been elected Presidents in Veneto, Lombardy and Friuli-Venezia Giulia, while

⁴ Italian Constitutional Court, Judgment no 274/2003.



Brothers of Italy, another right-wing party, took power in the Abruzzo region in 2019. At the local level, there is a similar tendency. When about half of Italy's municipalities were called to vote in 2019, the center-right block led by the League won, from among those with over 15,000 inhabitants, in 75 municipalities (up from 36).

A good indicator for the social and demographic context of local governments is the OECD definition of functional urban areas as composed of a densely inhabited city and a surrounding area (commuting zone) whose labor market is highly integrated with the city. Following this definition, only 30 per cent of Italy's population live in metropolitan areas (more than 500,000 inhabitants), 20 per cent in small- and medium-sized urban agglomerations (50,000 to 500,000 inhabitants), compared to an OECD average of 49 per cent and 18 per cent, respectively.

As for the structure of municipalities, only 144 of them have more than 50,000 inhabitants, while 70 per cent have less than 5,000 inhabitants and are thus, according to the Italian classification, 'small municipalities'. The average population size is 7,653. But this, of course, says little in view of an extremely wide spectrum ranging from Rome's almost 2.9 million inhabitants to 33 in the municipality of Morterone in the Region of Lombardy.

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2.2 Local Financial Arrangements in Italy: An Introduction

Alice Valdesalici, *Eurac Research*

According to the legal framework resulting from the 2001 constitutional reform - and progressively entering into force - local authorities, i.e., municipalities, provinces and metropolitan cities - shall be financed by means of own tax sources, shared taxes, not-earmarked equalization transfers, plus additional transfers provided for exceptional cases (Article 119 Constitution). However, over the last decade (2010-2020) local finance has witnessed a structural metamorphosis marked by an overall increase of local taxes and a correspondent decrease (-32 per cent) of state transfers altogether considered.⁵ At present, local financing is mostly based on taxes, which are created and regulated in their foundations by the central level of government (so-called devolved taxes).

Having specific regard to municipalities, they are vested with a tax varying power and/or are entitled to the revenue generated within their territory. In 2018, the share of local taxes compared to overall local revenues was 46 per cent and this figure has been increasing. This is the result of frequent revisions adopted by national legislation from 2012 onwards. Since 2014 one of the major municipal tax sources is the *Imposta Unica Comunale* (literally, Single Municipal Tax), composed of a local tax on property of housing (IMU), a local tax on waste (TARI) and a local tax for general public services provided by the municipalities (TASI). Local taxes also include a surtax on individual income (IRPEF), consisting of a fixed tax rate defined by national law, which resembles a shared tax, and an optional tax rate which can be determined by each municipality within an upper limit of 0,8 per cent. Tax benefits can be set within the limits provided by the national legislation. Autonomous own tax sources represent an exception to this scheme. The tourist tax is one example: a national law entitles municipalities to impose a tourist tax to be applied within the upper limit set by the state (Legislative Decree no 23/2011).

In order to remedy inter-municipal imbalances, the state has set up an equalization fund providing for non-earmarked transfers. Since the constitutional reform of 2001, the overall system of equalization is undergoing a comprehensive reform. According to Article 119(4) of the Constitution, a state law shall establish a non-earmarked equalization fund, to be assigned to entities with lower fiscal capacity per-capita. At the same time, the state holds the exclusive legislative power over the equalization system and over the determination of the fundamental functions of local entities to be ensured in a uniform manner across the country (Article 117(2) Constitution).

This framework was implemented partly by Law no 42/2009, partly by a number of governmental decrees. In particular, Law no 42/2009 requires the gradual overcoming of the funding system, which links the transfers to the resources spent in the previous financial years (so-called historic spending). The new calculation of the funding shall be based on objective

⁵ All data in the text are taken from: IFEL Dipartimento Finanza Locale, 'La finanza comunale in sintesi. Rapporto 2019' (IFEL 2019) <https://www.fondazioneifel.it/documenti-e-pubblicazioni/item/download/3410_1784abea3a086d86f6363eaf17c6d78f>.



and pre-defined parameters to be applied uniformly to all entities (so-called standard costs and needs). Pursuant to Article 11, two equalization mechanisms shall be established on the basis of a twofold classification of the decentralized functions. A first scheme has to ensure the funding of fundamental functions (around 80 per cent of local spending), while a second one is envisaged for the other residual (non-fundamental) functions (20 per cent of local spending). The impact of equalization differs between the two groups: a full financing is foreseen for fundamental functions, while only a partial equalization is prescribed for all others. A second differentiation consists in the financing parameter: equalization transfers are calculated applying the standard costs and needs criteria to the first group only, while for non-fundamental functions equalization is related to the per-capita fiscal capacity.

The regulation of these equalization mechanisms (methodology and definition of parameters) has been left to governmental decrees (e.g., Law Decree no 216/2010 as later modified and integrated), while a public-private company (SOSE) is in charge of calculating the standard costs and needs. These have to be calculated for each fundamental function taking into consideration the peculiarities of the single function and each category of entity (e.g. the size of municipalities).

Within this complex legal framework, the Stability Law 2013 (Law no 228/2012) has finally set up the Fund of Municipal Solidarity, as later modified by the Stability Law 2014 (Law no 147/2013, paragraph 729). However, the transition towards the new system started only in 2015. The Fund is financed through a share of the revenue generated from the local tax on properties - IMU (accounting for 38.23 per cent in 2015 and for 24.43 per cent in 2016) and only a selection of local tax revenues is taken as benchmark, in order to determine who is entitled to benefit from it. In 2016, the resources of the equalization fund that were distributed on the basis of the new standardized parameters amounted to only 30 per cent, while the rest was allocated taking into account historic spending (the old parameter). The share is progressively increasing, and the new system should enter fully into force in 2021.

Starting from 2015, spending autonomy of local entities has expanded significantly. The Internal Stability Pact has been abandoned and a new system based on the principle of balanced budget is in place.⁶ The impact of the principle of 'balanced budget' for local authorities has been specified by Article 9 of Law no 243/2012, as later modified by Law no 164/2016. It prescribes the achievement (paragraph 1) of a non-negative value - on accrual basis - in the balance between final revenues and final expenditures. The new legal framework imposes limits to deficits and to the possibility to incur debts and, at the same time, it sets strict limitations to overspending. Deviations from the equilibrium could occur after agreement reached at the regional level or at the national level, among all territorial entities and/or with the State. These allow for compensatory measures, potentially releasing space to single entities for investment spending. It is not by chance, then, that in the last few years the use of other sources of funding, such as the use of public-private partnerships (project finance, leasing) or EU resources, has increased.

All in all, municipalities do not receive other transfers, with minor exceptions. One example consists in the measures in favor of tiny municipalities with less than 5,000 inhabitants. In 2017

⁶ In this respect, see also report section 3.2. on Investment Spending of Local Entities.



the Fund for Structural, Economic and Social Development has been set up and it is distributed on the basis of parameters that serve to safeguard of the environment and the cultural heritage, as well as the economic, social and infrastructural development of small municipalities. In addition, to cope with the challenge of increasingly depopulated small municipalities forms of reduced taxation have been introduced, for foreigners that move their residence in small municipalities of the south.

Also the financing of provinces and metropolitan cities, the system is based on the same type of sources, i.e., devolved and shared taxes, plus transfers from the experimental fund for financial consolidation of provinces. However, the legal framework is even more complex and uncertain. As to the provinces, this is the result of the austerity measures that have progressively reduced the transfers, on the one hand, and of the undergoing process of territorial reorganization regarding in particular the (reduction of) functions allocated to the provincial level. As to metropolitan cities, the situation is even more uncertain: they have been finally established by Law no 56/2014, but their system of financing remains undefined. The result is that the provincial scheme with reduced resources still applies to them entailing problems of underfunded mandates.⁷

Notwithstanding the discrepancies among the single local entities in terms of population size and density, territorial and socio-economic characteristics, all local entities of a certain type are vested with the same competences and the same system of financing applies. However, the system described above applies to local entities within ordinary regions. For special regions, the rules are different. First, the general financial rules do not directly apply to them, but they have been asked to reform their systems according to the same basic principles. The specific regulations have to be agreed between each special region and the state in bilateral negotiations. In sum, special regions enjoy a higher degree of financial autonomy, but they differ one from the other to a great extent. Second, some special regions are in charge of local finance, whereas in others this remains a state competence. But it is the responsibility of all regions (special and ordinary) to ensure the respect of the balanced budget principle taking into account all territorial entities within the regional territory of reference.

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⁷ Commissione Parlamentare per l'Attuazione del Federalismo Fiscale, 'Resoconto Stenografico' (Audizione 99, 23 February 2017) 5

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2.3 Investment Spending of Local Entities

Alice Valdesalici, *Eurac Research*

Relevance of the Practice

Investment spending of local entities has been severely affected by the economic crisis and the solutions the center has adopted to cope with it. The large reduction of transfers, together with the additional obligations introduced through the Internal Stability Pact (requiring substantial surpluses in the budget of local entities), have added a heavy burden to local finance. As a result, municipalities are the entities that contribute the most to reduce the level of indebtedness. Nevertheless, this goes mainly to the detriment of investment spending. With minor exceptions (mostly in the northern part of the country), the data of the period 2010-2018 show a significant decrease (- 38 per cent).⁸

Among the flexibility measures introduced to favor a turnaround, it is worth to mention the infra-regional agreements and the national solidarity pacts. Together with the principle of balanced budget, these instruments have been introduced as of 2016 in order to assign extra-financial room to certain entities and foster investment spending within the territories.

Description of the Practice

As to the infra-regional agreements, each region can come to term with the local entities located within its territory in order to assign extra financial room to some of them. This is done by 'borrowing' financial space from those entities that do not spend/need the entire amount of resources at their disposal, as the principle of balanced budget applies to the entire regional territory, the region included. This is mandated in order to ensure the balance of the budget on a regional scale. Anyhow, each entity has to ensure the recovery of the deficit within the following three years. The same compensatory function is exercised by the national solidarity pacts in case there is no room for maneuver on a regional basis. These pacts permit the activation of compensatory measures at the national level, potentially releasing space to local entities for investment spending. In this respect, Article 10, Law no 243/2012 - as later modified, and implemented by governmental decree (Decree of the Presidents of the Council of Ministers no 21 of 21 February 2017) - stipulates that investments made through debt or the use of surpluses of the previous years are subordinated to an agreement to be reached at the regional level. The agreement serves the purpose of ensuring the respect of the balanced budget rule taking into account all entities within the territory of reference, including the region itself. If no room is left on a regional base, the 'horizontal' national solidarity pact

⁸ All data in the text are taken from: IFEL Dipartimento Finanza Locale, 'La finanza comunale in sintesi. Rapporto 2019' (IFEL 2019) <https://www.fondazioneifel.it/documenti-e-pubblicazioni/item/download/3410_1784abea3a086d86f6363eaf17c6d78f>.



redistributes the existing financial spaces respectively among regions, municipalities and provinces/metropolitan cities on a national base.

To be noted is that both instruments represent a tool of last resort. They integrate the already existing margin of maneuver each entity is vested with and can be activated only if the single entity cannot cover its investment spending either incurring debts (in the respect of the limitation applied to the single entity), or using its surplus. To be noted is the fact that surpluses shall primarily be used to extinguish the existing debts; later, they can be earmarked for investment spending (Article 9(3)). Both instruments have a horizontal nature that is to allow extra-flexibility to certain entities, to the detriment of other entities, measured on regional or on a national base. Furthermore, it is worth stressing that the extra resources are available under conditionality. As a matter of fact, they are earmarked and can be used only for the purposes defined by the law. In addition, the related use of 'free-space' is limited to the current financial year.

In addition to that, 'vertical' national solidarity pacts are also foreseen (Law no 232/2016). These are meant to favor investment spending of both regions and local entities, in case there are no financial spaces available by means of the other two 'horizontal' instruments. The vertical nature is linked to the fact that the resources to cover the extra-financial margin of action come from the state budget. Back in 2017 the resources available for local entities were 700 million Euro a year. As of 2018 the amount has been expanded to 900 million Euro a year with a quota reserved to school and sport infrastructures.

Assessment of the Practice

As some scholars highlight, any assessment must be taken with a grain of salt if it does not include a comprehensive ex-post qualitative and quantitative data analysis and that is something lacking so far in the case of investment spending in Trentino and other Italian territories. This is because very small details can make a difference whether a practice can be regarded as effective, at least from the perspective of political economy. Generally speaking, although instruments regarding local investment spending have been in place for three years now and the available data shows an ongoing exchange in terms of financial spaces among local entities, within and beyond the single region, so far investment spending has not registered the desired turnaround. Having a look at the available data, in fact, investments remain on average well below the level of 2010 (-36 per cent). Nevertheless, having a closer look at the data of the last two years (2017-2018), these show an interesting positive trend (+9 per cent), even if with great variations between the northern (+13 per cent) and the southern (+9 per cent) part of the country, with 0 per cent registered for central Italy and +7 per cent for the two main Islands. Discrepancies can also be found between ordinary regions (+9 per cent) and special regions (+13 per cent). Despite these potentially positive trends, this can only be considered as a preliminary assessment of the role played by the mechanisms concerning local investment spending and only the coming years will show whether it is confirmed or not. However, the context of a recession has certainly further exacerbated the problem of a lack of financial space and flexibility for investments. As one observer has pointed out, fiscal



consolidation in Italy typically means cutting investments and while such consolidation used to be cyclical in nature, recession made it a structural issue.⁹

Once the above-mentioned turnaround concerning local investment spending is achieved, it will be key to look not only at one-time investment but also on the long-term expenses that they require.¹⁰ Some Emilia-Romagna municipalities after the 2012 earthquake are cases in point for a lack of such a link. They used easily available resources to invest not only in the rebuilding of destroyed infrastructure but also in facilities such as public swimming-pools. The current expenses that the operation of these facilities require were not always duly considered. Thus, the nexus between investments and long-term costs, which is key for financial sustainability, has sometimes received insufficient attention in the past and that will have to be avoided in the future.

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Sciancalepore C, 'Le intese regionali nella regola fiscale del pareggio di bilancio: esperienze e prospettive future' (IRPET and Osservatorio regionale sul federalismo fiscale 2017)

⁹ Interview with Giorgio Brosio, Professor, Department of Economics and Statistics, University of Turin (17 May 2021).

¹⁰ Interview with Emanuele Padovani, Associate Professor, Department of Management, University of Bologna (7 May 2021).



2.4 The Revision of the Inter-Municipal Equalization Mechanism in Trentino

Alice Valdesalici, *Eurac Research*

Relevance of the Practice

In the Autonomous Province of Trento there are altogether 166 municipalities. The territory is almost entirely mountainous, except for small flat areas located in the valleys crossed by the major rivers of the province. These circumstances have had profound consequences in the uneven distribution of the population: the highest population density is found in the lower districts, such as the Adige Valley, Vallagarina, Alta Valsugana and Alto Garda e Ledro, which have a density of over 100 inhabitants/km². 49.5 per cent of the provincial population lives in these areas. The major urban areas, Trento, Rovereto, Pergine Valsugana, Arco and Riva del Garda, are the only five municipalities with more than 10,000 inhabitants. By contrast, the alpine valleys at higher altitudes have a much lower population ratio. It is not by chance then that the population density in the provincial territory ranges from 789 and 6 inhabitants per km². Only 7 per cent of the overall population lives in the areas between 1,000-2,000 meters above sea level and only 12 per cent in territories between 750 and 1,000 meters. 87,95 per cent of the 166 municipalities are tiny municipalities with less than 5,000 inhabitants and most of the entities over 500 meters are tiny municipalities. As such there exists a strong divide between (the few) urban municipalities and the many rural municipalities regarding both revenues and expenditure needs which the Province attempts to overcome through an equalization scheme.

Description of the Practice

The existing discrepancies within the territory justify the establishment of an inter-municipal equalization fund to correct the imbalances and ensure a comparable level of services throughout the provincial territory. The general rules thereof are provided in the Provincial Law no 36/1993, whereas in the annual arrangement on local finance the province and the local entities agree on the detailed regulations. By virtue of the exclusive legislative competence over local finance attributed by the Statute to the Autonomous Province of Trento, the latter has adopted the above-mentioned Provincial Law no 36/1993. Among other things, this law regulates the procedures and contents of the annual agreement on local finance, which establishes both the amount of financial resources to be transferred to municipalities and other local entities, as well as the measures necessary to guarantee the coordination of municipal and provincial finance, with particular reference to the measures for the pursuit of provincial finance objectives.

As to the procedure for adopting the annual arrangement on local finance, the proposal is drafted by the Province, however an agreement has to be reached with the representatives of



the local entities that sit in the Council of Local Autonomies (Article 81 of the Autonomy Statute and Article 3 of the provincial law). The basic rules governing the equalization fund are contained in Article 6 of the provincial law. The provision sets as the general objective of the fund that of rebalancing the financial endowments of the municipalities and the level of services offered to the population. As for the distribution among the municipalities, it is foreseen that this will be determined annually by the provincial executive with a resolution adopted on the basis of the criteria and parameters set forth in the annual agreement and with the ultimate aim of guaranteeing: (i) the rebalancing of the level of services offered with respect to average provincial standards; and (ii) efficiency in the use of the transferred resources.

In addition, the distribution of the fund is carried out based on a standardized level of expenditure that is assessed, for each municipality, also taking into account the following variables:

- the differentials in the costs to deliver services in relation to the different environmental and demographic context;
- the imbalances in the territorial distribution of the taxable bases and of the revenues from municipal assets;
- the weight of actual revenues deriving from taxes, duties and tariffs with respect to the standard values;
- the exercise of functions connected with the provision of specific services characterized by a non-homogeneous distribution throughout the provincial territory and pertaining to singular municipal socio-economic situations;
- the financial effects on the expenditures of the municipalities resulting from policies of interest to the province in matters of municipal competence.

In light of this legal framework, on 8 November 2019, the annual agreement on local finance has been reached. With reference to the equalization mechanism, at first, the agreement stipulates that the fund has a twofold dimension: vertical and horizontal. While the provincial level grants 61 million euros, approximately 14 million euros derive from the municipalities with greater tax-revenues and assets (solidarity quota). Second, for 2020 the interested parties have agreed to change the distribution criteria.

On top of that, with the agreement for 2020 the provincial executive and the representatives of local authorities agree on the revision of equalization system with the aim to update the evaluations of the standard expenditure of municipalities taken as benchmark, as well as to introduce among the equalization criteria also the value of the municipalities' own current revenues (as a measure of existing differences in terms of fiscal capacity).

To pursue this objective, an analysis of the financial situation of municipalities at the end of 2017 was conducted, with reference to those entities with less than 15,000 inhabitants so as to highlight strengths and weaknesses of the system. The analysis has revealed anomalies in the current equalization system. On the one hand, there are municipalities that after the equalization transfers are able to achieve a positive current balance, on the other hand, with the present level of transfers some other municipalities permanently experience a negative (or otherwise unstable) current balance.



Therefore, the need has emerged to revise the equalization mechanism having regard to the municipalities with a population of less than 15,000 inhabitants. As such the agreement for 2020 integrates the distribution criteria basing, on one hand, on a standard level of expenditure, estimated per each municipality taking into account demographic, socio-economic and geographical characteristics; and, on the other hand, on the level of own revenues, so as to also take into account the ability of each municipality to independently finance the standardized level of expenditure. Standard expenditures are estimated through an econometric model that takes into account the following variables: number of inhabitants; growth rate (or decrease) of the resident population; share of population from 1 to 5 years; share of population over 65 years; altitude; area (territorial dimension/size of the municipality); population density; number of tourist presences; number of local units (enterprises). Own revenue capacity is defined by taking into account two criteria:

- the level of tax revenues with respect to a standard calculated on an econometric basis, taking into account the demographic dynamics, the number of tourists, the presence of companies, the number of houses and the number of local units (businesses), the number of houses and the taxable IRPEF income;
- the level of revenues of non-tax nature with respect to a standard calculated as the average of the demographic class of belonging.

Given these benchmarks, the equalization transfers attributed to each municipality are therefore calculated starting from the municipality's standard expenditure figure and deducting:

- a share of the actual extra-tax revenues;
- the standardized tax revenues and considering a share equal to 80 per cent of the difference between actual and standardized revenues. This share reduces the allocation on the equalization fund in cases where actual revenues are higher than standard revenues and, conversely, increases them in cases where actual revenues are lower than standard revenues. In this way, municipalities with a higher fiscal capacity than the standard revenues 'give up' a share of the greater resources in favor of municipalities with a fiscal capacity below the standard.

As a result the degree of equalization of the differences in terms of fiscal capacity is high, though not complete, so as not to discourage the effort of each municipality to raise its own revenues.

Assessment of the Practice

Compared to the national equalization system, inter-municipal equalization in Trentino has been regarded as more evolved and complete.¹¹ Of course, it is difficult for any mechanism with the aim of sharing financial resources in a fair way to overcome the key challenge of

¹¹ Interview with Maria Teresa Nardo, Associate Professor, Department of Political and Social Sciences, University of Calabria (17 May 2021).



avoiding overly complex calculation which inevitably results in a lack of transparency. This is arguably one of the main limitations of the national system.¹²

Compared to its preceding system of 2018, the application of Trentino's new model of 2020 entails significant changes in the allocations to each single municipality. As such, a gradual transition to the new system has been planned, providing for its full operation only in 2024. It is therefore too early to assess the impact of the new mechanism on the functioning of local system. Nonetheless, it reflects a clear political signal towards the valorization of even the smallest municipalities with a view to keeping all public services as closest as possible to the citizens. This runs contrary to the approach of the former provincial governments, which had instead put in place both measures to encourage mergers between small municipalities and compulsory forms of inter-municipal cooperation. Indeed, it is important to note in this context that equalization schemes are linked with such cooperation in various ways. For one, these schemes may disincentivize collaboration because they remove part of the financial pressure to work together. But also issues of electoral accountability and public satisfaction with services need to be taken into account, besides financial issues, when evaluating the link between these two instruments.¹³

Anyway, although each political majority that has governed the Autonomous Province of Trento has in any case worked to enhance local autonomy, in the last decade evaluations of efficiency and cost-effectiveness have also been introduced. This outcome has been prompted by the overall reduction of resources due to the economic and financial crisis as well as by the need to comply with the EU ever more stringent obligation on public finance. From a legal perspective a significant role in this respect has been played also by the principles inspiring the national reform of fiscal federalism (law no 42/2009) and the provincial competence on the financial coordination of so-called 'integrated territorial system' that includes all entities located in the provincial territory.

However, as efficiency arguments frequently come along with expenditure cuts, they do not necessarily lead to an increase in popular support, but rather the opposite. Read in this context, then, the changes under consideration embody a different vision put forward by the current provincial government and characterized by the desire to enhance the local dimension at all costs. One can hardly deny the central position of the municipal authorities for sustainable living in a territory like the one of the Autonomous Province of Trento which is characterized by significant portions of rural areas at medium-high altitudes. Small municipalities in these areas suffer from significant diseconomies of scale with many public services being very expensive. As the traditional market logic is has negative effects in such local governments, public policy interventions are needed if people shall be incentivized to stay in in small mountainous villages.¹⁴ Action is necessary not only to avoid depopulation of these areas but also the related risk of (harmful) abandonment of the territory. The question that arises is

¹² Interview with Giorgio Brosio, Professor, Department of Economics and Statistics, University of Turin (17 May 2021).

¹³ Statement by Federico Boffa, Professor, Faculty of Economics and Managements, Free University of Bolzano/Bozen (LoGov Country Workshop, Local Financial Arrangements, 14 April 2021).

¹⁴ Interview with Gianfranco Postal, Magistrate, Court of Auditors of Trento, (25 May 2021).



whether we can still afford a local financing scheme in which efficiency plays a far too marginal role.

Looking at Trentino's inter-municipal equalization not from the perspective of its effectiveness but that of autonomy (both local and regional), it is important to note that Italy's 'Alpine' special regions play through their integrated territorial system concerning public finance a sort of Janus-faced role. They coordinate local finance inside their territory and effectively replace through the direct management of the equalization mechanism the national government. As some observers highlight, Trentino's system of inter-municipal equalization could thereby serve as an example for other territories because it would be desirable that regional administrations should take over responsibility in this area.¹⁵

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Provincial Law on Local Finance, Provincial Law no 36/1993 (Articles 3 and 6)

Agreement on Local Finance for the year 2020, November 2019,
<<https://www.cal.tn.it/albo/2019>>

¹⁵ Interview with Elena D'Orlando, Head of Department of Legal Studies, University of Udine (13 May 2021).



2.5 Financial Assistance to Municipalities with Structural Deficits

Karl Kössler, *Eurac Research*

Relevance of the Practice

Italy is characterized not only by a deep cleavage in socio-economic terms between the north, center and south of the country, but also between local governments. Even if a certain gap sometimes exists also between municipalities within these three macro-regions, it is beyond doubt that the number of local governments whose populations can be defined as vulnerable in social and material terms is particularly high in the southern regions of Campania, Sicily and Calabria.¹⁶ A comparison of municipalities with more than 50,000 inhabitants shows a similar picture, as all towns and cities in the quartile with the highest vulnerability are located in Italy's south.¹⁷ Such vulnerability goes beyond mere poverty and has come to be seen in recent years as a state in which 'the autonomy and capacity of self-determination of individuals are permanently endangered' due to their marginalization concerning the main systems of social integration and distribution of resources.¹⁸ Thus, it is also seen as ultimately running contrary to building resilience of (local) populations.¹⁹

This situation in southern Italy is both a reason for and result of the fact that migratory patterns do not only concern the rural-urban dimension but also substantial movement especially of the young and educated from the south, including its urban areas, to the north of the country.²⁰ The main challenge that this 'brain drain' entails for southern municipalities, both rural and urban, is a lack of personal resources and administrative capacity.²¹ The structural weakness of many of these municipalities, which have run high deficits for years and have little or no leeway for investment, has recently led the national government to transfer payments in those cases in which this financially precarious situation follows from 'the socio-economic characteristics of the community and territory and not from organizational pathologies'.²² The establishment of such a fund occurred in August 2020 and therefore also has to be seen in the light of an effort to ensure the continued provision of basic public services also by local governments with structural deficits.

¹⁶ National Institute for Statistics, 'Le misure della vulnerabilità: Un'applicazione a diversi ambiti territoriali' (2020) 36.

¹⁷ *ibid* 70f.

¹⁸ Costanzo Ranci, *Le nuove disuguaglianze sociali in Italia* (Il Mulino 2002).

¹⁹ See United Nations, 'Human Development Report: Sustaining Human Progress: Reducing Vulnerabilities and Building Resilience' (2014).

²⁰ Interview with Giorgio Brosio, Professor, Department of Economics and Statistics, University of Turin (17 May 2021).

²¹ Interview with Giulio Citroni, Associate Professor, Department of Political and Social Sciences, University of Calabria (17 June 2021).

²² Article 53(1) of Law Decree no 104/2020.



Description of the Practice

In 2020, Italy's Constitutional Court had to deal with the delicate issue of the time frame and modalities of the deficit recovery of local governments within their multiannual financial rebalancing procedures. The judges held a provision of a Law Decree of 2019²³ to be unconstitutional because it allowed municipalities in financial distress, like Reggio Calabria and others, to use resources earmarked for the payment of past debts for current expenditure, thus widening the deficit gap.²⁴ Some observers have criticized both the court for the decision's alleged lack of a clear line of argument and the legislator for taking the ruling as a starting point, facilitated by the arguable unclarity, for rather unrelated regulatory measures.²⁵

Anyway, the fact is that Article 53(1) of Law Decree no 104/2020 stipulated, with explicit reference to the implementation of this court decision, the establishment of a fund to facilitate the financial recovery of local governments with structural deficits which are attributable to their socio-economic characteristics (and not to organizational pathologies). This fund's financial resources are transferred without conditions for what the money is to be spent and they are non-refundable. Beyond having a financial rebalancing plan, the criteria for being eligible for such assistance are not only the strictly financial indicator of low fiscal capacity but also social and material vulnerability in the above-mentioned sense, relying on a composite index calculated by the National Institute for Statistics (*Istituto nazionale di statistica* – ISTAT).

This index of social and material vulnerability (IVSM) was developed by ISTAT within a project focusing on census-based data at municipal level ('8milaCensus')²⁶ and brings together seven indicators regarding such vulnerability: the number of one-parent families, of families composed of six or more individuals, of potentially care-dependent families composed exclusively of people over 65 years of age with at least one over 80, people with little living space, individuals with low formal education, people aged 15 to 29 not integrated into the education system or labor market and families without income from employment or from unemployment insurance from former employment. While especially the latter three indicators show a clear north-south divide, several also reveal significant differences between rural and urban municipalities.

In the latter regard the IVSM applies the classification of territory developed within a national strategy against the demographic decline of certain areas.²⁷ This classification defines areas as a function of their distance from urban centers, constituted either by a single municipality (*polo*) or more of them (*polo intercomunale*), which offer essential public services of healthcare, education and transportation. Municipalities within 20 minutes from such centers are urban fringes (*cintura*) and those beyond that 'internal areas' (*aree interne*) which are again

²³ Article 38(2) of Law Decree no 34/2019.

²⁴ Constitutional Court, Judgement no 115/2020.

²⁵ Clemente Forte and Marco Pieroni, 'La sentenza n. 115 del 2020 della Corte costituzionale: Una pronuncia di non agevole lettura' (2020) 4 Forum di Quaderni Costituzionali 248, 277 and 263.

²⁶ For more information, see <<http://ottomilacensus.istat.it/>>.

²⁷ Agency for Territorial Cohesion, 'Strategia per contrastare la caduta demografica e rilanciare lo sviluppo e i servizi di queste aree attraverso fondi ordinari della Legge di Stabilità e i fondi comunitari', within the National Reform Plan (Piano Nazionale di Riforma – PNR) <<https://www.agenziacoessione.gov.it/>>.



subdivided into the three categories of intermediary, peripheral and ultra-peripheral municipalities (*comuni intermedi, periferici e ultraperiferici*). As for the IVSM and the financial assistance, which are supposed to be based on it, the number of one-parent families is clearly more common in urban centers. By contrast, other indicators such as the number of individuals with low formal education, of potentially care-dependent families and families without income from employment or unemployment insurance concerns local governments of the ‘internal areas’ to a greater degree.²⁸

With the IVSM and low fiscal capacity being mentioned in the Law Decree of August 2020 as the criteria for distributing the financial means, 20 local governments benefitted from the EUR 200 million foreseen for 2020-2022, most of which went to the Municipality of Reggio Calabria, a city of almost 200,000 inhabitants. When in 2021 additional EUR 100 million were set aside for this special fund, another roughly 20 local governments received assistance. Looking at this measure from an urban-rural perspective, it is interesting to see that among these 20 beneficiaries there are smaller municipalities but with the Municipality of Naples also a huge metropolis.²⁹ In what form and to what extent these financial transfers to aid local governments with structural deficits will continue in the future remains to be seen.

Assessment of the Practice

It is obvious that any assessment of a practice that is so new (started only in August 2020) cannot be much more than preliminary. But what is certainly remarkable about this initiative is the fact that it recognized for the first time that some local governments are structurally different from others regarding certain criteria of social and material vulnerability, as well as fiscal capacity and that they are caught in a vicious circle of continuously high deficits and low public services.³⁰

On the other hand, it is evident that the fund was an ad hoc emergency measure for financial stability, also in the context of Covid-19. This is demonstrated by the fact that merely roughly 40 municipalities have so far benefitted and that some doubts have been cast on whether the calculations of the indexes by the Ministry of Economy to identify the eligible recipients of financial assistance have followed the principle of equal treatment of all local governments.³¹ Thus, it is certainly legitimate to describe the practice, as the Court of Auditors did, as one concerning only a limited number of municipalities with the aim to prevent the foreseeable slowdown of financial recovery plans and to keep their deficits under control.³² In this regard, the question has also been raised from a legal point of view whether the initiative, seen as emergency-based and unsystematic, is in line with Article 119 of the Constitution, which allows no other forms of financial equalization than those expressly mentioned in this provision and

²⁸ National Institute for Statistics, ‘Le misure della vulnerabilità’, above, 9-31.

²⁹ Interview with Maria Teresa Nardo, Associate Professor, Department of Political and Social Sciences, University of Calabria (17 May 2021).

³⁰ *ibid.*

³¹ *ibid.*

³² Court of Auditors, Deliberation no 14/SSRRCO/AUD/20 of 4 September 2020, ‘Memoria della Corte dei conti sul decreto-legge n. 104 recante “Misure urgenti per il sostegno e il rilancio dell’economia”’ para 23.



stipulates for the latter that they must always follow the principles of generality and equal treatment.³³

As for the effectiveness of the practice, several other considerations appear to be relevant. Some economists are generally skeptical regarding (excessive) financial transfers to local governments of the ‘internal areas’ because analyses of these municipalities would suggest that corruption and mismanagement are more problematic in those where funds are more readily available.³⁴ On the other hand, this assessment may also be linked to the fact that in the other municipalities there are just no (or little) funds to (mis)manage which by nature reduces the potential for corruption, but, importantly, also any chances for liberating these local governments from the above-mentioned vicious circle of structural deficits.

For that to happen it is crucial to bear in mind that financial assistance may only be part of a solution because a lack of money is only part of the problem. Additional funds have a limited impact if weaknesses regarding administrative capacities and the organization of public services persist.³⁵ It is not a coincidence, therefore, that a number of experts sees insufficient training of politicians and administrative staff of municipalities as one of the most urgent problems that Italian local government faces today.³⁶ It has been pointed out that such training has been neglected in particular since the global crisis of 2007-08. Whether that will change, however, precisely in times in which the Covid-19 pandemic entails another financial and economic crisis remains to be seen.

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³³ Forte and Pieroni, ‘La sentenza n. 115 del 2020 della Corte costituzionale’, above, 263.

³⁴ Statement by Federico Boffa, Professor, Faculty of Economics and Managements, Free University of Bolzano/Bozen (LoGov Country Workshop, Local Financial Arrangements, 14 April 2021).

³⁵ Interview with Maria Teresa Nardo, above.

³⁶ Interview with Emanuele Padovani, Associate Professor, Department of Management, University of Bologna (7 May 2021); Interview with Walter Tortorella, Head of Department of Studies of Territorial Economics, IFEL Foundation (21 May 2021); Interview with Andrea Lippi, Professor, Department of Political and Social Sciences, University of Florence (10 June 2021); Interview with Giulio Citroni, above.



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3. Local Financial Arrangements in Germany

3.1 The System of Local Government in Germany

Christoph Krönke, *Ludwig Maximilian University of Munich*

Types of Local Governments

In Germany, government at the local level is administered through municipalities (*Gemeinden*) as well as second-tier local governments such as counties (*Kreise*). Larger municipalities with more than 100,000 citizens are often assigned the status of independent city or county-free city (*kreisfreie Stadt*); in addition to their municipality responsibilities, these cities also carry out (second-tier) county responsibilities. In some of the German *Länder*, there are even third-tier local governments, for example districts (*Bezirke*) in Bavaria.³⁷ There are no areas that fall directly under federal or *Länder* rule, as the system of local government extends to the entire territory of the country. However, as jurisdiction over the organizational powers of local authorities lies with each of the 16 *Länder*, 'local government' may come in different shapes. This is particularly true for its internal organization, but may equally be said of its precise powers and responsibilities. Nevertheless, there are several common features of local government.

The German concept of local self-government, as enshrined in Article 28(2) of the Basic Law, implies that local government entities have a general competence (*Allzuständigkeit*) to carry out all responsibilities that are relevant to the local community. Since this general competence is comprehensive, there is, as a result, no such thing as single purpose local governments in Germany. This means that local governments in Germany may, for instance, run public libraries, museums, theaters, opera houses or concert halls, that they can provide airport facilities, energy/water supply, waste/sewage disposal, run hospitals, kindergarten facilities or homes for the elderly. Of course, these vast competences do not go unchecked; local authorities may engage in such activities only within their financial capacity and, in all their activities, local authorities have to abide by the laws and limitations of federal and *Länder* legislation. Nevertheless, contrary to the Anglo-Saxon concept of 'ultra-vires'³⁸, local authorities do not act illegally if they take measures in areas that do not fall within responsibilities explicitly transferred to them by federal or state legislation. In view of their general competence, they just need not to be empowered specifically to take action at the local level.

³⁷ For these and the following considerations see Martin Burgi, 'Federal Republic of Germany' in Nico Steytler (ed), *Local Government and Metropolitan Regions in Federal Systems* (McGill-Queen's University Press 2009) 140-142.

³⁸ See Veith Mehde, 'Steering, Supporting, Enabling: The Role of Law in Local Government Reforms' (2006) 28 *Law & Policy* 164, 165.



Legal Status of Local Governments

The right of local governments to self-government (i.e. to carry out all responsibilities falling within their ‘general competence’) is constitutionally enshrined at the federal level in Article 28(2) of the Basic Law (BL).³⁹ This provision reads as follows: ‘Within the limits prescribed by law, municipalities shall be guaranteed the right to regulate all local affairs in their own responsibility. Within the limits of their responsibilities as defined by law, associations of municipalities shall equally have the right of self-government according to the laws. The guarantee of self-government shall include the basis of financial autonomy; it shall comprise the right of municipalities to a source of tax revenues that corresponds with the economic ability of the tax debtors (e.g. business tax – *Gewerbesteuer*), and the right to fix the rates at which these sources shall be taxed.’ Provisions similar to Article 28(2) BL are also contained in the constitutions of the 16 *Länder* which thus reinforce the constitutional recognition of local authorities and their right to self-government. The constitutional recognition of local government is generally the same for all municipalities, regardless of size or socio-economic importance.

In contrast, the constitutional standing of counties and districts is weaker. Compared to the comprehensive self-government of their constituent municipalities, these second- and third-tier local government entities may not carry out all responsibilities of local importance but are granted the right to self-government only ‘within the limits of their responsibilities as defined by law’ (Article 28(2) BL).

It is important to stress that Article 28(2) BL as well as the corresponding constitutional provisions at *Länder* level do not grant local autonomy as an absolute right. Local autonomy is only guaranteed in principle, while its precise scope is subject to legislation. Thus, it is the lawmakers at federal and *Länder* level that define the precise extent and limitations of local self-government. In practice, the sheer volume of (sometimes very detailed) federal and *Länder* statutes has considerably limited local autonomy. However, as local autonomy is constitutionally guaranteed in principle, local governments are protected by virtue of Article 28(2) BL against excessive and immoderate restrictions of local autonomy and preserves a ‘core sphere’ (*Kernbereich*) of responsibilities that must remain with municipalities (i.e. finances, local planning, personnel matters, organizational autonomy and the freedom to engage in joint administration with neighboring communities). In addition to that, Article 28(2) BL protects local authorities, to some extent, against the revocation of responsibilities (*Aufgabenentzug*) e.g. by reallocating them at a higher (more centralized) administrative level (*Hochzonung*). As a result, only *very substantial* gains in cost-efficiency, for instance, may justify that responsibilities are taken away from local governments.

(A)Symmetry of the Local Government System

³⁹ See Burgi, *Federal Republic of Germany*, above, 143-146.



As pointed out, the legal status is primarily the same for all municipalities regardless of their size and socio-economic importance, although larger municipalities (and especially independent cities) have, with no doubt, more political bearing. As a general principle, the German system follows a symmetrical approach towards the legal status of local governments. However, this symmetry of responsibilities *de jure* can be modified in various ways which may result, *de facto*, in an asymmetrical allocation of responsibilities.

Local authorities may, for example, agree among themselves to join forces and create joint administrative units to carry out specific responsibilities in forms of what is called inter-municipal cooperation (*interkommunale Zusammenarbeit*). For instance, they may, with regard to capacity and cost-effectiveness, share their resources and establish a joint inter-municipal corporation (*Zweckverband*) which is assigned to take care of sewage and/or waste disposal. Such cooperation is particularly common between smaller municipalities but are equally practiced within larger conurbations and between counties and independent cities.

Because of their size, independent cities are capable of carrying out both municipal and county responsibilities through their city administration as a single unit. In rural areas, by contrast, county responsibilities are carried out by counties along with their constituent (smaller) municipalities. The precise division of duties between counties and their municipalities is laid down in *Länder* statutes and may therefore vary. As a general rule, the allocation of responsibilities depends on the capacities of the individual local unit. This means that for reasons of administrative efficiency, counties will regularly assume the execution of duties that cannot be effectively handled by their constituent municipalities. For instance, hospitals will usually be run at county (or even district) level while minor administrative duties such as citizen registration may remain with the constituent municipalities.

Political and Social Context in Germany

Despite the recent turbulences in the course of the financial and migration crises, the political system established under the Basic Law has proven to be relatively stable. In the overall perspective, two parties, the Christian Democrats (CDU/CSU) and the Social Democrats (SPD) still each win between 20 to 40 per cent of total votes while four smaller parties, the Liberal Free Democrats (FDP), the Greens (*Bündnis 90/Die Grünen*), the Left Party (*Die Linke*) and the Alternative for Germany (AfD), attract between 5 and 20 per cent of all voters. In the East German 'new' *Länder*, *Die Linke* and AfD are usually stronger in elections than in West Germany. On the *Länder* level and on the local level, the landscape of political parties is more diverse. In addition to the aforementioned parties, there are several parties which are particularly active in certain regions and municipalities, taking account of political issues with specific relevance for the respective region or municipality. In Bavaria, for example, the Independent Voters (Freie Wähler) are usually quite strong in the elections – they won 11,6 per cent of the votes during the 2018 elections for the Bavarian *Landtag* and are hence currently part of the Bavarian government, and they are represented in numerous municipal councils.

The spatial distribution of the population still reflects, to a certain extent, the decentralized structure of the Federal Republic of Germany. 27 per cent of the population (i.e. around 22



million people) live in smaller municipalities with 5,000 – 20,000 inhabitants. Another 27 per cent live in medium sized cities (*Mittelstädte*) with 20,000 – 100,000 inhabitants. 31 per cent of the German population live in major cities (*Großstädte*) with more than 100,000 inhabitants. The largest cities with more than 1,000,000 inhabitants each are Berlin (3,700,000), Hamburg (1,890,000), Munich (1,470,000) and Cologne (1,080,000). Of course, many smaller municipalities and medium sized cities are part of a metropolitan area (*Ballungsraum*). Together with Böblingen (50,000), Waiblingen (55,000), Sindelfingen (64,000), Tübingen (89,000), Ludwigsburg (93,000) and Esslingen (93,000), for instance, Reutlingen (115,000), Heilbronn (123,000) and Stuttgart (634,000) as well as all surrounding municipalities form the Stuttgart metropolitan area (total population: 5,300,000). In this perspective, around 77 per cent of the German population nowadays live in metropolitan regions.

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3.2 Local Financial Arrangements in Germany: An Introduction

Nicole Lieb, *Ludwig Maximilian University of Munich*

The financial situation of local governments is critical in large parts of Germany. The budgets of many local governments are in the red and are leading to an increase in debt, which is why loans (*Kassenkredite*) are increasingly being used as a financing instrument for current expenditure. The reasons for this are manifold (financial crisis, economic decline, tax reforms, responsibility assignments by the federal and *Länder* governments, increase in investments in the social sector), but the consequence is clear: This development endangers the autonomous action and creative freedom of local governments.

The financial sovereignty is part of the guarantee of the right to local self-government under Article 28(2) of the Basic Law (BL). It guarantees the municipalities an independent income and expenditure management within the framework of an orderly budgetary system. At the core of this sovereignty are the principles of financial self-responsibility, which is made clear by sentence 3 of Article 28(2) BL: 'The guarantee of self-government shall include the basis of financial autonomy; it shall comprise the right of municipalities to a source of tax revenues that corresponds with the economic ability of the tax debtors [e.g. business tax – *Gewerbesteuer*], and the right to fix the rates at which these sources shall be taxed.' A central problem of the financial plight of the municipalities is the not cost-covering congestion of ever costlier tasks (*Aufgabenüberbürdung*) through the federal government. This is the opposite of the revocation of responsibilities (*Aufgabenzug*). Within the framework of the Federalism Reform I, this problem could be stopped or mitigated by the prohibition on the assignment of responsibilities (*Aufgabenübertragungsverbot*) in Article 84(1)(7) BL.

Municipalities earn their revenue mainly through two main instruments: Levies and financial allocations. Levies can be taxes (*Steuern*), contributions (*Beiträge*) or fees (*Gebühren*) which are based on the Local Tax Law (*Kommunalabgabengesetz*) of the respective Land. Financial allocations are based on the Financial Equalization Act of the respective Land and the financial constitutional provisions of the respective *Land* constitution. Taxes account for the largest share of revenue (40 per cent), followed by allocations (20 per cent) and fees/contributions (10 per cent).

Tax revenue can be generated by local authorities in the form of local excise and expenditure taxes. In this respect, the Local Tax Laws grant them the right to find taxes, provided that these taxes are not 'similar to taxes regulated by federal law'. Important examples of this type of tax are the amusement tax, the dog tax, the overnight stay tax and the tax on second homes. Concerning a second group of taxes, only the revenue sovereignty and not also the tax finding right lies with the municipalities. However, they have the possibility to determine the tax burden of their inhabitants in relation to their financial needs by setting so-called assessment rates to a limited extent. This applies to real taxes (land tax and business tax). Article 106 (7)(1) BL obliges the *Länder* to pass on a certain share of their total share of the so-called community taxes (income tax, corporation tax and turnover tax) to the municipalities (municipal financial equalization).



There are also short-term financing instruments such as loans, donations or sponsoring. In addition, municipalities generate income from economic activity, including interest from leases, rentals, capital investments and the concession fee for the provision of public roads for the laying of supply lines. The participation of municipalities in general legal transactions, in particular the acquisition and sale of assets, is subject to various conditions regulated in the respective Municipal Code (*Gemeindeordnung*). The initiation of insolvency proceedings against the assets of a municipality is excluded by law.⁴⁰

The legal framework within which the municipalities exercise their revenue and expenditure sovereignty is formed by Budget System (*Haushaltswesen*). The legal basis for this can be found in the respective Municipal Code while the legal basis of the budget economy in the respective municipality is the budget by-law (*Haushaltssatzung*) which has to be adopted for each calendar year in the framework of the budget plan (*Haushaltsplan*). At the end of each year financial accounting (*Rechnungslegung*) has to be made, which is then subject to a so-called audit (*Rechnungsprüfung*).

The structure of the county finances follows the structure described for the municipalities in many areas, and there is also a precarious financial situation at this level. A county specific financing instrument of great economic and political importance is the county levy (*Kreisumlage*). It is levied by the counties on the municipalities belonging to the county which constitutes a fundamental, but constitutionally justified encroachment on the municipalities' guarantee of local self-government under Article 28(2) BL. There is often a dispute between the municipalities and counties about the legitimate amount of the county levy.

It is not possible to make a clear distinction between rural local governments (RLGs) and urban local governments (ULGs). ULGs usually have the advantage that they can cover a considerable portion of their financial needs with income from business tax because many companies settle in conurbations. Nevertheless, no general statement can be made about this as there are also ULGs with precarious financial situations. Dealing with financial issues is therefore an issue for both RLG and ULG.

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⁴⁰ Compare for example Art 77 Bavarian Municipal Code.



3.3 Municipal Day-Care Facilities

Nicole Lieb, *Ludwig Maximilian University of Munich*

Relevance of the Practice

Since 1 August 2013 all children from the age of 1 to the age of 3 are entitled to early childhood support in a day-care facility.⁴¹ In practice, many local governments – especially in conurbations – are unable to meet the demand for day-care places because they lack financial resources to provide facilities or to expand or modernize existing day-care facilities, as well as to recruit sufficient personnel. According to an analysis by the Institute of the German Economy 273,000 childcare places for children under the age of three are currently lacking throughout Germany. More than every tenth child at this age cannot be cared for and the parents therefore are incapable to resume employment which also impacts the economy. This means that one of the local government's core responsibilities, the safeguarding of services of general interest, is increasingly endangered. Ways must be sought of how local governments can fulfil their legal obligation to offer day-care places and the necessary expansion of the corresponding capacities without overburdening the local budget situation and their own personnel resources. Urban local governments (ULGs) in particular are struggling to find suitable properties and personnel.

Description of the Practice

The expansion, further development and improvement of the quality of day-care facilities has a high priority on the political agenda. Such intended objectives are established by the federal legislature, but their (costly) implementation in practice is incumbent on the *Länder* under the Basic Law (Article 83ff of the Basic Law [BL]). As a result of the prohibition on the assignment of responsibilities (*Aufgabenübertragungsverbot*) under Article 84(1)(7) BL, the problem has shifted to financial compensation between the *Länder* and the municipalities in accordance with the principle of connectivity of the respective *Länder* constitution.⁴²

According to Social Security Code VIII (SGB VIII), the financing of day care facilities for children is regulated by the respective *Länder* law. Accordingly, the structures, responsibilities and level of financing for day-care in Germany vary greatly. There are different cost pillars within a day-care facility, for which there are different financing regulations (depending on the *Länder*). Each *Land* also uses a different personnel key for childcare (= for how many children one educator is responsible). In all East German *Länder* this key is traditionally much higher (i.e. less educators for the same amount of children) than in the west *Länder*. There is the need to

⁴¹ The responsibility therefore lays (in most of the *Länder*) within the counties or county-free cities, see para 69(I) SGB VIII in accordance with the respective *Länder* law.

⁴² See for more details on the principle of connectivity Martin Burgi, *Kommunalrecht* (6th edn, CH Beck 2019) para 18 marginal no 6.



cover operating costs (personnel and material costs) and investment costs, but also the possibility to receive further funding or demand parental contributions. In most cases, the financing consists of state subsidies (by Federal and *Länder* level), participation fees or charges, subsidies from the local public youth welfare institution, subsidies from the municipalities and personal contributions from the institution itself. That means municipalities, counties and *Länder* as well as sponsors, parents and the federal government share the financing which results in a network that is difficult to describe in every detail. Since this is not only regulated in the *Länder* day-care facility laws, but also in additional regulations and guidelines, an overview of the *Länder* is hardly possible. It becomes even more difficult when one considers that the regulations only give a coherent picture against the background of the general financial resources of the *Länder*, counties and municipalities as well as the municipal financial equalization (*Finanzausgleich*). Due to different financing structures the cost share remaining with the municipalities is not comparable across regions. The cost of a day-care facility to be borne by the parents also depends strongly on the place of residence, the institution, the age of the child, the care offered (i.e. personnel key) and the care periods and sometimes it is also influenced by social aspects such as income and the number of children in the family. The coalition agreement of 2018 presents as one of its objectives with regard to the topic 'focus on families and children' the expansion of the day care facilities and a reduction in parents' fees up to and including exemption from fees.⁴³ The federal government is supporting the *Länder* with the 'Gute KiTa' Law with a total of EUR 5.5 billion until 2022 in measures to further develop the quality of childcare and to reduce fees for parents.⁴⁴

However, two overall forms of financing have emerged. If the facility is subsidized irrespective of the actual occupancy of the places, the project-executing agency has planning security. This financing of the offer is also referred to as 'object financing' (*Objektfinanzierung*). If in contrast to financing via the 'object', only the number of actually occupied places – i.e. the children cared for – plays a role in the institution, this is referred to as 'subject financing' (*Subjektfinanzierung*). Each *Land* has to decide what is the best approach for its municipalities. This depends primarily on financial capacity, which is why structurally weak and therefore financially weak RLGs have to fight harder than flourishing ULGs. But the ULGs have to face problems like real estate and staff shortage.⁴⁵ It must therefore be ensured at the federal government and *Länder* level that the financial resources actually reach where they are needed (linkage to report section 5 on intergovernmental relations). RLGs naturally also have to struggle with declining financial resources due to population decline, while ULGs have to meet a greatly increased demand for day care places in a short period of time due to an increased influx. Both the birth rate seems to be rising again and migrants with their families prefer to settle in urban areas as they hope for better job and integration opportunities there.

⁴³ 'Coalition Agreement between CDU, SCU and SPD' (2018)

<https://www.cdu.de/system/tdf/media/dokumente/koalitionsvertrag_2018.pdf?file=1> see marginal no 735ff.

⁴⁴ See for more information and the measures already taken <<https://www.bmfsfj.de/gute-kita-gesetz>>.

⁴⁵ The average salary of educators - and generally in social professions - is too low to afford the mostly expensive life in conurbations.



Assessment of the Practice

Over the past decade, many support packages have been passed in Germany to promote day-care facilities. However, these packages are always only temporary financial aid, which does not give the facilities much planning security. Just as little planning security is provided by subject financing. The institutions are dependent on the support of the federal government and the *Länder*. Despite the introduction of a legal right to a place in a day-care facility, the practice continues to lag behind. This applies equally to urban and to rural areas. The promises made at federal level often lead to excessive financial demands on the individual municipality. Support packages by the federal government set fixed subsidy sums instead of sharing the actual costs incurred. A long-term solution to cost sharing must therefore continue to be worked on and above all the federal government and the *Länder* must make financial resources available on a long-term basis. In the best case, this happens without making the system more complicated than it already is. The individual municipalities are not in a position to run their own day-care facilities without sufficient financial support from the government levels. On the other hand, the danger of an increasing political influence on the self-governing structure of local governments through the increasing provision of financial resources at federal and state level should be taken into consideration.

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3.4 Financing of Inter-Connected Transport Services or Linked Transportation Authorities

Lea Bosch, *Ludwig Maximilian University of Munich*

Relevance of the Practice

In the 1970s, the regionalization of local public transport began. The transfer of responsibility for regional and local public transport to the *Länder* accompanied the privatization of the German Federal Railways.

Following the different laws on local public transport (*ÖPNV-Gesetze*, e.g. Article 8(1) Law on Local Public Transport in Bavaria (BayÖPNVG)) the planning, organization and provision of general local public transport is a voluntary task of the counties and independent municipalities within their own sphere of activity. 'At first glance, these organizations appear to be well-known regional associations of local governments, if not the *Land* government has kept responsibility. However, they have to co-operate with suppliers of transport, from which they have to buy services. Thus, regionalization led to complicated structures of public-private co-ordination and contracting, which correspond to the concept of regional governance.'⁴⁶

In general, local public transport includes only transportation via buses, not via tracks. The accountable authorities differ according to type of transport: for transportation via buses the local governments, for transportation via tracks the *Land*-government is responsible. For this reason, the declining financial capacity of the municipalities and counties, especially in rural areas, also jeopardizes the provision of local public transport. Youths and elderly in rural areas in particular, who are especially dependent on local public transport, thus suffer from this lack of functioning infrastructure. However, even in the urban areas, the needs of growing cities for a high performing local public transport exceeds capability. Demographic change is thus leading to new – varied – challenges in both urban and rural areas with regard to public transport planning, coordination and notably financing.⁴⁷

Description of the Practice

The statutory commissioning authorities (*gesetzliche Aufgabenträger*) for local transport are competent to merge with other such authorities.⁴⁸ Thus, local transport companies are often run or owned not only by one single authority, but mostly in close collaboration of neighboring

⁴⁶ Arthur Benz and Anna Meineck, 'Sub-National Government and Regional Governance in Germany' in Vincent Hoffmann-Martinot and Hellmut Wollmann (eds), *State and Local Government Reforms in France and Germany* (Springer 2016) 69f.

⁴⁷ Martin Burgi, *Kommunalrecht* (CH Beck 2018) para 6 Rn 19; Jens Kersten, 'Demographie als Verwaltungsaufgabe' (2007) 38 *Die Verwaltung* 309.

⁴⁸ Antitrust problems may occur due to the merger of various companies, see Christian Jung and Sascha Michaels, 'Fusionskontrolle in einem sich wandelnden ÖPNV-Markt' (2005) 3 *IR* 55.



municipalities, counties and the *Land*. Sometimes they even exist across the borders of different *Länder* (e.g. Berlin-Brandenburg Transport Association).⁴⁹ Therefore, these authorities usually hold a joint venture.⁵⁰ Many municipalities – especially in metropolitan regions – have a high interest in cross-border traffic⁵¹: Firstly cross border in its geographic meaning, to cross the municipalities' borders. Secondly in a personnel meaning, as municipalities guarantee the use of local transportation not only for inhabitants of the own municipality but for everyone. This organizational form of local public transport is called inter-connected transport service or transport association (*Verkehrsverbund*). In the respect of financing an inter-connected transport service, the population figures of the respective municipalities, the use of the offer by the respective municipalities' inhabitants, the financial capacity of the respective municipality and many more factors are of decisive importance. Even though the urban local governments (ULGs) usually have a larger budget, and thus a better negotiating position, they depend on the rural local governments (RLGs). Due to urban employment but limited urban space for housing⁵², ULGs are dependent on cooperation with the RLGs for the provision of housing and for infrastructural connection to the city. It results in a fruitful collaboration of RGLs and UGLs in these linked transport associations, a combination of all means of transportation in one provider and a shared distribution of the cost burden among all authorities involved. Nevertheless, the transport associations are under great financial pressure.

The primary financing of the local inter-connected transport service is provided by ring-fenced financial allocations (*zweckgebundene Finanzausweisung*) from the *Länder*.⁵³ These kind of allocations must be used for the purpose for which they are provided by the state. The financial allocations are generally based on the fiscal equalization law (e.g., *Bayerisches Finanzausgleichsgesetz*, BayFAG) of the respective *Land* and the fiscal constitutional provisions of the respective *Länder*-constitutions. First sentence of Article 106(7) of the Basic Law (BL) obliges the *Länder* to pass on a certain proportion of their total share of community taxes to the municipalities. In addition, the *Land*-legislature determines whether and to what extent the revenue from *Land*-taxes accrues to the municipalities (Article 106(7) BL, second sentence). The ring-fenced allocations, like in the case of public transport, must be distinguished from the general financial allocations. Since the general financial allocations are not earmarked, they are freely at the disposal of the municipality.

Additionally and obviously a user charge is levied, which is therefore also a source of income, but usually not sufficient to cover costs. The source of revenue varies therefore with individual and specific organization of the linked transport association. It depends on collaboration of

⁴⁹ See: Burgi, *Kommunalrecht*, above, para 17 Rn 24ff for more detailed descriptions of the establishment of municipal undertakings and the prohibition of their economic viability and public service obligations. For more details on the Berlin-Brandenburg Transport Association, see Diana Runge and Jan Werner, 'Der "Berliner Verkehrsvertrag": Verkehrsvertrag zwischen dem Land Berlin und den Berliner Verkehrsbetrieben (BVG) AöR' (2009) IR 268.

⁵⁰ With regard to the establishment of municipal undertakings and the prohibition of economic efficiency or their obligation to serve the public good, see: Burgi, *Kommunalrecht*, above, 17 Rn 24ff.

⁵¹ Janbernd Oebbecke, 'Der öffentliche Dienstleistungsauftrag nach der VO (EG) 1370/2007' (2019) *Neue Zeitschrift für Verwaltungsrecht* 1724.

⁵² See therefor also report section 2.2. on Municipal Housing Companies.

⁵³ Burgi, *Kommunalrecht*, above, para 18 Rn 17.



different authorities. Thus, this part of the financing is based on individual agreements between the authorities involved and therefore varies considerably. In this respect, however, the following should be added: In particular, mere profit-making intentions never constitute a public purpose, which municipal undertakings ultimately pursue. Nevertheless, a municipal enterprise must operate economically, i.e. also with the intention of making a profit.⁵⁴

The financially stronger a municipality is, the more it can also invest out of its own general budget on top in its own local public transport. This may of course raise questions and problems under State aid law, and thus, questions concerning EU law. This type of financing is however possible in principle. According to the case law of the European Court of Justice (ECJ), the criterion of State aid is not met if specific parameters are fulfilled, e.g. the recipient undertaking has actually been entrusted with clearly defined public service obligations.⁵⁵

Assessment of the Practice

The linked transport associations around a large city are only partially prepared for current challenges, notably due to lack of budget. There are in particular financial issues and tough negotiations between the authorities involved. The need for punctual, cheap, safe, flexible and fast local transport is growing rapidly, especially in cities and metropolitan regions. The frequency must be increased and services must be further adapted to the needs of the users. In this way, the rural areas surrounding large cities can also be integrated into the metropolitan area. The authorities and LGs must invest more and more money. To do this, the municipalities are dependent on the help of the *Länder*. On the other hand, there is a great danger that local transport in rural areas, which are not close to a large city, will almost come to a standstill. Concepts for individualized transport are being developed for this purpose. Key considerations in this regard will be transport on demand, involving artificial intelligence and autonomous driving. However, this entails comparatively equally high costs. The RLGs will therefore be required to continue into the future by connecting and coordinating (transport) more deeply among each other. However, the RLGs are far from being able to achieve it – especially financially – by themselves. Hence, here too, major investments will have to be made, particularly by the *Länder*.

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⁵⁴ Regarding this point, see Hans Jarass, 'Aktivitäten kommunaler Unternehmen außerhalb des Gemeindegebiets, insbesondere im öffentlichen Personennahverkehr' (2006) Deutsches Verwaltungsblatt 1, 4ff.

⁵⁵ ECLI:EU:C:2003:415 (Altmark Trans). For all parameters, see [Burgi, Kommunalrecht, above, para 17 Rn 29ff](#); [Christian Jung, and Jan Deuster, 'Europäische Kommission genehmigt ÖPNV-Finanzierungssystem des Verkehrsverbunds Rhein-Ruhr' \(2011\) IR 148](#); [Oebbecke, 'Der öffentliche Dienstleistungsauftrag nach der VO \(EG\) 1370/2007', above.](#)



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3.5 Public-Private Partnerships (PPP)

Philip Nedelcu, *Ludwig Maximilian University of Munich*

Relevance of the Practice

When looking for means to implement cost- and knowledge-intensive projects (mostly infrastructure), governments of all levels in Germany have for quite a while resorted to Public-Private Partnerships (in the following: PPP) as a mode of financing and/or operating ongoing or one-time projects within their sphere of influence.⁵⁶ PPPs in the field of education infrastructure rank first by number, whereas the highest investment volume in recent years occurred in the area of road construction.⁵⁷ In terms of government entity involved, the biggest group is made up of PPPs commenced by local governments (LGs).⁵⁸ Examples from the state of Bavaria include the development of schools, public swimming pools and sports facilities.⁵⁹ In other German *Länder*, LGs also realize projects such as the handling of sewage⁶⁰ or waste facilities under a PPP model.

Description of the Practice

The term PPP describes a wide variety of different ways and approaches to conduct projects involving both a public authority and (a) private actor(s) that are based on a contract between the LG and the private company. While there are many different ways for an LG to fulfill the tasks assigned to it,⁶¹ the PPP model was ‘born’ out of the desire to minimize public debt by running public projects more (cost-) efficient. However, a PPP goes beyond a (debt) financing of projects in that it constitutes an alternative means of organization and procurement of public projects. It is however different from a ‘normal’ procurement process, as the LG and one or several private companies actually conduct a project together, thereby covering both

⁵⁶ See for a list of examples of (mostly *Länder*) PPP: Presidents of the Courts of Auditors of the Federation and the Länder (eds), ‘Gemeinsamer Erfahrungsbericht zur Wirtschaftlichkeit von ÖPP-Projekten’ (14 September 2011) 50ff (hereinafter cited as: Report); see also the project database of *Partnerschaft Deutschland*, accessible via <<https://www.ppp-projekt Datenbank.de/index.php?id=9>> accessed 25 June 2020.

⁵⁷ ‘Chancen und Risiken Öffentlich-Privater Partnerschaften’ (expert opinion by the Advisory Board to the Federal Ministry of Finance, September 2016) 11ff (hereafter cited as: Opinion); see also ‘ÖPP-Projekte mit Vertragsabschluss im Hoch- und Straßenbau nach Investitionsvolumen getrennt’ (Partnerschaft Deutschland 2019) <https://www.ppp-projekt Datenbank.de/fileadmin/user_upload/191231_Projekte_Hochbau_Tiefbau.pdf> accessed 25 June 2020.

⁵⁸ Opinion, 11, 21.

⁵⁹ See the examples listed in the first part of the PPP guidelines published by the Ministry of the Interior (hereinafter cited as: PPP Guidelines), ‘Public Private Partnership zur Realisierung öffentlicher Baumaßnahmen in Bayern’ (Gesprächsrunde PPP 2016) <https://www.stmb.bayern.de/assets/stmi/buw/bauthemen/ii4_ppp_leitfaden_teil1.pdf> accessed 22 April 2020 21ff.

⁶⁰ See for this practice in general report section 4.3. on Central Water Management.

⁶¹ See Martin Burgi, *Kommunalrecht* (6th edn, CH Beck 2018) para 17 marginal no 69.



financing and construction and maintenance. It is important to note that LGs may only decide to pursue a PPP if the project could not be realized in a more efficient way under a 'normal' procurement process.⁶² However, the (partially) private financing in itself is not the reason for the model's popularity.⁶³ The potential of a PPP lies in the idea and its structure (especially the allocation of risks), setting certain incentives for both parties that can make the project indeed more (cost-)efficient overall.⁶⁴

As mentioned, there are many different ways to structure a PPP. The models differ in terms of risk allocation and in terms of the ownership of the developed property, but also in terms of the administration of the project once the construction phase is completed.

Before going into these differences in more detail, a summary of the stages common to all PPPs will be outlined.⁶⁵ At first, the LG has to evaluate whether it is at all feasible to conduct the envisaged project as a PPP. Secondly, the authorities should clarify the responsibilities within their own organization, focusing on the question which tasks they can/want to fulfil themselves and which tasks they want to delegate to external parties (i.e. the private partner or other private entities). Based upon these findings, the LG (thirdly) has to compare the potential PPP with a 'normally' procured project to see whether resorting to a PPP is in fact economically beneficial. Only then the procurement proceedings (as a fourth step) might be commenced. After the procurement process, the selected private partner and the LG conclude an agreement (PPP contract) that outlines each party's rights and obligations, especially describing who is responsible for which parts of the project. It is within this contract that the risk allocation and property situation are regulated. Afterwards, the project enters the development stage and – upon completion – is implemented and (jointly) run for the duration of the contract (normally between 10 and 30 years). For most PPPs, the private actor conducts the development and maintenance himself or by employing subcontractors, while the government is tasked with controlling the progress and reacting to potentially necessary adaptations or changes to the contractual framework.

Having outlined the timespan and stages of a PPP, the following part of the entry will deal with the different models of PPPs employed by taking up the above-mentioned examples from Bavaria involving both rural local governments (RLGs) and urban local governments (ULGs).

Firstly, there are several ways to allocate the economic risks, mostly pertaining to a sufficient usage/turnout. In that regard, the project can be structured in two main ways.⁶⁶ One way is to allocate these risks to the government, meaning the private company just constructs and runs the project without bearing any subsequent risk (*Verfügbarkeitsmodelle ohne Marktrisiko*). The

⁶² This is part of the general obligation to manage the public budget in an economic and efficient way under Art 61(2) of the Bavarian Municipal Code. The same paragraph also encourages LGs to engage in public partnerships or other alternative means of financing where this is feasible. The Bundesrechnungshof (Federal Audit Agency) has criticized the federal government for pursuing a PPP model for a highway where a classical realisation would have been more economical. See Steven Geyer, 'Rechnungshof rügt Scheuers Autobahn-Plan' *Hannoversche Allgemeine* (13 October 2018) <<https://www.haz.de/Nachrichten/Politik/Deutschland-Welt/Bundesrechnungshof-ruegt-Andreas-Scheuers-OePP-Plan-fuer-Autobahn-A49>> accessed 24 June 20.

⁶³ To the contrary, public actors usually get more beneficial rates for financing models like loans. Opinion, 8, 26ff.

⁶⁴ See *ibid* 15ff, 23.

⁶⁵ See for these steps the PPP Guidelines, 12ff.

⁶⁶ These are described in the PPP Guidelines, 10.



other way allocates the risk of sufficient usage and other risks concerning e.g. pricing to the private company (*Marktrisikomodelle mit Preis- und/oder Auslastungsrisiko*). The idea behind this approach is to generate an incentive for the private company to conduct the project as efficient as possible, maximizing the gains for both partners.

In Bavaria, most municipal PPPs follow the former model.⁶⁷ This is due to the fact that they deal with the provision of services for which citizens cannot be charged (e.g. schools, roads), as the later model only works for projects that are offered on a fee-basis (e.g. public pools, waste management), as the collection of the fee enables the private company to get its costs reimbursed and create profit.

The second decisive point is the question of ownership. As the PPPs deal mostly with the construction of tangible objects such as buildings or roads, the parties have to agree in the contract who is vested with the ownership of the constructed property.

There are many different models in this regard⁶⁸, the parties can agree to give the ownership to one of the parties or decide to realize the project through a jointly-owned corporation, but can e.g. also agree that the private actor owns the property for the duration of the contract and then transfers it to the government. As a description of all models available would go beyond the scope of this entry, the following paragraph will only address the most common model employed in Bavaria, the so-called ownership model⁶⁹. Under this model, the LG becomes the owner of the property upon construction.⁷⁰ In exchange, the LG pays a fixed sum to the private partner that covers the construction, maintenance and further services provided for by the private partner. This model is mostly employed if the project is limited to construction, renovation or maintenance of a building.⁷¹

Both ULGs (Nuremberg) and RLGs (Poing, Kirchseeon, Weiden) have relied on PPPs to build new school buildings. There are also examples of both ULGs (Ingolstadt) and RLGs (Sonthofen) constructing public baths/spas under a PPP.⁷²

There have also been attempts to comprise projects from several LGs in one PPP to realize these projects more efficiently, e.g. in Offenbach county in the state of Hesse. However, the project costs increased massively over time contrary to the prognosis in the initial assessment of the project.⁷³ An additional independent assessment conducted after the increase criticized the complexity of the contractual relationships and a lack of control on the governmental side.⁷⁴ This shows that cooperation (e.g. between several RLGs) in the form of a joint PPP

⁶⁷ c.f. *ibid* 21ff.

⁶⁸ See, for an overview of the variety of models, *ibid* 10ff; see also the short summary by the Partnerschaft Deutschland, accessible via <https://www.ppp-projekt Datenbank.de/fileadmin/user_upload/Downloads/OEPP-Vertragsmodelle.pdf> accessed 18 June 2020.

⁶⁹ Another common model being based upon a leasehold (*Erbbaurecht*) granted within the PPP contract. This model is usually employed in cases where the private company also runs the constructed facilities, e.g. for the public pools in Ingolstadt or Sonthofen, see PPP Guidelines published by the Ministry of the Interior, 28ff.

⁷⁰ If the project concerns the renovation/remodelling of existing property, the government remains the owner of the property throughout the project period.

⁷¹ c.f. the PPP Guidelines, 21ff.

⁷² See *ibid* for a detailed list of examples including the ones mentioned in this entry.

⁷³ Opinion, 21.

⁷⁴ *ibid*.



should be considered carefully as it might make the implementation of each single project more efficient at first sight, but will also increase complexity.

Assessment of the Practice

The practice of PPPs gives LGs the potential to realize projects in a more economical way⁷⁵ while at the same time making use of the experience and skills of the private partners. The continuous involvement of one company distinguishes PPPs from other projects that are divided into different stages with different private actors involved on each stage, leading to a potential lack of efficiency.⁷⁶ Both these aspects can make PPPs extremely helpful for smaller LGs when it comes to a one-time, large-scale project for which the LG itself lacks the necessary experience. Another potential advantage compared to the 'classical' procurement lies in the different timing and maturity relating to the LG's financial obligations. Normally, LGs will have to pay all costs as soon as the construction project is finished. In a PPP, the construction costs are normally borne by the private partner (and/or banks) in the first place, with the LG reimbursing the private partner subsequently by paying periodical fees or a lump sum when the contract expires.

Nonetheless, LGs have to keep in mind that PPPs are not a means of (debt) financing to ease their financial commitments,⁷⁷ as the costs are still incurred by both parties (i.e. also by them) depending on the contractual set-up. Specifically, LGs may not resort to a PPP to bypass budgetary restrictions that would otherwise prohibit the project.⁷⁸ Additionally, the PPP model is not feasible for all projects. To the contrary, there can be various reasons that speak in favor of the 'classical' implementation in terms of efficiency, e.g. the high transaction costs caused by the complex contractual relationships between the partners.⁷⁹ A proper pre-assessment is indispensable to get a clear picture before the project is commenced.

Criticism relating to PPPs focuses on the fact that private actors might make use of the necessity for PPPs on the government side by allocating risks to the government that would otherwise be incurred by them. However, the government should be able to mitigate this by conducting a thorough preparation and early examination of the project to identify its demands and its position towards potential private partners.

⁷⁵ E.g. one project concerned the replacement of several public baths that used to create massive losses by one public bath/spa that was constructed and operated by a private actor, with the government paying a subsidy equalling 1/3 of the losses previously incurred, see PPP Guidelines, 29.

⁷⁶ 'Öffentlich Private Partnerschaften unter Berücksichtigung des IT-Sektors' (WD 5-3000-053/09, Research Services of the German Bundestag 2009) 10.

⁷⁷ This is also emphasised in Opinion, 28.

⁷⁸ Report 3ff, 43.

⁷⁹ See, e.g., the recommendation against PPP for smaller infrastructure projects in Opinion, 21, 35ff.



These and other points of criticism could also explain why LGs recently also resort to public-public-partnerships (i.e. cooperation between governmental agencies in a similar manner)⁸⁰ for the realization of complex projects.⁸¹

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⁸⁰ See, therefor in general Heinz J Bonk and Werner Neumann, ‘Teil IV. Öffentlich Rechtlicher Vertrag’ in Paul Stelkens, Heinz J Bonk and Michael Sachs (eds), *Verwaltungsverfahrensgesetz* (9th edn, CH Beck 2018) para 54 marginal nos 82ff.

⁸¹ See for a study about public-public partnerships and a summary of the most relevant findings, Sascha Knauf, Frederike Milde and Christoph Stumpf, ‘Studie Öffentlich-Öffentliche Partnerschaften 2018’ (CURACON 2018)
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4. Local Financial Arrangements in Spain

4.1 The System of Local Government in Spain

Francisco Velasco Caballero, *Instituto de Derecho Local, Universidad Autónoma de Madrid*

Types of Local Government

The Spanish Constitution assigns public authority to four levels of government: the central state, autonomous communities, provinces and municipalities. Spain consists of 17 autonomous communities, two autonomous cities (Ceuta and Melilla), and two types of local bodies: 50 provinces and 8,131 municipalities.

The Constitution includes two principles regarding local government: the right to 'local autonomy' from all public authorities including the state legislature, and legislative powers over local government given to the central state and autonomous communities. The constitutional recognition of a right to local autonomy (Article 137 of the Constitution [CE]) implies that the municipalities and provinces are not merely internal divisions of the autonomous communities, but part of the state as a whole. The Constitutional Court has ruled that the guarantee of local autonomy 'does not ensure specific contents or spheres of authority established and fixed once and for all, but rather the preservation of an institution in terms that are recognizable for the image that society has of such institution in each time and place' (Ruling of the Constitutional Court [STC] 32/1981). Local autonomy is contrary to any hierarchical position of the local governments under the state or the autonomous communities.

Legal Status of Local Governments

The legal system of local government falls under the concurrent jurisdiction of the state and the autonomous communities. The state has the power to establish the 'basis of the legal system of the public administrations'. On the other hand, the statutes of autonomy confer to the autonomous communities complementary powers over local government. In interpreting the Constitution together with the statutes of autonomy, the Constitutional Court has concluded that the Spanish local system has a 'two-fold nature'. The state is responsible for the 'fundamental' regulations while the autonomous communities are responsible for the 'non-fundamental' or so-called 'development' regulations (STC 214/1989, FJ 4). When regulating the local government system, both state and autonomous communities' laws must respect local autonomy, as directly guaranteed by Article 137 of the Constitution. But the Constitution does not specify what this local autonomy shall consist of, since it limits itself to a vague connection between local autonomy and 'matters of local interest', without specifying what these are. Consequently, both state and autonomous communities' laws have a wide margin for regulating the functions and organization of local governments.



The current fundamental regulations of the state on local government are primarily found in two Acts repeatedly amended: Law of the Basis of the Local System (LBRL) of 1985, and a Royal Legislative Decree of 2004, which approves the Restated Text of the Local Tax Authorities Act (LHL). This far, the state has interpreted its own 'fundamental' powers broadly, limiting the legislative and executive powers of the autonomous communities. The amendment of several statutes of autonomy since 2006 has not changed this situation.

Generally speaking, Spain's current local government system includes very limited state and autonomous community supervision or control on municipal and provincial activity. The Constitutional Court has ruled that the local autonomy guaranteed by Article 137 excludes these governmental controls to a great extent (STC 4/1981). In the absence of such controls, only courts are ordinarily responsible for oversight of the administrative activity of local councils. The LBRL replaces state and regional controls on local governments with a complex system of intergovernmental relations based on the idea of full respect for the powers of local institutions and the principle of cooperation. Basically, the LBRL establishes legal instruments to prevent conflicts between state and autonomous communities on one hand, and local authorities on the other while obliging local governments to share information with other government levels. To prevent or resolve conflicts of authority, the law promotes the 'free cooperation' of public administrations, either in the form of agreements or by participation in collaborative bodies, and by encouraging local level administrations to participate in the decision-making processes.

On this legal basis, the Spanish local government system has overall functioned satisfactorily since 1985. Local government is thoroughly democratized and has been receptive to new forms of participatory democracy. The elimination of controls from the upper-level territories has resulted in significant improvements to local public services, despite some cases of corruption in urban planning.

(A)Symmetry of the Local Government System

The Spanish local government system is very uniform and symmetrical due to the approaches of both the central state and most autonomous communities: the central state has established a common two-tier system with few variations for all Spain; and the autonomous communities have introduced very few particularities for the local government of their territory.

First, the state maintains a structure of local government that, to a large extent, was defined in 1833. That is, each village, town or city is a municipality. And the whole territory of Spain is divided into 50 provinces which currently (not originally) act as the second level of local government. Every municipality is integrated in a province.

Second, regional particularities within the 17 autonomous communities are scarce. It has been said before that each autonomous community has legislative power to develop the state basic legislation on local government. But since the state basic legislation is in fact very intense and extensive, and imposes a local government scheme made up of municipalities and provinces, the possibilities of innovation for any autonomous community are quite limited. Particular institutions have appeared especially in Catalonia and Aragon, which add a third level of



government: the townships (*comarcas*). Also, in the areas of some large cities such as Barcelona, Madrid, Vigo or Valencia there are some metropolitan government structures, normally focused on the management of very specific municipal services. The metropolitan area of Madrid does not have its own government structure because that space is occupied by the regional government (the Autonomous Community of Madrid).

Political and Social Context in Spain

Local politics is largely symmetrical to national and regional ones. National or regional parties also act at the local level. And this limits the effective autonomy of local politicians, even though they are elected locally. Currently, after the municipal elections of May 2019, most municipalities have leftist governments, although many of them are minoritarian. Some very important cities, such as Madrid, Malaga or Zaragoza, have conservative municipal governments.

Provincial governments are indirectly elected, by the councilors of the municipalities in each province. In that indirect election the political parties have great power. In this way, provincial governments normally reproduce municipal political majorities.

Beyond the local level, the general political situation shows common features to many other European countries: strong polarization of politics and absence of clear majorities. This has led to the current – and for the first time since 1978 – coalition government, between the traditional center-left Social Democratic Party (PSOE) and a new radical left-wing party (Unidas Podemos).

The general social and political situation is marked by two circumstances. A national economy that, although formally recovered from the great crisis of 2008, still shows very high unemployment rates (around 15 per cent of the active population), and where income inequalities dramatically increase. The second major social and political concern is the territorial integrity of Spain. Since approximately 2010 a very strong independence movement has emerged in Catalonia, which is one of the richest regions in Spain. This secessionist movement has the support of approximately 50 per cent of the population of the region.

More than 80 per cent of the 8,131 Spanish municipalities are very small having less than 5,000 inhabitants. Given the technical and economic incapacity of these municipalities, in many tasks they are replaced by the 50 provinces, which show a remarkable financial capacity. In some autonomous communities such as Catalonia or Aragon there are, in addition to the provinces, other intermediate supra-municipal local entities.

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4.2 Local Financial Arrangements in Spain: An Introduction

Francisco Velasco Caballero (coord), Félix D Laguna Martínez, César Martínez Sánchez, Félix Vega Borrego, Diego Marín-Barnuevo Fabo, Ester Marco Peñas, *Instituto de Derecho Local, Universidad Autónoma de Madrid*

General Structure

The Spanish local finance dimension represents the 6 per cent of the Spanish GDP, smaller than the countries around us (11,1 per cent of EU GDP). In terms of national accounts, local government expenditure accounts for 13,7 per cent of the total public expenditure. Regarding tax revenue (excluding social security contributions), local taxes represent 16.4 per cent of the total tax revenue.⁸²

Local government financing in Spain is an exclusive competence of the state with hardly any involvement from autonomous communities (regions). However, some regions have established additional funds other than those considered here, thereby transferring part of their own tax revenues to local governments. These funds are of little and unequal relevance in qualitative terms.

Public Revenues

Local government financing is mainly based on taxes (52,9 per cent of its revenues), higher than the European average (38,1 per cent);⁸³ the latter trend lends greater fiscal autonomy. The general transfers from the state budget to the municipalities cover a small part of their current income (22,2 per cent in 2015).⁸⁴ Since the economic crisis in 2008, the differential growth of local taxes (31 per cent) with respect to general transfers from the state (2,1 per cent) is strengthened. The majority of the general transfers are unconditional transfers, from the Supplementary Fund for Financing (*Fondo complementario de financiación* - FCF) for the large municipalities (more than 75,000 inhabitants and provincial and autonomous communities' capitals), and the Local Sharing of the state Revenues (*Participación municipal en los ingresos del Estado* - PIE) for the rest of the municipalities. One issue of the general transfers system is that the changes of population between municipalities are not reflected in the transfers from FCF. The latter does not occur in the case of transfers from PIE. The FCF is

⁸² Ministry of Finance, 'Recaudación y Estadísticas del Sistema Tributario Español 2006 – 2016' (2019) 100 and 107.

⁸³ Ministry of Finance, 'Informe de la Comisión de Expertos para la Revisión del Modelo de Financiación Local' (2017).

⁸⁴ See *ibid.*



determined, for each budgetary year, taking into consideration the rise on state tax revenues between the system base year (2004) and the year concerned. The PIE is also based on the rise on state tax revenues, but once the total participation has been determined, the latter is distributed between the municipalities essentially taking into account three variables: population, average tax effort and the inverse of fiscal capacity.⁸⁵

Tax System

Spain shows high shares of total taxes received by the non-central authorities (one of the highest in the EU together with Sweden, Germany, Belgium and Denmark), close to the 10 per cent of the total taxes⁸⁶. The local tax system is primarily based on actual taxes on property (in particular, Real Property Tax – *Impuesto sobre Bienes Inmuebles* – IBI) that, in some occasions, have little connection with the ability to pay of the concrete taxpayer. The taxes for the provision of services have a moderate position in the total amount of revenue collected.

Public Spending

The structure of the local expenditure is focused on the traditional municipal functions, having a lower relative weight regarding welfare state benefits (0.8 per cent of the GDP on social protection, health and education services, compared with 6.1 per cent in the EU). Since the entry into force of the current financing system in 2004 until 2015, the local public spending has increased by 31 per cent. The most significant items are: economy and commerce (112.2 per cent), population aging (88.4 per cent), general services (67.2 per cent), fire protection services (57.7 per cent), waste management (54 per cent), transport (42.9 per cent) and sports and leisure services (41.7 per cent), accounting for 46.1 per cent of total expenditures in 2015. The rise in public expenditure has been more pronounced in municipalities with less than 50,000 inhabitants. However, since the beginning of the crisis in 2008, the local public spending has decreased significantly (-7.7 per cent in terms of GDP), a substantial reduction exceeding those of EU countries (-1.8 per cent), while the income has grown at a faster rate (8.3 per cent). This decrease is mainly the result of a strict application of the national rules on budgetary discipline, such as the obligation of maintain a budgetary position close to balance or in surplus or the fulfillment of the expenditure benchmark (mandates set out in Article 135 of the Spanish Constitution and Articles 11(4) and 12, respectively, of Spanish Organic Law no 2/2012 on Budgetary Stability and Financial Sustainability).

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⁸⁵ See report section 3.2. on Financing Rural Local Governments Faced with Ageing and Dispersion.

⁸⁶ European Commission, 'Taxation Trends in the European Union. Data for the EU Member States, Iceland and Norway' (2018).



Bosch Roca N and Suárez Pandiello J, 'Politics and Finance in Spanish Municipalities' (2015) 212
Hacienda pública Española 51

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4.3 Financing Rural Local Governments Faced with Depopulation, Ageing and Dispersion

Francisco Velasco Caballero (coord), Félix D. Laguna Martínez, César Martínez Sánchez, Félix Vega Borrego, Diego Marín-Barnuevo Fabo, Ester Marco Peñas, *Instituto de Derecho Local, Universidad Autónoma de Madrid*

Relevance of the Practice

Rural areas face three enormous demographic challenges nowadays: depopulation, ageing and dispersion. These three factors impact negatively on municipal budgets. On the one hand, depopulation and ageing reduce tax revenue as they usually imply an economic downturn. On the other hand, the dispersion of population typical of rural areas, added to the increasing depopulation and ageing of several central regions of the country, may (and do) increase the cost of providing public services.

Description of the Practice

Having this in mind, the relevant practice relates to the insufficient attention paid to specific demographic issues (e.g. depopulation, dispersion and ageing) by the state within its financial transfer scheme. This reality leads to the undercompensation –if any– of the existing differences between large Spanish municipalities, which increase in population, and small and medium municipalities, which otherwise age and decrease in population.

Moreover, the unequal treatment of large and small (and medium) municipalities related to the already mentioned disregarded factors of depopulation, ageing and dispersion might even worsen taking into account the participation (approx. 2 per cent) of large municipalities (98) on state tax revenue collected in each large city (e.g. VAT and Personal Income Tax). This extraordinary revenue is based on three variables: total population of each city (75 per cent), average tax effort (12.5 per cent) and the inverse of the ability to pay or fiscal capacity (12.5 per cent). Theoretically, whereas the last variable refers to the broadness of tax bases, the second one refers to the tax rate set by each municipality. Small Spanish municipalities (8,026) do not receive these extraordinary revenues and this might exacerbate the unbalancing effects of the insufficient recognition of dispersion and ageing in the implementation of the general financial transfer scheme.

Assessment of the Practice

Under the Spanish legislation, local governments are required to provide certain services according to their size. Therefore, the main purpose of the financing system is to assign



sufficient financial resources to local governments so that they may comply with that obligation.

However, insufficient recognition of depopulation dispersion and ageing within the financial transfer scheme might allow considering that the general financial system does not aim at an actual leveling between local governments. Indeed, it can exacerbate the divide between rural and urban areas. The following provisional conclusions could be drawn from recent empirical studies:

- cities of more than 500,000 inhabitants are *over*-financed (due to the status quo clause);
- there are enormous – and unjustified – *differences* regarding per capita financing (e.g., Barcelona receives EUR 701 per inhabitant, while Almeria receives EUR 227);
- unlike the financing system for autonomous communities, the current local government financing system does not address the main problems of rural municipalities: population decrease, ageing and dispersion;
- the system does *not* take into account the effective costs of service provision either, which may adversely affect rural municipalities, where public services are more expensive (due to the lack of diseconomies of scale).

Notwithstanding this assessment, it must also be taken into account that the second tier of local government (the provinces) is obliged by the laws to provide the municipalities with financial and technical assistance, what partially rebalances the comparative underfunding of small -and mainly rural- local governments.

The workshops and interviews conducted for this ‘relevant practice’ show that the current local financing scheme ensures the provision of mandatory local services (water supply, sewerage, maintenance of public roads, etc.). In relation to this general conclusion, three important clarifications are necessary.

First, although demographic aging naturally results in a higher cost of public health and care services, this phenomenon does not necessarily produce an imbalance in local financing, since the provision of those services corresponds mainly to the autonomous communities, not to the municipalities.

Second, rural inhabitants do not receive any favorable treatment from the local financial system. Although the fiscal capacity of small municipalities is normally smaller than that of large municipalities (due to lower wealth rates and less economic activity), public services in small municipalities are also largely financed by local taxes. Consequently, the local *tax burden* on the inhabitants of rural areas is very similar to that of the inhabitants of urban municipalities.

Third, the rural neutrality of the local financial system is partially offset by the technical and financial assistance and cooperation of the provinces (second tier of local government). However, this compensatory effect is very different among the 50 provinces. The workshops and interviews carried out in this relevant practice show that some provinces concentrate all their economic and personal resources in rural municipalities (as it is the case of Valladolid), while other provinces (such as Barcelona) allocate a significant part of their income to urban municipalities, so that rebalancing effect with regard to rurality is less relevant.



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4.4 The Local Recovery Plan to Overcome the Effects of Covid-19

Ester Marco Peñas (coord), Félix D. Laguna Martínez, César Martínez Sánchez, Félix Vega Borrego, Diego Marín-Barnuevo Fabo, Francisco Velasco Caballero *Instituto de Derecho Local, Universidad Autónoma de Madrid*

Relevance of the Practice

The outbreak of Covid-19 has significantly affected all aspects of life across Europe, impacting differently in urban and rural areas. In addition to threatening our health, the pandemic is also posing serious challenges to our socio-economic systems.

In rural areas, farmers, businesses, and communities have been affected, although probably not at the same level as in urban areas. As part of the 'Coronavirus response investment initiative plus' (CRII+), the European Commission announced a new set of measures specifically addressed to support farmers and rural areas, by allowing further flexibility in the use of Structural Funds and the European Agricultural Fund for Rural Development (EAFRD) and extending the deadline for Common Agricultural Policy (CAP) payment applications. The Covid-19 crisis has made us all more aware of the importance of food security and the need to help and to stand-by our farmers, who experience a very severe crisis, which in some cases threatens the survival of their business. In terms of local governments' financing, the loss of income in rural municipalities could be not too high, due to their lower relative dependence on taxes linked to economic activity and personal income. But, on the other hand, expenditure on social services could have increased dramatically, due to the greater elderly and dependent population.

In general terms, urban municipalities have been harder hit by Covid-19. The epidemic has led to increased expenditure on prevention and health surveillance. At the same time, urban municipalities have suffered a drastic reduction in the income generated by fees charged to users of public transit. Moreover, local taxes linked to the real estate business has also been significantly reduced.

In view of the different incidence of Covid-19 in urban and rural municipalities, the 'The Local Recovery Plan', proposed by the Spanish Federation of Municipalities and Provinces (FEMP), must pay different attention to the different types of municipalities and, at the same time, not exacerbate the financial differences between urban and rural municipalities. This plan should fulfill a dual simultaneous function: rebalancing local finances of *all* municipalities, insofar as all of them have been affected by the Covid-19 crisis and creating new opportunities to make rural areas more attractive places to live and work. In this framework, we intend to assess whether the proposed 'Local Recovery Plan' may rebalance the growing economic and financial gap between rural and urban areas.

We endeavor to analyze the following guiding questions of report section 3 (local finances):



- Are there any special provisions on rural local government financing (e.g., special funds aimed at revitalizing the rural economy and contributing to socio-economic sectors)?
- How do financial arrangements cope with the challenge of increasingly depopulated rural local governments (RLGs) experiencing a decrease in taxpayers (through an exodus of young and working people) and an increase in service receivers?
- To what extent does the proposed 'Local Recovery Plan' deal with specific urban expenses such as public transport?

Description of the Practice

The proposal of the Local Recovery Plan is built on two pillars. The First Pillar deals with the use of the current savings of local entities—amounting to EUR 17.8 billion. In this regard, the relaxation of budgetary discipline (i.e., expenditure benchmark) is requested so that local entities can broadly spend their savings.

The Second Pillar demands the creation of three new funds:

- one fund designed to boost economic activity. This fund will amount to EUR 5 billion in 2020 and EUR 1 billion in 2021. Additionally, 14 per cent of the grants that Spain will receive from the EU will be allocated to this fund;
- an extraordinary fund for urban public transport to cover the current deficit caused by the Covid-19 crisis (passengers have dropped by 90 per cent). This fund will support both bus (EUR 1 billion) and subway (EUR 725 million) services;
- a third fund will compensate for the expenses incurred by local bodies in the implementation of the new guaranteed minimum income scheme.

Assessment of the Practice

The Local Recovery Plan does not aim at an actual leveling between local governments. Indeed, an inadequate design can exacerbate the divide between rural and urban areas.

Fund allocation criteria are not yet clearly defined. However, from the perspective of urban-rural interplay, the following should be considered. First, savings are particularly relevant in big cities, which are generally over-financed (due to the local financing system). Second, a distribution key based exclusively on the total population will not address the two main problems of rural municipalities: population aging and dispersion. However, among the six priority axes of the Recovery and Resilience Mechanism scope of application is 'social and territorial cohesion', which can benefit the financial position of rural local entities. Third, the funds must consider the effective costs of service provision, which may adversely affect rural municipalities, where public services are more expensive (due to the lack of economies of scale). Fourth, the provincial councils are playing a unifying role to facilitate the provision of funding by the smaller municipalities. In Catalonia, for instance, provincial councils are involved in certain projects to be financed with European funds from the Recovery and Resilience Facility. For example, the Tarragona Provincial Council participates in the Tarragona Hydrogen



Valley project. An alliance that aspires to be part of a strategic projects for economic recovery and transformation (known in Spanish as PERTE) around green hydrogen. Fifth, specific funds have been established to foster the digitization of rural areas. In general terms, if an inclusive digital transition is achieved, which reaches everybody, this will result in richer and more egalitarian municipalities. Finally, agriculture has been considered a key strategic sector to ensure food security. In fact, a strategic project for economic recovery and transformation (PERTE) in the agri-food sector is coming into being.

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4.5 Delegation of Tax Competences to Upper-Tier Local Bodies: The Case of OAPs

Félix Daniel Laguna (coord), Francisco Velasco Caballero, César Martínez Sánchez, Félix Vega Borrego, Diego Marín-Barnuevo Fabo, Ester Marco Peñas, *Instituto de Derecho Local, Universidad Autónoma de Madrid*

Relevance of the Practice

Taxes in a broad sense account for approximately 59 per cent of the resources of municipalities on average,⁸⁷ dropping to 50.6 per cent in the case of small (rural) municipalities – those accounting for less than 5,000 inhabitants.⁸⁸ These figures show the relevance of local taxes to any municipality. Nevertheless, it is well known that rural municipalities face enormous challenges when it comes to the management, auditing, and collection of local taxes and other sources of public income. The technical, organizational and even economic complexities inherently related to the size of these municipalities⁸⁹ explain that they usually resort to upper-tier local bodies to fulfill their duties in terms of management, collection and, to a less extent, auditing of taxes.

Municipalities rule autonomously their taxes and do it so concerning their management, collection, and auditing within the limits of the state law and other possible regulations.⁹⁰ Nevertheless, they may also delegate the management, collection, and auditing of their taxes and other public sources of income to upper-tier local bodies (e.g. provinces) or the autonomous regions (*comunidades autónomas*).⁹¹ Actually, upper-tier local bodies like provinces legally aim at assisting small and medium-sized municipalities within their territory in different matters including taxation.⁹² Among different possibilities, the province may create an autonomous public body (single purpose body) to centralize the management, collection, and auditing of taxes of municipalities within its territory that may be willing to delegate such legal competences.

The analysis of this particular practice aims at confirming whether it is possible to alleviate the great differences between rural and urban municipalities concerning the efficiency and effectiveness of their own local tax systems by centralizing revenue and costs. This practice may ease the excessive burden of technical, organizational and economic resources that rural municipalities face with respect to their own tax system and may even allow fulfilling functions

⁸⁷ See Ministerio de Hacienda, 'Haciendas locales en cifras – Año 2017' (2019) 43.

⁸⁸ *ibid* 44. It is relevant to recall that more than 80% (84.01%) of the 8,131 municipalities in Spain count less than 5,000 inhabitants. *Ibid* 12.

⁸⁹ As mentioned in the Introduction to Local Financial Arrangements in Spain, report section 3.1.

⁹⁰ See Art 106(1) and (3) of Law no 7/1985, of 2 April, on Local Government Basic Regulations [Reguladora de las Bases de Régimen Local] (hereinafter, LBRL).

⁹¹ See Art 106(3) LBRL. See also Art 7 of Royal Legislative Decree no 2/2004, of 5 March, approving the consolidated text of the Local Finance Regulatory Act (hereinafter, TRLHL).

⁹² See Arts 26 and 36 LBRL.



that would not be possible to fulfill without the assistance of the province due to the scarce resources and financial situation of rural municipalities. Nevertheless, it is relevant to highlight that several upper-tier bodies not only have competences and functions stemming from rural municipalities but also from larger ones.⁹³ This might be because these bodies become a sort of technical specialized unit on taxes that allows them to better fulfill such functions and competences in terms of revenue and costs. In this regard, it might also be worth analyzing whether these bodies actually treat on an equal footing both urban and rural municipalities and whether the delegation of competences by larger municipalities to the relevant body does not undermine the legitimate interests and needs of rural municipalities.

Description of the Practice

Provinces may create Single Purpose Bodies (*Organismos Autónomos Provinciales – OAPs*) aimed at fulfilling the functions and competences delegated by municipalities in terms of management, collection, and auditing of taxes, as well as other public sources of income.

When established, municipalities within the province may delegate to the OAPs specific functions related to their local tax system that may go from one single tax and one single competence (management, collection or auditing) to all taxes and other sources of public income and all the competencies within the boundaries of the state law. In this regard, Article 7(3) TRLHL lays down that the delegation agreement must consider the extent and content of the delegation. It is relevant to point out that municipalities might revoke the delegation agreements at any time.

OAPs act vis-à-vis third parties (e.g. taxpayers) on behalf of the municipalities that have delegated functions and competencies to them and do it so to the extent of the delegation agreements. The exact scope of their competences and functions relate to the content of the delegation agreements.

The territorial scope of OAPs is extended to the province and this may facilitate (and sometimes enable) the management, auditing, and the collection of the taxes in municipalities other than the ones they stem from.

OAPs usually charge municipalities a specific percentage depending on the different delegated functions and competences as well as on the collection of taxes and other public sources of income.

Municipalities may receive a down payment for the expected collection of taxes, especially when it comes to specific local taxes such as *Impuesto Sobre Bienes Inmuebles* (Local Property Tax) and *Impuesto Sobre Actividades Económicas* (Local Trade Tax) as considered in Article 149(2) TRLHL.

⁹³ With respect to the upper-tier local body created by the Province of Alicante, it is relevant to highlight, for instance, the municipalities of Altea, Benidorm, Calpe, Orihuela and Torrevieja (\approx 22,000, 69,000, 22,000, 77,500 and 83,000 inhabitants, respectively). See Spanish National Statistics Institute, 'Cifras oficiales de población resultantes de la revisión del Padrón municipal a 1 de enero' (*Instituto Nacional de Estadística*, 27 December 2019) <<https://www.ine.es/dynt3/inebase/index.htm?padre=517&capsel=517>> accessed 22 July 2020.



Assessment of the Practice

According to data collected in 2015, 25 out of 50 provinces created OAPs,⁹⁴ and approximately 4,373 out of 8,131 municipalities have delegated some types of competencies and functions on management, collection, and auditing of local taxes and other sources of income, such as fines, to their respective OAP.⁹⁵ The competences and functions of the different OAPs depend on the delegation agreement made by municipalities⁹⁶, as already considered. Moreover, it is worth mentioning that the amplified territorial scope of the OAPs in comparison to each municipality on the collection of taxes has been proved the advantage of this delegation system.

Not only there have been achievements in terms of tax collection, also from the legal point of view, OPAs have raised issues and some legal changes that have turned out to be very beneficial for the municipalities (specially for small municipalities, due to the inability of carrying them out by themselves). For example, the request of large amounts from the state as compensation for bonuses granted to toll highways; or the amendment of the legislative framework to recognize the possibility of delegating the powers of management, inspection, and collection of non-public law income.

Having said all that, and given the differences among OAPs, the analysis of this practice has focused on the cases of Alicante and Barcelona taking into account e.g. the number of delegation agreements (141 and 309, respectively) and their figures on the collection of taxes (EUR 817.085.844,96 and EUR 1.888.750.842,79, respectively), among other reasons.⁹⁷

The Barcelona OPA (*Organisme de Gestió Tributària* of the Province of Barcelona) is a good sample for a comparative analysis of tax collection delegations to the same upper-tier local body by so much small as also medium-sized and large municipalities. Delegations agreed by large municipalities with the OPA seem to be not as effective and sustainable as delegations agreed with small or rural municipalities. The delegation of tax collecting powers to the OPA by one or several large municipalities must properly dimension the material and personal resources that the management of the income of those municipalities will require. As an example, the delegation of the collection of fines from the Barcelona City Council was canceled because it absorbed excessive resources from the OPA (*Organisme de Gestió Tributària*)

⁹⁴ See, for instance, [Alicante](#), [Barcelona](#), [Granada](#), [Salamanca](#), [Sevilla](#) and [Toledo](#).

⁹⁵ See Irene Belmonte Martín and Josefa Luna Martínez, 'El Mapa de la gestión tributaria local en España. Una primera aproximación al diseño de indicadores para su evaluación' (XII AECPA Congress, San Sebastián, July 2015) 7-9 <<https://aecpa.es/es-es/el-mapa-de-la-gestion-tributaria-local-en-espana-una-primera-aproxima/congress-papers/1322/>> accessed 24 June 2020.

⁹⁶ See, for instance, the municipalities and functions delegated to the OAP of Barcelona (*Organisme de Gestió Tributària* – ORGT) in the following link, <https://transparencia-orgt.diba.cat/sites/transparencia-orgt.diba.cat/files/public/node-fitxers/a_-_quadre_delegacions_ajuntaments_2.xls#overlay-context=quadre-delegacions-ajuntaments> accessed 24 June 2020.

⁹⁷ See, with respect to Alicante, 'Memoria Anual 2018' (SUMA and Fundación Pequeño Deseo 2018) 9 <<https://www.suma.es/memorias/2018/2018MemoriaSuma.pdf>> accessed 22 July 2020, and, with respect to Barcelona, Organisme de Gestió Tributària – Diputació Barcelona, 'Memòria de l'exercici 2019' 13 <http://transparencia-orgt.diba.cat/sites/transparencia-orgt.diba.cat/files/public/node-fitxers/memoria_orgt_2019.pdf> accessed 22 July 2020.



In general terms, certain complex management functions (such as the granting of tax benefits or the inspection of public domain rates) are better carried out directly by municipalities than by a delegated OAP. On the contrary, delegation to an OAP proves more efficient for taxing functions which are less complex, such as the simple collection of the debts, as this is a task more likely to be computerized and treated with uniform procedures. This output suggests that only small municipalities should delegate wide tax managerial functions to the corresponding OAP, while large municipalities should delegate only the sheer tax collection.

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5. Local Financial Arrangements in Switzerland

5.1 The System of Local Government in Switzerland

Flavien Felder, *IFF Institute of Federalism, University of Fribourg*

Types of Local Governments

The Swiss model of federalism, based on the principle of subsidiarity, is structured in three layers of political representation, i.e. the Confederation (national government), the cantons and the municipalities. The Constitution of the Swiss Confederation, however, focuses on two layers only, the national and cantonal. In its Article 1 it not only lists the official 26 cantons but also gives them constitutive effect. In Article 3 it sets the rules for the power-sharing arrangements between the Confederation and the cantons: 'The Cantons are sovereign except to the extent that their sovereignty is limited by the Federal Constitution. They exercise all rights that are not vested in the Confederation.' However, one must bear in mind that the term 'competent' would be more appropriate than 'sovereign' to describe the power vested in the cantons. In fact, the cantons have competence on all the tasks and duties that do not fall on the Confederation. But they nevertheless remain subdued to the Confederation, as the majority of the other cantons can impose their will on a canton via a revision of the Swiss Constitution. Indeed, according to the Article 48(a) of the Swiss Constitution, at the request of interested cantons, the Confederation may declare intercantonal agreements to be generally binding or require cantons to participate in intercantonal agreements in the following fields:

- the execution of criminal penalties and measures;
- school education in the matters specified in Article 62(4);
- cantonal institutions of higher education;
- cultural institutions of supra-regional importance; e. waste management;
- waste water treatment;
- urban transport;
- advanced medical science and specialist clinics;
- institutions for the rehabilitation and care of invalids.

The Federal Constitution does not attribute any competence to regulate local government to the national government. The municipalities are therefore created by and subjected to cantonal regulation. Thus, each canton defines the status and the competences of its municipalities in its cantonal constitution and legislation. We therefore differentiate 26 systems of municipalities corresponding to each of the 26 Swiss cantons. Still, one can identify five main types of municipalities:

- the classical political municipalities which are called *commune* in French, *comune* in Italian and *Gemeinde, Ortsgemeinde* or *Einwohnergemeinde* in German depending on the cantons. They are the basic general-purpose type of municipality;



- the so-called *bourgeoise* municipalities that have survived from the Middle Age in some cantons. When in 1798 the Helvetic Republic is proclaimed; the cantons are put on an equal footing and the inhabitants of the Swiss territory receive the Swiss citizenship. The original bourgeois do not agree to share the communal properties (lands, forests, etc.) with the new *bourgeoise*. Thus, the *bourgeoise* municipalities keep the control over the communal properties and the political municipalities guarantee the political rights to the new *bourgeoise*. As of today, in the cantons where such *bourgeoise* municipalities remain, they are mainly land owners and service providers (for example retirement houses, subsidized apartments, young offenders' facilities, etc.);
- the ecclesiastical community is the territorial division that is attached to a church and that is often called parish (*paroisse* in French). They are a single-purpose body;
- the so-called scholar commune *commune scolaire* is also a single-purpose body that deals with the school system on a certain territory within the limits assigned by the canton and that does not automatically match with the political municipality. For example, the school program remains a cantonal competence but the decision to build the school or to organize the carriage of school pupils is, to a large extent, delegated to the scholar municipalities;⁹⁸
- other types of municipalities that exist in some cantons.

Finally, one must add that the majority of the Swiss cantons have put in place an intermediary political level between the cantons and the municipalities called the district (*district* in French, *Bezirk*, *Verwaltungsregion*, *Verwaltungskreis*, *Wahlkreis*, *Amtei* or *Amt* in German, *distretto* in Italian). Out of the 26 cantons, only six do not have such a subdivision. These districts are very different from each other but they usually correspond to a group of municipalities. Again, the cantons hold the primary competence regarding their internal organization and scope.

Legal Status of Local Governments

The constitution framework that prevailed until 1999 did not mention municipalities, unless incidentally. Only the adoption of a new constitution that year ensured that local autonomy was granted constitutional protection.⁹⁹ Article 50 reads as follows: (i) 'The autonomy of the communes is guaranteed in accordance with cantonal law.'; (ii) 'The Confederation shall take account in its activities of the possible consequences for the communes.'; (iii) 'In doing so, it shall take account of the special position of the cities and urban areas as well as the mountain regions.'

The effect of the new provision is limited. The extent of local autonomy remains in the hands of the cantons ('in accordance with cantonal law') and each of them thus continues to autonomously define its internal governance system. Only as far as cantonal law provides for municipal autonomy, it is guaranteed by the Federal Constitution. Consequently, municipal autonomy is justiciable and the Federal Supreme Court hears disputes concerning violations of it (Article 189(1)(e)). When it does so, it refers to the cantonal constitution and the cantonal

⁹⁸ Nicolas Schmitt, *Local Government in Switzerland: Organisation and Competences* (forthcoming).

⁹⁹ Schmitt, *Local Government in Switzerland*, above.



legislative framework to determine the scope of local autonomy and decide whether the canton has impinged on it or not.

If the Article 50(2) of the Constitution constrains the Confederation, while fulfilling its tasks (e.g. military, national highways), to be considerate of municipalities, it does not confer additional jurisdiction on the Confederation. Essentially, this constitutional provision aims at fostering vertical cooperation between the three institutional levels of the Swiss federal structure but without bypassing the intermediary level, the cantons. The article refers specifically to the urban-rural divide and explicitly compels the national government to take account of the special priorities and needs of cities and urban areas on the one hand and mountain regions on the other hand. Among the concrete initiatives, the Tripartite Conference can be mentioned. It will be discussed at length further in the Country Report.

(A) Symmetry of the Local Government System

As mentioned above, there are 26 systems of local government corresponding to the 26 Swiss cantons. Thus, there are considerable differences regarding the rules that apply to urban local governments (ULGs) and rural local governments (RLGs), etc. For example, the Canton of Zürich has granted a special status to the cities of Zürich and Winterthur. Most cantons, however, are based on a symmetric system and allocate the same tasks and responsibilities to all municipalities, irrespective of their size.

Despite of the wide variety of cantonal local government arrangements, some common features can be identified. Schmitt demonstrates that all municipalities are run by an executive council of five to ten members who are elected by the citizens and who are compelled to take decisions on a collegial basis.¹⁰⁰ While they traditionally are not paid for their work, the elected members of municipalities' councils in the ULGs tend to be professionals.

As regards legislative power, small municipalities (not to say RLGs) have citizens' assemblies that meet regularly to pass new laws and/or to elect the executive council members and other authorities. On the contrary, some cantons have compelled larger municipalities (ULGs) to create a parliament, i.e. an elected legislative body *representing* the citizens. As Schmitt notes, the Canton of Fribourg has adopted the Law on the Municipalities (*Loi sur les communes* in French) that requires eight specific municipalities to set up such a parliament while municipalities with over 600 inhabitants are only invited to do so.¹⁰¹ Smaller municipalities can keep their citizens' assemblies.

Finally, Schmitt puts a light on an interesting paradox: while municipalities still enjoy a large set of competencies and have the right to collect taxes (and set the tax rates), judicial power is not granted to the municipalities. In fact, the lowest judicial level is, in some cantons, the district's judge. Once again, one must look carefully at all the 26 cantonal organizations in order

¹⁰⁰ Schmitt, *Local Government in Switzerland*, above.

¹⁰¹ *ibid.*



to grasp the subtleties of the local government systems that make Swiss federalism so complex.¹⁰²

Political and Social Context in Switzerland

If the prominent role and the many responsibilities conferred to the municipalities have long been praised and recognized as a key factor for the success of the Swiss political model, one must note that they tend to lose their luster. In fact, the degree of autonomy enjoyed by the municipalities decreases due to the increasing requirements (land use planning, environmental protection, social aid, waste management, etc.) from the Confederation, the cantons and, to some extent, the people themselves. The democratic pressure (complexity of the legal frameworks, over technical policy fields, procedural overload, etc.) on the municipalities is difficult to manage, especially for non-professional elected representatives and somehow encourages the centralization of the decision-making power and the pooling of local tasks and duties at a superior level.

In the last 30 years, Switzerland has thus witnessed a strong acceleration of the number of amalgamations of its municipalities. From more than 3,200 municipalities in 1999, the number has dropped to approximately 2,200 municipalities in 2018. While the rural municipalities tend to merge, it can be observed that urban municipalities tend instead to agglomerate¹⁰³ via different types of inter-municipal agreements. In any case, cantons and municipalities follow their own path with little interference from the national government. Today, approximately two thirds of the Swiss population is concentrated in the cities' centers¹⁰⁴ or agglomerations.

According to 2017 data, the 2,212 Swiss municipalities are relatively small, with 1,060 inhabitants on average, but very different in size. The smallest is Corippo with 12 permanent inhabitants and, like many others, spreads on less than 1 km². The largest in terms of territory is Scuol with 438.62 km² and the most populated is Zurich with 400,000 inhabitants. Many municipalities being unable to cope with the organizational requirements of today's life (school facilities, firefighter's service, water sanitation, etc.) and finding it difficult to recruit personnel, a strong process of merging local authorities has begun some sixty years ago and has accelerated in the last thirty years.

The four main coalition parties, namely the FDP. The Liberals, the Christian Democratic People's Party, the Social Democratic Party and the Swiss People's Party are all represented at the Federal level and in almost all the 26 cantons. Interestingly, in the urban cities, the traditional political parties are well organized and represented while in the smaller rural

¹⁰² *ibid.*

¹⁰³ According to the Federal Office of Statistics, the agglomeration can be defined as follows: An agglomeration is a group of municipalities with a total of more than 20,000 inhabitants (incl. overnight stays in converted hotels). It consists of a dense center and usually a crown. The delimitation of the crown is based on the intensity of the commuter flows.

¹⁰⁴ According to the Federal Office of Statistics, the city-center can be defined as follows: The municipality which, among the central municipalities of an agglomeration, has the highest number of HENs (= sum of inhabitants, work places and overnight stays in converted hotels) is considered as a city-center. In some cases, it is possible for an agglomeration to have several central cities.



municipalities, political parties are less active. The peculiarity of small municipalities where every citizen knows each other means that people vote first for a specific candidate rather than for the parties.

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5.2 Local Financial Arrangements in Switzerland: An Introduction

Flavien Felder, *IFF Institute of Federalism, University of Fribourg*

In Switzerland, all three tiers of government, namely the Confederation, the cantons (states) and the communes (municipalities), have the right to levy taxes to the extent that the Federal Constitution does not limit these public bodies (Article 3 of the Constitution). While the two upper tiers enjoy a full sovereignty, the communes only have a derived sovereignty as their right to levy taxes can be limited by the cantons.

The fiscal autonomy of the communes is rooted in the Swiss federal system. Although one sees a trend towards more centralization of competencies, the principle of subsidiarity is still a pillar of the system: tasks that can be done at a lower political level should be done at a lower level, closer to the people concerned by them. Thus, Swiss communes are not in charge of minor duties only (waste removal) but are also competent for tasks of higher importance such as education, social care, etc. Consequently, the communes levy approximately 20 per cent of the total tax revenue of the three administrative tiers¹⁰⁵.

In the case of Switzerland, where budgets are highly decentralized, the equalization of resources and the equalization of charges are two tools that help mitigate imbalances among public bodies. These imbalances can be of different natures. For example, the amount of tax revenue can be very unbalanced (i.e. equalization of resources) and the burden of financing public services can be highly unevenly distributed between urban and rural communes (i.e. equalization of charges).

In 2008, Switzerland introduced a fiscal equalization system between the Confederation and the cantons accompanied by an inter-cantonal distribution (subnational level). The Federal Act on fiscal equalization and expenditures compensation entered into force in 2003 and was revised in 2019. Practically, the financial flows are multiple, horizontal and vertical, and the overall system is quite complex. A chart resuming the system is available on the website of the Swiss Federal Department of Finance:¹⁰⁶

¹⁰⁵ In 2014, tax revenues (3 tiers) totaled CHF 131 billion: Confederation: CHF 60,6 billion; cantons: CHF 43,5 billion; communes: CHF 26,8.

¹⁰⁶ '2021 fiscal equalization payments in CHF mn' (*Federal Department of Finance*)

<<https://www.efd.admin.ch/efd/en/home/themen/finanzpolitik/national-fiscal-equalization/fb-nationaler-finanzausgleich/grafik-nfa.html>> last accessed 15 February 2020.

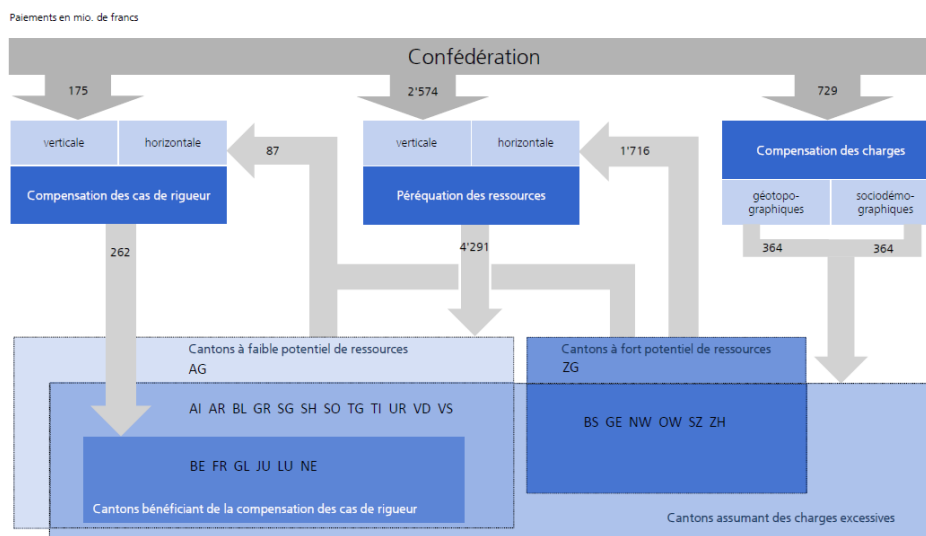


Figure 1: Fiscal equalization system between the Swiss Confederation and the cantons.

At the local level, similar mechanisms are in place within the cantons. As each canton developed its own specific intercommunal equalization system, carrying out a comprehensive survey of the different schemes is a challenging endeavor. In 2013, the think tank Avenir Suisse published an interesting comparative monitoring of all the 26 intercommunal systems.¹⁰⁷ The author underlined that the majority of the intercommunal equalization systems were often unnecessarily complicated, encouraged spending behaviors and thus maintained inefficient municipal structures.

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¹⁰⁷ Lukas Rühli, *Monitoring des Cantons 5: Le Labyrinthe de la péréquation financière* (Avenir Suisse 2013) 21.



5.3 The Intercommunal Equalization System in the Canton of Vaud

Flavien Felder, *IFF Institute of Federalism, University of Fribourg*

Relevance of the Practice

One of the major political goals of the intercommunal equalization systems is to encourage a decentralized occupation of the territory and to find a balance between the urban and rural areas of the canton. The urban center of the Canton of Vaud (the City of Lausanne) and the other secondary urban municipalities (Vevey, Montreux, etc.) are attractive but the rural communes must also be seen as pleasant places to live.

This practice focuses on the intercommunal equalization system in place in the Canton of Vaud since 2011 as a result of new negotiations on the distribution of the competencies between the canton and the communes. It is a relevant practice for the LoGov project on urban-rural divide as local financial arrangements are at the core of intercommunal relations and the main purpose of the system is namely to find a balance between urban and rural municipalities in the canton. For a full list of the purposes, see the Article 1 of the Act on intercommunal equalization (LPIC) of the Canton of Vaud (free translation).

- Article 1: (LPIC) Purposes of the law:
- a. Mitigate the inequalities in tax burden resulting from differences in contributory capacity, while guaranteeing the autonomy of the municipalities in terms of taxation;
 - b. Do not hinder or even favor the mergers of Vaud municipalities;
 - c. Provide municipalities with the resources they need to accomplish the tasks incumbent upon them by contributing to the sustainable balance of their finances;
 - d. Distribute between the *communes* certain charges falling under the canton and the *communes*;
 - e. Compensate the particular charges of the center cities;
 - f. Allocate certain municipal charges among the municipalities, causing excessive disparities between the municipalities.

This practice is certainly also relevant for the other four Working Packages of the LoGov project but more specifically for report section 2 on the local responsibilities and public services and report section 5 on the intergovernmental relations since it provides useful information regarding the financing of the social costs and the so-called thematic expenditures: transport and forest management in the Canton of Vaud.

Description of the Practice

The State Council of the Canton of Vaud is responsible for implementing the cantonal Act on intercommunal equalization (Article 19 LPIC). Its Service of the Communes and Housing, within the Institutions and Security Department is in charge of its implementation. In addition, the



Union des Communes Vaudoises (UCV), an association of municipalities¹⁰⁸ created in 1910 to safeguard the competencies of the communes and to promote their interests towards the Canton of Vaud, helps in generating the data and monitoring the system. Gianni Saita, General Secretary of the UCV and author of the review ‘La Péréquation en Questions: 2020’¹⁰⁹ analyses the Article 1 LPIC to explain the whole system. He points out that letters a and c focus on the economic dimension of the equalization system while letter d integrates an additional element to it, namely the social cost that is to be covered by the cantons and/or the communes.¹¹⁰ Letters e and f add two additional constraints to the system: the socio-demographic characteristic (economic burden on city centers) and the thematic expenses (forest management for example). Finally, point b underlines that transfers must be consistent with the public policy regarding municipal mergers.¹¹¹

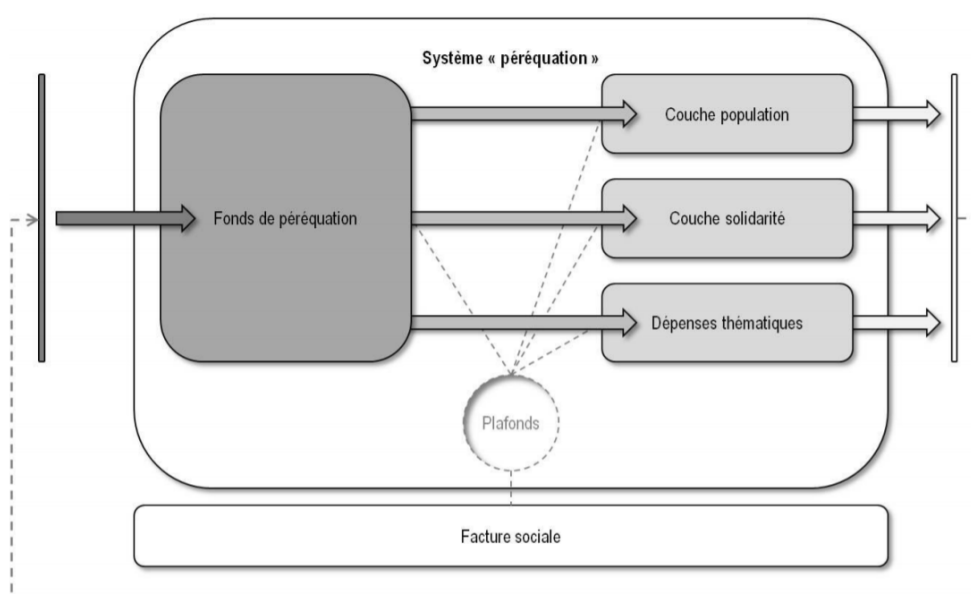


Figure 2: Direct equalization system in the Canton of Vaud.

The above diagram represents how the five characteristics of the direct equalization system listed above operate in the Canton of Vaud and how they regulate the financial intercommunal relations.¹¹² At the entrance of the system, the communes contribute to the equalization fund (*fonds de péréquation*). The financial resources available in the fund are distributed to the communes according to three different layers: the population layer (*couche population*); the solidarity layer (*couche solidarité*) and the thematic expenditures (*dépenses thématiques*). In order to limit redistributions (output) and / or the contributions of municipalities to the equalization fund (input), the legislator puts in place three thresholds, called ‘caps’

¹⁰⁸ In 2020, it represents approximately 90% of the 309 communes of the canton (urban and rural).

¹⁰⁹ The document can be downloaded on the website of the Union des Communes Vaudoises, <<https://www.ucv.ch/thematiques/economie-et-finances/perequations-financieres>> accessed February 2020.

¹¹⁰ We do not further discuss the letter d as it aims specifically at the financing of the social cost and falls into the category of indirect equalization (the system takes into account the fiscal capacity of the communes but does not include a redistribution mechanism).

¹¹¹ Gianni Saita, ‘La Péréquation en questions: 2020’ (Union des Communes Vaudoises 2019).

¹¹² *ibid.*



(*plafonds*).¹¹³ Finally, a large arrow with dotted lines wrapping the diagram shows that municipalities' contributions (inputs) to the fund generate the redistributions to other municipalities (outputs).

In 2020, the equalization fund of the Canton of Vaud will reach CHF 727 million (inputs). The redistribution (outputs) can be represented by the following diagram.¹¹⁴

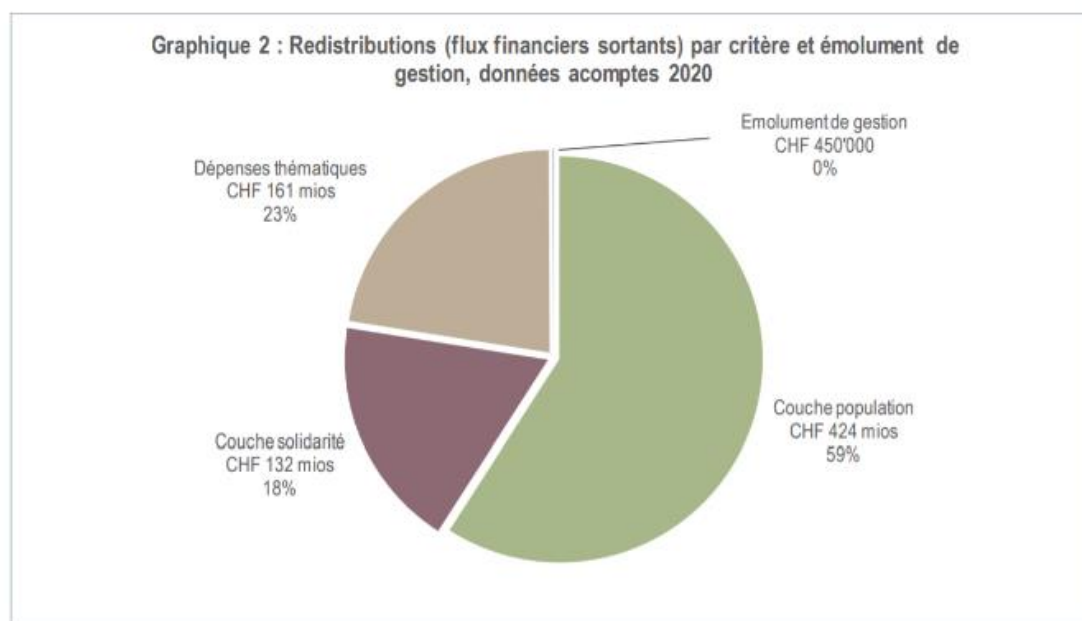


Figure 3: Redistribution of equalization funds in 2020.

The population layer (*couche population*) corresponds to a redistribution formula based on the number of citizens per commune. The basic idea is that a higher density increases the public sector spending. It is typically a way to cope with the challenge of commuters from suburbs to urban-centers.¹¹⁵

The solidarity layer (*couche solidarité*) relies on the hypothesis that the thinner the financial capacity of the commune, the bigger its difficulty to finance its public services. Therefore, a solidarity mechanism helps the poorer communes to cover the basic public services.¹¹⁶

The thematic expenditures (*dépenses thématiques*) are limited to two sectors in the Canton of Vaud: transport and forest management. And this mechanism covers only the management costs of the two sectors (no investment expenditures). The idea is to compensate both the urban-centers that are in charge of the public transports, school transports and road management as well as the rural municipalities that have the duty to manage their forests for the benefit of all.

The equalization caps (*plafonds péréquatifs*) are designed to keep the rich municipalities' contributions to the equalization fund within certain limits that do not unbalance their public

¹¹³ The social cost (*facture sociale*) and its calculation belong to the system but are not further discussed here.

¹¹⁴ Saitta, 'La Péréquation en questions', above.

¹¹⁵ Saitta, 'La Péréquation en questions', above.

¹¹⁶ *ibid.*



finances. First, the equalization efforts (input) cannot exceed a certain tax point (Article 8 LPIC). Second, the municipalities that have a high tax rate can claim compensations if they agree to reduce the tax rates (Article 6 LPIC). Third, the equalization contributions distributed to the poorer municipalities (output) cannot exceed a certain tax point (Article 7 LPIC).¹¹⁷

Assessment of the Practice

If the implicit practice objective is to encourage people to spread out in the whole territory of the Canton of Vaud, the explicit objectives are listed in Article 1 LPIC. One can see that both types of objectives are achieved. Nevertheless, in October 2019, the Court of Audit of the Canton of Vaud released an audit on the intercommunal equalization system and highlighted some dysfunction.¹¹⁸ In particular, the heterogeneity of the data provided by the communes create equalization bias that must be corrected by a better management of the whole system.

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¹¹⁷ *ibid.*

¹¹⁸ The document can be downloaded on the website of the Union des Communes Vaudoises <https://www.vd.ch/fileadmin/user_upload/organisation/cour_comptes/1_Rapports_d_audit/56_Rapport.pdf> accessed February 2020.



5.4 Financial Merger Incentives for Municipalities: A Bottom-up Perspective

Lawrence Zünd and Flavien Felder, *IFF Institute of Federalism, University of Fribourg*

Relevance of the Practice

Municipal mergers are a relatively recent topic in Switzerland. Indeed, while the municipal structure has undergone only minor changes since the creation of the federal state, the last thirty years have seen a clear increase in the number of mergers targeting mainly rural municipalities.¹¹⁹

This trend can be explained by deep economic and social changes that affect the Swiss municipalities.¹²⁰ On the one hand, the multiplication and the complexity of the tasks assumed by municipalities of all sizes require greater professionalization and specialization of the municipal entity, and on the other hand, as they have to cope with an increasing demand by citizens regarding public services, the financial situation of some municipalities has been worsening since the beginning of the 1990s.¹²¹ While larger urban municipalities have enough tax revenue to carry these tasks on their own, smaller and often rural municipalities are reaching their limits. Also, in small and rural municipalities, it is increasingly difficult to find citizens ready to dedicate themselves for the public affairs and to join their municipal council.

If we consider the advantages that fusion proponents present, a merger may then appear as a solution: increased efficiency in the accomplishment of tasks, lower costs by economy of scale, improvement of the supply and quality of municipal services.¹²² This has resulted in a growing number of cantons encouraging mergers of municipalities on their territory.¹²³ This encouragement can take the form of negative or positive incentives. The Canton of Neuchâtel has a policy of positive incentives, which aims at giving an advantage or reward to municipalities engaging in a process of fusion.

¹¹⁹ Council of State, 'Rapport du Conseil d'Etat au Grand Conseil à l'appui d'un projet de loi portant modification de la loi sur les droits politiques (LDP)' (Report to the Grand Council, 31 August 2015) 2 <https://www.ne.ch/autorites/GC/objets/Documents/Rapports/2015/15041_CE.pdf>.

¹²⁰ Economic and Development Review Committee (EDRC) of the OECD, 'Switzerland' (OECD Economic Surveys 2019) <<http://www.oecd.org/economy/surveys/Switzerland-2019-OECD-economic-survey-overview.pdf>>.

¹²¹ Daniel Kettiger, 'Gemeindefusionen – ein Thema mit vielen Facetten' (PuMAConsult GmbH 2004) 4 <https://www.kettiger.ch/fileadmin/user_upload/Dokumente/Downloads/Kettiger_Aufsatz-Gemeindefusion.pdf>, Council of State, 'Rapport du Conseil d'Etat au Grand Conseil' 3.

¹²² Pierre-Alain Rumley, *La Suisse demain* (Presses du Belvédère 2010).

Interview with Daniel Kettiger, 'Fusionen machen es nicht billiger, aber besser' (*Wiener Zeitung*, 27 November 2009) <https://www.kettiger.ch/fileadmin/user_upload/Dokumente/Downloads/interview_gemeindefusion_wienerzeitung.pdf>.

¹²³ Patrick Monay, 'Des fusions de communes à la chaîne' (*24heures.ch*, 2 June 2015) <<https://www.24heures.ch/suisse/fusions-communes-chaine/story/28908718>>.



By interviewing local authorities and taking a bottom-up perspective to focus on the municipalities' perception, the study of this practice is relevant for the LoGov researchers as it will allow them to identify and discuss:

- some factors of success / failure of mergers;
- the negotiation processes between reluctant municipalities with different needs and objectives (rural/urban);
- the perception by municipalities of the cantonal assistance they have benefited from;
- the evaluation by municipalities of the provided assistance
- the incentives considered as particularly important for the success of a merger;
- the missing measures that could improve the merger assistance mechanisms and avoid failed mergers.

Description of the Practice

The Canton of Neuchâtel has a policy of positive incentives that apply equally to urban and rural municipalities. The canton, with its financial and consulting assistance aims at supporting municipalities engaging in a process of fusion. In practice, these incentives primary target the small rural municipalities or small municipalities closely linked to an urban municipality. For example, the three small and rural municipalities of Peseux, Valangin and Corcelles-Cormondrèche are merging with the City of Neuchâtel, formally creating a new Municipality of Neuchâtel as of 1 January 2021.

The system of financial incentives is the most common in Switzerland. Along with Neuchâtel, 15 other cantons have financial incentives: Zurich, Bern, Lucerne, Glarus, Fribourg, Solothurn, Schaffhausen, St. Gallen, Grisons, Argovie, Thurgau, Tessin, Vaud, Valais and Jura.¹²⁴

In the Canton of Neuchâtel, the calculation method necessary for granting financial assistance is clearly defined by law. It is therefore possible for all parties involved to calculate the amount of the total assistance that would be granted by the canton according to the law.¹²⁵ This has two main implications for the Canton of Neuchâtel. While, on the one hand, the clear calculation method leaves the canton little room for maneuver when it has to determine the amount of the financial assistance and makes the merger financially more attractive to reluctant municipalities, on the other hand, this clarity offers relative transparency regarding the justification of the financial assistance being granted. The amount of the assistance is calculated by multiplying, for each of the merged municipalities, the amount of 200 francs per inhabitant, weighted by the average relative tax coefficient and the inverse of the average

¹²⁴ See report section 3.1. on Local Financial Arrangements in Switzerland: An Introduction. Reto Steiner and Claire Kaiser, 'Gemeindefusionen aus kantonaler Sicht' (working paper, KPM Bern 2010). https://www.researchgate.net/profile/Reto_Steiner/publication/303541769_Gemeindefusionen_aus_kantonaler_Sicht/links/57473a8608ae2301b0b8017a.pdf.

¹²⁵ Law on the Municipal Aid Fund of January 30, 2002 (LFAC NE); Application Regulations for the Law on the Assistance Fund for Municipalities of October 22, 2003 (RALFAC NE); Decree Relating to the Use of the Balance of the Fund Intended for the Structural Reforms of Municipalities of March 29, 2006.



relative tax income of all the merged municipalities.¹²⁶ The population taken into account for the calculation is capped at 2,500 inhabitants per municipality.¹²⁷ This ceiling can exceptionally be raised to 5,000 inhabitants, for municipalities with more than 10,000 inhabitants.¹²⁸

Financial assistance is allocated according to the need and importance of the project,¹²⁹ and can cover both the study costs to evaluate the merger, as well as the subsidization of the merger.¹³⁰ There is no right to obtain financial assistance.¹³¹ The Council of State of Neuchâtel decides which municipalities are supported, it determines the amount of this support and sets the conditions for granting the assistance.¹³²

The canton also makes available technical and legal assistance to municipalities wishing to merge. With these various measures, the Canton of Neuchâtel aims at supporting all municipal mergers of all size and avoid that the reduced size of some municipalities -and thus their inability to bear with all the costs engaging in a merge can induce- restrains them to engage in this process.

Assessment of the Practice

The Canton of Neuchâtel encourages the merger of municipalities by providing various types of support. The cantonal assistance, that can be considered either as a means of reducing the costs of the merger or as a form of reward, aims at increasing the number of mergers by making it more attractive to the municipalities. However, for this objective to be reached, the assistance offered by the canton must correspond as best as possible to the needs and expectations of the municipalities that might consider a merger. If the canton is unable to do so, it faces the risk of wasting resources without achieving results.

In general, one can say that the citizens' emotional affection to the independence of their municipality is often a brake on mergers that cantonal incentives cannot overcome without a strong political commitment of the local elected representatives who are really decisive. The

¹²⁶ RALFAC NE Art 17(1) The subsidy granted for municipal merger projects submitted to the population of the municipalities concerned until December 31, 2016 is: a) 800 francs per inhabitant, if the merger has been accepted; b) 600 francs per inhabitant, if the merger has been rejected and a new merger project bringing together at least two municipalities that are parties to the first project is accepted until December 31, 2020.

(2) The subsidy granted for municipal merger projects that do not meet the conditions of the first paragraph is 200 francs per inhabitant.

(3) These amounts are weighted by the average relative tax coefficient and the inverse of the average tax income of all the municipalities concerned. (Translated by author, Law available in French <<http://rsn.ne.ch/DATA/program/books/rsne/hm/172410.htm>>).

¹²⁷ RALFAC NE Art 18(1)

¹²⁸ RALFAC NE Art 18(2).

¹²⁹ Law on the Municipal Aid Fund (LFAC) Art 5 (3). Incentive aid is in principle allocated according to the need and the importance of collaborations or mergers and takes into account, in particular, the tax coefficient and the financial situation of the municipalities concerned. (Translated by author, Law available in French, <<http://rsn.ne.ch/DATA/program/books/rsne/hm/17241.htm>>).

¹³⁰ RALFAC NE Art 13(4).

¹³¹ LAFAC Art 3(3).

¹³² LAFAC Art 3(1), (2).



example mentioned above of the new City of Neuchâtel after the merging of four existing municipalities (1 urban and 3 rural) is telling as the original project was to merge four additional rural municipalities (Hauterive, St-Blaise, Enges and la Tène). These municipalities rejected the idea of merging with the urban City of Neuchâtel but are now considering a merging together to form a larger rural municipality within the agglomeration of Neuchâtel.

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5.5 Third Report Entry: The Intercommunal Equalization System in the Canton of Fribourg

Flavien Felder, *IFF Institute of Federalism, University of Fribourg*

Relevance of the Practice

The State Council of the canton is responsible to organize the management of the financial equalization in due respect of the provisions listed in the corresponding act.¹³³ In practice, this task is in the hands of the Municipalities Department, which is entitled to conduct the financial and administrative supervision of local authorities (municipalities, inter-municipal associations, agglomerations and legal entities under public law). This department is also responsible for drafting policies aiming at encouraging mergers of municipalities and for dividing efficiently the public tasks between the state and the municipalities. It collaborates with the Prefect, works closely with the municipalities, and offers them different type of services, management tools and trainings. This type of services can be found in all the Latin cantons in a form or another. In general, they are attached to the State Council and financed by the cantonal taxes.

Until 2010, the financial equalization was exclusively indirect, as the cantonal subsidies for municipal expenses and the financial participation of the municipalities in the cantonal expenses were determined according to the financial capacity (calculated, as usual, on the basis of resources and expenses). In 2011, this system was replaced by a radically new system of horizontal equalization of resources and vertical cost compensation of public expenditures aiming at reaching the following objectives.¹³⁴

The objectives of the revised Inter-Municipal Financial Equalization Act adopted by the citizens of the Canton of Fribourg on 7 March 2010 is to partially compensate for the disparities in the fiscal potential of the municipalities¹³⁵ and to partially compensate for the financial needs of the municipalities as assessed by a synthetic needs index.¹³⁶ In this revised mechanism, one significant improvement lies in the fact that the resource equalization tool does no longer provide for a minimum allocation and functions optimally thanks to a simple, completely symmetrical and linear system.¹³⁷ Another significant change relates to the second tool of the equalization mechanism, namely the needs-based equalization which, contrary to what applies in all other cantons, no longer concentrates its financial transfers to structurally weak regions to compensate for the costs of remoteness or difficulties due to topography but favors instead the centers/urban municipalities.¹³⁸ This is a paradigmatic shift as far as the urban-rural interplay in the Canton of Fribourg is concerned. As a matter of fact, this tool does no longer

¹³³ Art 18(1) of the Canton of Fribourg Inter-Municipal Financial Equalization Act, SGF 142.1.

¹³⁴ Lukas Rühli, 'Monitoring des Cantons 5: Le Labyrinthe de la péréquation financière' (Avenir Suisse 2013) 18 <<https://www.avenir-suisse.ch/fr/publication/le-labyrinthe-de-la-perequation-financiere/>>.

¹³⁵ Art 3 of the Inter-Municipal Financial Equalization Act.

¹³⁶ Art 9 of the Inter-Municipal Financial Equalization Act.

¹³⁷ Rühli, 'Monitoring des Cantons 5', above, 18.

¹³⁸ *ibid.*



primarily compensate the rural municipalities for their 'remoteness costs' or topographic burdens. On the contrary it takes better account of the burdens borne by urban centers.

Description of the Practice

Two distinct instruments, the resource equalization and the needs-based equalization, are implemented by the Canton of Fribourg to achieve the expected effects of its inter-municipal financial equalization mechanism.

The first instrument, the resource equalization, is based on the fiscal potential of each municipality calculated per capita (or inhabitant), on the basis of eight types of regular municipal taxes:¹³⁹ (i) the personal income tax; (ii) the personal wealth tax; (iii) the tax on the profits of legal entities; (iv) the tax on the capital of legal entities; (v) the tax at source; (vi) the tax on capital benefits; (vii) the real estate tax; (viii) a part of the motor vehicle tax. The yields of these taxes are calculated at the rate of the basic cantonal tax or, at a standardized rate, in order to neutralize the effect of the communal coefficients¹⁴⁰ chosen by municipalities. In addition, the reference period corresponds to the three most recent consecutive fiscal years for which published statistics from the Direct Tax Administration Service are available.¹⁴¹ For example, the 2021 resource equalization is based on the 2016, 2017 and 2018 fiscal years.

This instrument does not require any additional funds, as the amounts are transferred from the contributing to the beneficiary municipalities on the same value date of 30 June. The total annual amount of the levies and payments are thus identical. The overall amount of resource equalization is the result of a choice made by the legislator: the initial amount corresponds to the volume calculated in the previous indirect equalization system. An analysis of previous years' volumes showed that they represented about 2.5 per cent of the overall amount of potential resources in the last year taken into account. This is therefore the percentage that has been fixed in the law¹⁴² and it makes it possible to adjust the amount for resource equalization annually in line with the evolution of tax yields.¹⁴³ Rural municipalities that do not have particularly rich taxpayers among their citizens mostly benefit from this instrument. Other rural municipalities which, for historical or geographical reasons, can count on rich taxpayers do not automatically benefit from this instrument.

The second instrument, the needs-based equalization (or cost compensation) targets the municipal expenditure side. In order to measure the differences between the municipalities, it is no longer the expenditure that is directly defined but the specific needs that generate public expenditures by the concerned municipalities. As in the case of resource equalization, the system identifies the financial volume to be allocated to this instrument, how it is to be financed, which municipalities are to benefit and the amount to be allocated to each

¹³⁹ Art 4 of the Inter-Municipal Financial Equalization Act.

¹⁴⁰ *ibid.*

¹⁴¹ Art 5(2) of the Inter-Municipal Financial Equalization Act.

¹⁴² Art 6 of the Inter-Municipal Financial Equalization Act.

¹⁴³ Calculation Method, Annex 1 to the Inter-Municipal Financial Equalization Act, 4.



municipality.¹⁴⁴ To measure and determine the specific needs of the municipalities, the analysts use six criteria for which statistics are available for all municipalities and that are in close correlated relations with municipal expenditures.¹⁴⁵ It is worth noting here that contrary to what had long been the practice, this tool does no longer aim at compensating rural areas. On the contrary, it recognizes the peculiar burden borne by the urban centers that tend to be more densified and to have additional structural needs. Thus, the selected criteria of calculation for this second tool of the equalization mechanism in the Canton of Fribourg are: the population density; the employment rate; the population growth over 10 years; the number of persons aged 80 years and plus; the number of children of compulsory school age¹⁴⁶ and the number of children under 4 years of age. Like the equalization of resources, the criteria for the equalization of needs refer to the statistical data of the three most recent known reference years or, when not available, the data of one or two consecutive years,¹⁴⁷ related to the legal population of the three reference years.¹⁴⁸ For each of the six indicators, an additional calculation is operated resulting on six partial indices. The sum of the partial indices forms the synthetic index of need. The aggregated municipalities' synthetic index of need functions as the reference threshold of 100 points. The municipalities with an index above this threshold have specific needs that have to be compensated. Those municipalities with an index below 100 points have less needs and are not compensated.¹⁴⁹ As seen above, another peculiarity of this instrument is that it is purely vertical. Thus, the compensations are supported by the canton only¹⁵⁰ and to a maximum amount corresponding to the 50 per cent of the total amount transferred under the first instrument, the resource equalization.¹⁵¹ Contrary to some other cantons and the national equalization mechanism, the Canton of Fribourg does not have a compensation fund for hardship cases.

Assessment of the Practice

The Inter-Municipal Financial Equalization Act of the Canton of Fribourg provides that the financial solidarity system is to be reviewed every four years.¹⁵² Among other, the performance of the instruments and the relevance of the criteria must be tested.¹⁵³ The first evaluation report published in 2015¹⁵⁴ has made it possible to adopt minor changes of the system mainly by adjusting it to the new cantonal policies and to the new statistical data. More importantly, this practice demonstrates that rural municipalities (in the Canton of Fribourg and in

¹⁴⁴ *ibid* 5.

¹⁴⁵ Art 11 of the Inter-Municipal Financial Equalization Act.

¹⁴⁶ *ibid*.

¹⁴⁷ Arts 12 and 23 of the Inter-Municipal Financial Equalization Act.

¹⁴⁸ Calculation Method, above, 5.

¹⁴⁹ *ibid*.

¹⁵⁰ Art 14 of the Inter-Municipal Financial Equalization Act.

¹⁵¹ Art 13 of the Inter-Municipal Financial Equalization Act.

¹⁵² Art 20 of the Inter-Municipal Financial Equalization Act.

¹⁵³ *ibid*.

¹⁵⁴ B Dafflon, 'Évaluation du système de péréquation financière intercommunale - Rapport du Groupe de travail' (*Etat de Fribourg*, 11 May 2016) <<https://www.fr.ch/diaf/scom/actualites/evaluation-du-systeme-de-perequation-financiere-intercommunale-rapport-du-groupe-de-travail>>



Switzerland in general) can no longer easily claim financial compensation for their 'remoteness'. A telling example is that of the municipal road as for decades, the general assumption (largely accepted in the political spheres) was that rural municipalities were to be compensated for the expensive municipal roads maintenance. But the system now being based on more technical data proved that urban centers bear a higher burden as far as roads maintenance is concerned. Therefore, the system revised in 2010 allows for a more comprehensive and factual compensation of the municipalities' needs and integrates, in its second instrument, the 6 criteria listed above.

The Municipalities Department is convinced that the system is now more consistent with the needs of the municipalities and of the canton.¹⁵⁵ The law guarantees a very flexible approach that allows regular adjustments to match with the technical needs. This tends to demonstrate that the simplicity of the mechanism based on a bi-directional dynamic (horizontal equalization of resources by the municipalities and a vertical equalization of needs by the state) significantly reduces the political bargains among the municipalities. Technical adjustments recommended by the group of experts in the frame of the periodic review were easily approved and the law was adjusted accordingly.

One last component of the mechanism is yet to be mentioned here: the vertical/state contribution to the system is fixed by the law and cannot go above 50 per cent of the horizontal/municipal contribution to the resource equalization. This clearly prevents excessive demands from the municipalities since an increase of the cantonal contributions to the mechanism automatically results in the doubling of the municipalities' contributions to the equalization of resources instrument. In 2015, the authors of the report decided to maintain the 50 per cent relation.

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Canton of Fribourg Inter-Municipal Financial Equalization Act, SGF 142.1

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¹⁵⁵ Calculation Method, above, 8.



6. Local Financial Arrangements in Austria

6.1 The System of Local Government in Austria

Dalilah Pichler, *KDZ Centre for Public Administration Research Austria*

Types of Local Governments

The Austrian Constitution defines Austria as a federal state formed by nine *Länder*. These are further divided into districts (*Bezirke*), administrative units executing tasks for both the *Länder* and the national government, where no statutory city exists. There are, however, 15 statutory cities (*Statutarstädte*) with a special statute, combining the authority and responsibilities of a municipality and a district. Municipalities (*Gemeinden*) are granted the right to self-government as independent administrative bodies in their sphere of competence by Article 116 of the Austrian Constitution. In sum, the three relevant levels of government are the central government, *Länder* and municipal level with some exceptions such as statutory cities which are assigned responsibilities from district level as well as the Capital City of Vienna, which is a municipality and a *Land* at the same time.

Legal Status of Local Governments

The Austrian Constitution of 1920 entrenches and protects municipalities not only as local administrative units but also as institutions of self-government (Article 116(1)). However, Articles 115–20 of the Constitution also extensively predetermine the organization of municipalities, their powers and intergovernmental relations. This tight national constitutional regime reduces the complementary power of the *Länder* under Article 115(2) of the Constitution to autonomously regulate local government through their own laws (*Gemeindeordnungen*) which results in a tendency towards uniformity.

As for their responsibilities, municipalities may only act lawfully on the basis of competences that are expressly conferred upon them and circumscribed by either national or *Land* legislation. However, this legislation *must* make them responsible for ‘all matters that exclusively or preponderantly concern the local community’ and are ‘suited to performance by the community within its local boundaries’ (Article 118(2) of the Austrian Constitution). Whether national and *Land* legislators observe this rule is checked by the Constitutional Court.

The own autonomous competences of municipalities on this basis, which exist in addition to the competences delegated from the national or *Land* government, include, in particular, the following areas: traffic and transport; gas, water and electricity supply; waste collection; sewage disposal; kindergarten, parts of education; elderly care; cemeteries; and cultural and sport facilities are all within the competences of municipal administration. For providing these public services, municipalities manage their own budget independently and can own assets of



all kind and operate economic enterprises. A major share of municipal budgets comes from intragovernmental transfers, which is a complex system of re-distribution of revenues across all levels of government.

(A) Symmetry of the Local Government System

The distribution of powers is uniform for all municipalities and therefore fails to take into account differences between bigger urban and smaller rural local governments. The Austrian Constitution adheres to the ‘principle of the abstract uniform municipality’, as enshrined already in 1920. This means that, with the exceptions of the above-mentioned statutory cities and the capital Vienna,¹⁵⁶ all municipalities enjoy, also regarding their competences, equal legal status irrespective of variations in territorial size, population or economic and administrative capacities.

Performing the same tasks as big municipalities can be challenging for Austria’s smaller municipalities. The latter are the majority, as 55 per cent of 2,096 municipalities (in 2018) have less than 2,000 inhabitants and 88 per cent have less than 5,000 residents. Thus, Article 116(a) of the Austrian Constitution lays down the possibility for inter-municipal cooperation in the form of local authority associations (*Gemeindeverband*) to manage certain areas of responsibility such as water supply or waste management (single-purpose associations). Since 2011, the founding of multi-purpose associations (*Mehrzweckverband*) between municipalities is possible in order to go beyond coordination and centralize public service provision such as regional planning, economic development or welfare services. Even though it is legally possible, such multi-purpose associations are not very common.

Another form of cooperation is the possibility of municipalities merging into an institutionalized regional authority, the ‘territorial municipality’ (*Gebietsgemeinde*), as foreseen by Article 120 of the Constitution. The territorial municipality offers the possibility of bundling and/or controlling as many tasks as possible on a regional level, while at the same time maintaining decentralized provision of services by the individual local communities. The preservation of the local identity is guaranteed by own local mayors and municipal councils. However, this form of territorial merger (as opposed to amalgamations) is considered ‘dead law’, as it has never been put into practice.¹⁵⁷

Political and Social Context in Austria

The two major parties, the conservative Austrian People’s Party and the Social Democratic Party of Austria have historically shared the parliamentary majority, with the right-wing

¹⁵⁶ Vienna has different competences because it is at the same time a municipality and one of the nine *Länder* (Arts 108-112 of the Constitution).

¹⁵⁷ Thomas Prorok and others, ‘Struktur, Steuerung und Finanzierung von kommunalen Aufgaben in Stadtregionen’ (KDZ 2013) <<https://www.kdz.eu/de/content/struktur-steuerung-und-finanzierung-von-kommunalen-aufgaben-stadtregionen>> accessed 31 January 2020.



Austrian Freedom Party ranging on third place with a significant share of votes since the 1990s. Other smaller parties are the Green Party and the liberal NEOS party. All mentioned parties are currently represented in different levels of government with different majorities. On the local level, apart from local independent candidate lists, the majority of municipalities are still split between the People's Party and the Social Democrats. This is also reflected in the organization of municipal associations, one being the Austrian Association of Municipalities (*Gemeindebund*), which is typically associated with the conservative party and smaller rural municipalities, and the Austrian Association of Cities and Towns (*Städtebund*), being organizationally closer to the Social Democrats and representative of larger cities.¹⁵⁸ However, this differentiation should be seen in a more historical context, as many municipalities and cities are members of both associations.

As of 2018, 52 per cent of Austria's population lived in municipalities with less than 10,000 inhabitants and 48 per cent in only 86 larger towns and cities, with Vienna alone having 21 per cent of the Austrian population.

As in many countries, urban and rural areas in Austria face different social problems and demographic challenges. Regarding poverty and social exclusion, for example, residents of Austria's urban areas are more at risk than their rural counterparts because of more single parents' households and more households with no or little income.¹⁵⁹ On the other hand, rural areas are confronted with out-migration especially of young people, women and highly educated people to cities. This has significant long-term effects on economic development, as well as the provision of health care and elderly care services.¹⁶⁰

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Holzinger G, 'Die Organisation der Verwaltung' in Gerhart Holzinger, Peter Oberdorfer and Bernhard Raschauer (eds), *Österreichische Verwaltungslehre* (Verlag Österreich 2006)

¹⁵⁸ The representation through either one of these associations is constitutionally regulated in Art 115(3) of the Constitution.

¹⁵⁹ Österreichischer Städtebund, 'Österreichs Städte in Zahlen' (2017) 42.

¹⁶⁰ Bundesministerium für Land- und Forstwirtschaft, Nachhaltigkeit und Wasserwirtschaft, 'Masterplan ländlicher Raum' (BMLFUW 2017).



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6.2 Local Financial Arrangements in Austria: An Introduction

Robert Blöschl and Dalilah Pichler, *KDZ Centre for Public Administration Research Austria*

General Structure and Budgeting

In Austria there are three tiers of administration: the federal level (ministries etc), the *Länder* level and the local level (municipalities, cities). There are nine *Länder* including Vienna and around 2,100 municipalities. All municipalities manage their own budget independently and can own assets of all kind and operate economic enterprises.

Regarding the municipal financial management, municipalities must prepare an annual budget at the end of the year, which shows in detail which revenues and expenditures are expected for the next year. The local council has to approve the annual budget. In any case, the provision of basic services has to be guaranteed and there are strict regulations on how and for which projects the municipality can take on debts.

Revenues

In Austria there are four main sources of municipal revenue:

- shared tax transfers (around 40 per cent of total operational income);
- local and municipal taxes (around 20 per cent of total operational income);
- fees for municipal services incl. utilities and other educational and social services (around 20 per cent of total operational income);
- current transfers (around 10 per cent of total operational income);
- other fees and income sources (around 10 per cent of total operational income).

Capital transfers for investments are not listed but have been as high as current transfers in the past years as current transfers in absolute values.

A major share of municipal budgets comes from intragovernmental transfers, a complex system of re-distribution of revenues across all levels of government regulated in the Fiscal Equalization Act (*Finanzausgleichsgesetz, FAG*), which is negotiated every three to eight years between the three levels of administration.¹⁶¹ This act defines the amount of shared revenues municipalities are granted. One of the main criteria of distribution is the tiered population scheme which reflects changes in population in a nonlinear way. Based on this scheme, urban municipalities with larger populations receive a larger share of the revenues. Shared revenues are mainly comprised of shares out of taxes like the value added tax (VAT), income tax and corporate tax. In total around 15 per cent of shared revenues are allocated to municipalities in the context of fiscal equalization.¹⁶² Shared taxes amounted to EUR 6.7 billion in 2018 for the local governments (without the Capital City of Vienna).¹⁶³

¹⁶¹ See Johann Bröthaler, Anita Haindl and Karoline Mitterer, 'Funktionsweisen und finanzielle Entwicklungen im Finanzausgleichssystem' in Helfried Bauer and others (eds), *Finanzausgleich 2017: Ein Handbuch* (NWV 2017).

¹⁶² *ibid.*

¹⁶³ See Österreichischer Städtebund (ed), 'Stadtdialog. Schriftenreihe des Österreichischen Städtebundes, Gemeindefinanzen 2020 – Entwicklungen 2009 – 2023' (forthcoming).



In addition to shared revenues, local taxes are an important factor of municipal income. The most important local tax for municipalities' budgets is the 'municipality tax'. Companies based in Austria have to pay municipality tax amounting to 3 per cent of the total sum of salaries paid within one month. Therefore, municipalities with higher employment have higher municipality tax income. In general, this applies stronger to urban local governments (ULGs) and municipalities with a strong tourism industry. Property tax is levied on individuals owning property, the amount is set by the municipalities considering a legal tax cap. As there has not been a reform since 1973, the property tax is currently under revision and likely to be reformed in the next years.¹⁶⁴ Municipality tax amounted to about EUR 2.5 billion in 2018 whereas property tax amounted to about EUR 600 million (all municipalities except Vienna).¹⁶⁵

Besides shared revenues there is a further intragovernmental transfer system between municipalities and the federal and *Länder* level. Each *Land* determines a levy that all municipalities must transfer, e.g. in order to finance the hospitals run by the *Länder*. In return, the *Länder* and also the national government distribute transfers to support municipal investments. These transfers can be divided into current transfers and capital transfers. Current transfers are meant to finance the maintaining of public services. Capital transfers however are purposed to allow for investments in infrastructure for example. Current transfers amounted to EUR 1.6 billion in 2018 with current transfers from the federal level amounting to 20 per cent and from the *Länder* level to 60 per cent. Municipalities that are not able to break even their budgets (e.g. because of losses in municipality tax revenue or structural issues) are granted additional transfers from the *Länder* to cover the deficit. However, all further investments are subject to approval by the *Länder* level, who monitors the municipality until a sustainable and balanced budget is reached. Through this transfer system, rural local governments (RLGs) benefit stronger as levies are higher for municipalities with more income.

Fees are mainly generated through the provision of public services and utilities such as water, sewerage and waste. There are, however, local authority associations that carry out these services and have their own budget. In this case municipalities make proportionate payments to cover the costs of the associations.

To conclude, important expenditure-incurring tasks such as health care and social protection happen at subnational level, but a minor share is financed through municipal revenues. As a result, municipalities are financially dependent mainly on the shared tax transfers (*Ertragsanteile*) by higher levels of government due to the significant mismatch between revenue raising power and expenditure responsibilities.¹⁶⁶ While the shared tax transfers and local tax incomes are higher in ULGs, after the mandatory transfer (levies, current and capital transfers) the income of RLGs becomes more level with that of urban ones.

Public Spending and Debt

Municipalities cover a wide arrange of tasks from the construction and maintenance of streets to kindergartens, primary schools, residential care homes for elderly people and services like

¹⁶⁴ See Peter Mühlberger and Siegfried Ott, *Die Kommunen im Finanz- und Steuerrecht* (1st edn, DBV 2016); René Geißler and Falk Ebinger, 'Austria' in René Geißler, Gerhard Hammerschmid and Christian Raffer (eds), *Local Public Finance in Europe. Country Reports* (Bertelsmann Stiftung 2019).

¹⁶⁵ See Österreichischer Städtebund, 'Stadtdialog', above.

¹⁶⁶ European Commission, 'Country Report Austria 2019' COM (2019) 150 final.



water supply, sewerage and waste disposal.¹⁶⁷ Highest expenditures are carried out in the fields of services (e.g. water, sewerage, waste), welfare and education.¹⁶⁸ Expenditure has to follow the approved budget. If deviations from the budget occur (e.g. because of unforeseen projects) municipalities have to prepare a revised budget and gain the approval of the local council.

In general, municipalities are only allowed to take on long-term debt for capital spending. Current expenditures cannot be covered with long-term debt. There are rules for short-term loans which have to be paid back within the fiscal year. Furthermore, *Länder* law prohibits the use of risky financial instruments. Over the last ten years municipal debt slightly rose from EUR 11.5 billion in 2009 to 11.6 billion in 2018.¹⁶⁹

Recent Developments

Until 2019 Austrian municipalities followed the rules of a cameralistic system. The budgeting and accounting were done according to a cash-flow oriented system. From 2020 on an accrual system is now implemented. The income statement shows the resource flows within the municipality. The cash flow statement shows the cash inflows and outflows. The balance sheet includes balances of assets, accounts receivable, accounts payable, loans etc. With this shift to a more resource-oriented concept a holistic assessment of municipal accounting is possible.¹⁷⁰

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¹⁶⁷ See Geißler and Ebinger, 'Austria', above.

¹⁶⁸ See Österreichischer Städtebund, 'Stadtdialog', above.

¹⁶⁹ *ibid.*

¹⁷⁰ See Robert Blöschl, Clemens Hödl and Alexander Maimer, 'Mit der VRV 2015 zu mehr Generationengerechtigkeit' in Peter Biwald and others (eds), *Nachhaltig wirken. Impulse für den öffentlichen Sektor* (NWV 2019).



6.3 Budget Transparency with Open Spending Austria

Bernhard Krabina and Robert Blöschl, *KDZ Centre for Public Administration Research Austria*

Relevance of the Practice

Transparency in municipal finances is nothing new in Austria. However, sometimes looking up spending reports must be done in person at the city hall. Especially bigger cities have therefore published spending reports and planned budgets on their website, but data is often locked up in PDF documents, and thus not machine readable, which makes it more difficult to use in analysis or for the creation of data visualizations. Rural municipalities tend not to publish spending reports at all on their websites, even though a regulation exists that requires them to do so.¹⁷¹ Therefore, the only way for citizens of rural areas to inform themselves about municipal spending is to visit municipal offices in person where they can have a look at printouts of the spending reports.

In Austria, the municipalities have to report their budgets to the *Länder*, which deliver these reports to Statistics Austria (the federal statistics office), where they are aggregated and quality checked. An electronic dataset of all the spending data can be purchased at Statistics Austria, who agreed on making this data available to Open Spending Austria in case the individual municipality consents.

With more than 20,000 of the 27,000 datasets on the Austrian open data portal data.gv.at, Open Spending Austria is by far the largest data publisher. From the published data, several interactive visualizations are provided to inform and educate citizens, journalist, researchers, public officers and politicians.

Description of the Practice

In October 2013, the Centre for Public Administration Research (KDZ) launched an open spending portal in Austria holding the spending data of all 2,100 municipalities at www.offenerhaushalt.at. Each mayor has been sent login credentials enabling him or her to view and explore their own municipality's spending data from 2001 and with a few clicks release all data and visualizations on the portal for everyone to see and use.

After seven years of operation, Austria's award winning Open Spending portal covers 56 per cent of all municipalities, representing almost 80 per cent of the population. An analysis of the size of municipalities participating shows that the larger the municipality, the more likely they are participating: 100 per cent of the cities with 20,000 and more inhabitants are on the platform, while only 47 per cent of rural municipalities with less than 2,000 inhabitants are taking part.

¹⁷¹ Austrian Stability Pact 2012, see <https://www.ris.bka.gv.at/GeltendeFassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=20008232>.

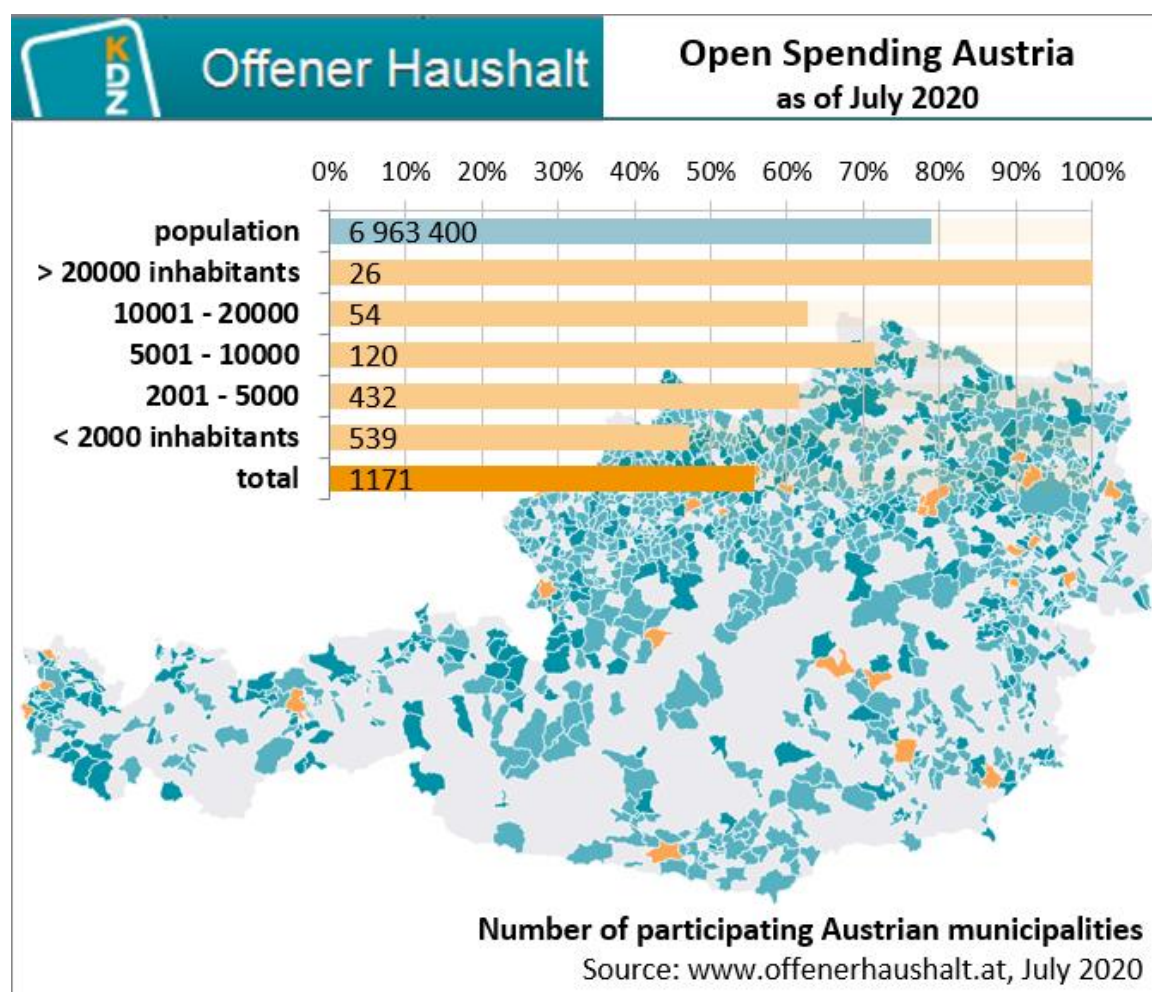


Figure 4: Number of participating Austrian municipalities according to size.

The portal not only makes spending data available online, it also provides several types of interactive data visualizations that make it easier for both local government officials and citizens to understand municipal budgets. The main features available for each municipality are:

- tree map of spending data according to political (functional) classifications (i.e., where does the money go?) including the corresponding economic classifications (i.e., what are the types of expenses?);
- line chart with detailed view of the budgets over a 19-year timeline;
- line chart of the debts and liabilities;
- donut chart of the use of EUR 1,000 of tax money;
- KDZ Quick Test: a systematic approach of the financial soundness of the municipality according to 5 sub-indicators displayed in bar charts;
- the ability to download spending data for each year in CSV format for further reuse (CC-BY license);

the ability to compare certain budget categories across municipalities (for those whose data is also published and only for logged-in users).

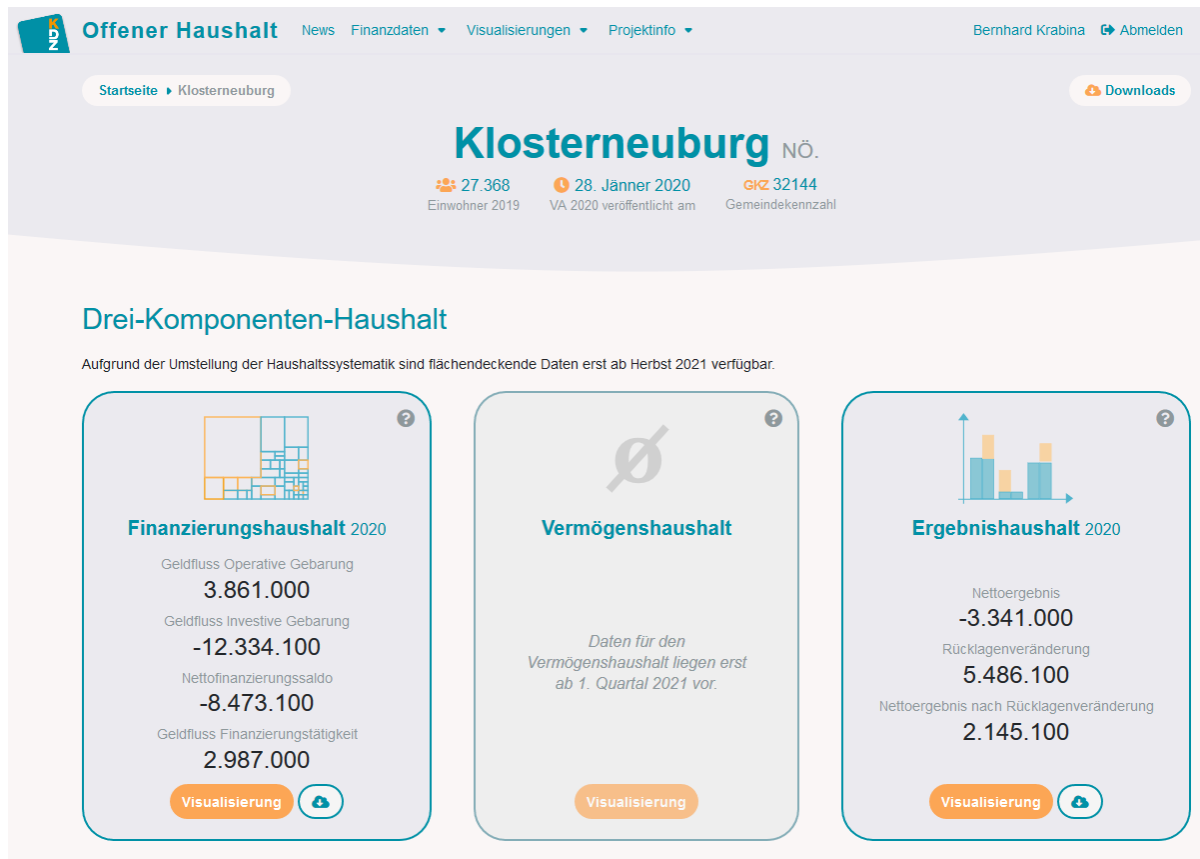


Figure 5: City of Klosterneuburg at Open Spending Austria.¹⁷²

The introduction of the accrual accounting system in Austria as of 2020 made it necessary to implement a major relaunch of the platform. As data currently is only available for the planned budget of 2020, only two of the three budget components can be visualized (see figure above). The two components already available are the cash flow statement (left) and the income statement (right). For the third component (middle, the balance sheet statement), data from the actual spending 2020 will be needed that will be available as of spring 2021.

Assessment of the Practice

The practice can be considered a big success. More than 1,100 municipalities are disclosing their spending data online including several interactive visualizations. It has been awarded several international and national awards and has continuously received media coverage. The platform measures on average 1,400 visits per month.

All 26 municipalities with more than 20,000 inhabitants are on the platform. 971 small municipalities with less than 5,000 inhabitants are using the platform. The smallest municipality only has 41 inhabitants, while the largest one (the City of Vienna) has 1,9 million.

¹⁷² 'Klosterneuburg' (*Offener Haushalt*, 28 January 2020)
<<https://www.offenerhaushalt.at/gemeinde/klosterneuburg>>.



Even though the features of the platform do not differ according to the size, the effects are different: Larger cities who already had a practice of publishing at least the PDF versions of their spending reports on their websites profit more from the benefit of the interactive visualization, while for rural areas, using the platform is most likely to be the first time that they are publishing spending data online at all. Just recently (in June 2020), three small Tyrolean municipalities left the platform due to privacy concerns. It became obvious that the smaller a municipality is, it is more likely that only one person is working in a department. Even though the names of persons are not published in the spending reports, it can be possible to research names of persons working in the municipality from their website and therefore concluded what their wage must be. There is an ongoing discussion among the Austrian Data Protection Authority and the municipal supervisory authority (of the Land Tyrol) about this question, especially because there are regulations in place which indicate that detailed spending data has to be published.

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6.4 Effects of the Intragovernmental Transfer System on Financial Strength

Dalilah Pichler, *KDZ Centre for Public Administration Research Austria*

Relevance of the Practice

The intragovernmental transfer system within the Austrian fiscal equalization mechanism provides a certain particularity in its outcome under the aspect of the urban-rural divide. From shared revenue and own taxes, urban local governments (ULGs) at first have an increased financial strength per capita compared to rural local governments (RLGs). However, the intragovernmental transfer system between the municipalities and their respective regional governments (*Länder*) shifts financial strength per capita substantially towards smaller local governments (LGs) at the expense of larger municipalities. This raises the question on how such a financial arrangement considers the different financial needs of RLGs and ULGs and shall be assessed in this entry.

Description of the Practice

The shared revenues are transferred to municipalities within the framework of the Fiscal Equalization Act (*Finanzausgleichsgesetz, FAG*) as a share of the federal taxes (such as value added tax, income tax, etc.). The tiered population scheme is used to compensate larger municipalities for the additional expenditure as regional or urban centers. While each municipality independent of its size finances the basic public services such as water supply, wastewater and waste management with cost-effective fees, the shared revenues can be used for other, less cost-effective public services. Regional or urban centers typically offer more public facilities for sports and leisure, child care services and cultural activities. These are also used by the residents of the surrounding municipalities within the commuter belt. Therefore, the idea of the tiered population scheme is that large cities receive a higher share of the revenue per capita than small municipalities without a corresponding function as regional center.

An essential indicator for the financial performance of a municipality is the financial strength per capita. This shows the extent to which a municipality can meet its financial needs from its own taxes (especially municipal tax and property tax) and shared revenues. The higher the financial strength per capita, the better a municipality is equipped with financial resources and can thus secure ongoing operations, but also make investments. However, the complex transfer system between municipalities and regional governments – which comes after the national distribution of shared revenues – leads to significant shifts in the financial resources of municipalities. On the one hand, regional governments receive current transfers from each municipality based on their financial strength per capita. Therefore, the more financial resources a local government has, the more it has to pay into these ‘regional funds’. These



transfers are mainly used for expenditures of hospitals or social welfare, which are services provided by the regional government. On the other hand, municipalities also receive capital transfers for investments. These typically co-finance infrastructure projects such as roads, public buildings or protective structures against natural disasters. Also current transfers from the regional governments are possible, e.g. to foster regional cooperation, co-finance child care expenses, support municipalities if they cannot reach a balanced budget or fund economically disadvantaged regions.

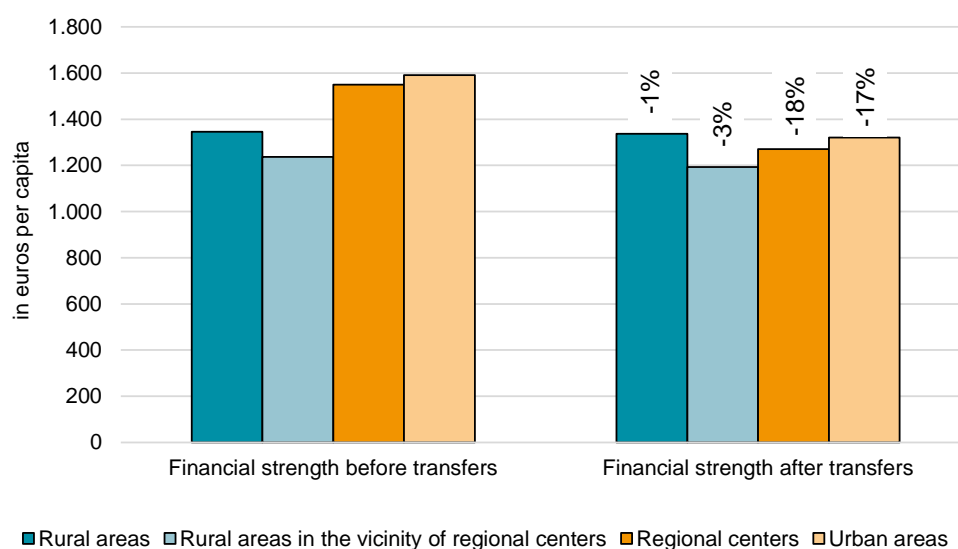


Figure 6: Financial strength in 2019 before and after transfers in euros per capita based on urban-rural typology¹⁷³

Overall, the intragovernmental transfers show a strong balancing effect of financial resources. The result of this regulation is a reduction of the differences in financial strength between the municipalities and a shift of funds from financially strong to financially weak municipalities. The impact of this transfer system on the municipalities financial strength is therefore significant. The above figure depicts the disproportionate burden for regional centers and urban areas. On the left, the financial strength before transfers shows a higher financial strength for regional centers and urban areas. The right part depicts the same indicator after intragovernmental transfers. The financial strength is reduced by 18 per cent in regional centers and 17 per cent in urban areas. However, as the majority of Austrian municipalities are categorized as rural areas (59 per cent) and rural areas in the vicinity of regional centers (26 per cent),¹⁷⁴ the impact of transfers within these categories is not visible. In total, the transfer system equalizes the financial strength in an urban-rural typology, not regarding the different services urban and rural areas provide.

The next figure additionally shows the effect of the intragovernmental transfers between municipalities and their regional government according to population size. The left part of the figure (financial strength before transfers) shows that the financial strength per capita basically increases with the size of the municipality. The fact that the smallest municipalities with up to

¹⁷³ Own adaptation, based on Statistik Austria, 'Gemeindefinanzdaten' (2019).

¹⁷⁴ Based on urban-rural typology of Statistik Austria 2016.



500 inhabitants have higher values is due to the high proportion of touristic municipalities, which can fall back on higher own tax revenues. The increase in financial strength per capita, especially from 10,000 inhabitants onwards, is due to the tiered population scheme in the context of fiscal equalization of shared revenues.

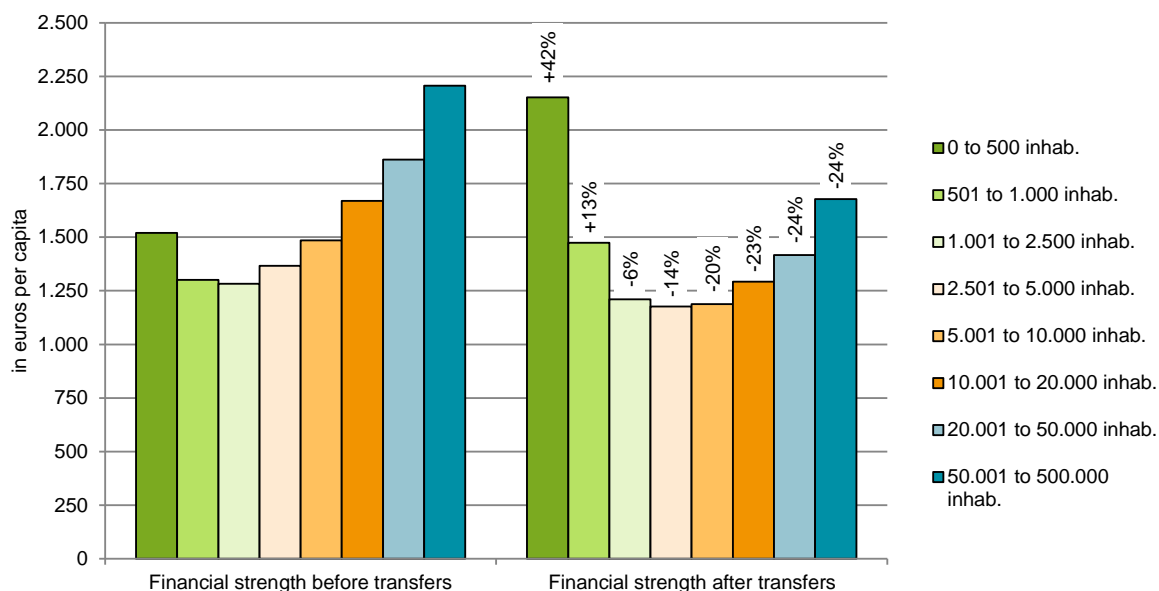


Figure 7: Financial strength in 2019 before and after transfers in euros per capita based on population size¹⁷⁵

In 2019, the municipalities paid EUR 3.7 billion as transfers to the *Länder*, in particular current transfers for hospitals, for welfare and a so-called general duty for the *Länder*. In return, EUR 1.8 billion flowed from the *Länder* to the municipalities mainly through capital transfers and partly as current transfers. In sum, 35 per cent of the municipalities' revenue shares from the national fiscal equalization process are reduced on average after the regional transfer system.¹⁷⁶

The right part of the above figure shows the financial strength after transfers. It can be seen that the financial resources according to population size change significantly as a result of the transfer system. There is a U-shaped form, as the financial strength of smaller municipalities with up to 1,000 inhabitants is increased. The per capita financial strength of the average municipality with up to 500 inhabitants increases by 42 per cent, that of the average municipality with up to 1,000 inhabitants by 13 per cent. In all other population classes, there is a decrease of financial strength. For municipalities with over 5,000 inhabitants, the reduction is between 20 to 24 per cent.

Assessment of the Practice

¹⁷⁵ Mitterer and Seisenbacher, 'Gemeindefinanzdaten 2021', above.

¹⁷⁶ Mitterer and Seisenbacher, 'Gemeindefinanzdaten 2021', above.



The fiscal equalization mechanism distributes the shared revenues to all levels of government. Because of a tiered population scheme, larger municipalities receive a larger share of these revenues. The original financial resources from the fiscal equalization are significantly changed based on the intragovernmental transfer system between *Länder* and their municipalities. This practice reduces the municipal autonomy by limiting the financial leeway. Also, it reduces the financial strength of medium-sized and large cities. It is true that small municipalities in rural areas struggle with thin settlement structures or provide large infrastructures for tourism. However, medium-sized cities have to maintain the function as a regional center, providing infrastructure in different areas of public interest for the surrounding municipalities.

Linking financial resources and actual public service provision is currently not planned, even though a financial equalization scheme with a stronger orientation towards actual service provision has been in discussion for a long time. In particular, there is a call for more transparency and the reduction of complexity through a harmonized framework for all regional governments.¹⁷⁷ A linkage between municipal tasks to be fulfilled as part of (mandatory) public service delivery and finances would ultimately lead to improved management and more efficient and effective use of resources.

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¹⁷⁷ Bröthaler and others, 'Funktionsweisen und finanzielle Entwicklungen im Finanzausgleichssystem', above.



6.5 The Role of EU Structural Funds for Austrian Local Governments and its Contribution to the Urban-Rural Interplay

Nikola Hochholdinger and Alexandra Schantl, *KDZ Centre for Public Administration Research Austria*

Relevance of the Practice

The Austrian financial equalization system provides financial resources to finance local governments tasks. Due to the specific framework conditions and challenges of urban local governments (ULGs) and rural local governments (RLGs), the question of how these funds can be distributed fairly between ULGs and RLGs seems to be a never-ending story. While RLGs want to have their structural challenges due to the rural exodus compensated by this intragovernmental transfer system, ULGs want to be reimbursed for their increased need for infrastructure development and their additional tasks due to the influx of people. However, there is a second level of redistribution in the form of an extensive subsidy system that leads to differentiated distribution effects with regard to urban and rural areas.

In this context EU funding has become more and more important over the last decades, in particular with regard to regional policy and development. For the EU-funding period 2014-2020 Austria has benefitted from the European Structural and Investment Funds (ESIF) through four national programs with 4.92 billion supplemented¹⁷⁸ by EUR 5.74 billion of national co-financing.¹⁷⁹ The biggest part of the funding has been dedicated to the European Agricultural Fund for Rural Development (EAFRD) with 72.5 per cent, around 20 per cent to the European Regional Development Fund (ERDF) and 8.2 per cent to European Social Fund (ESF). With less than one per cent of the planned funding, the European Maritime and Fisheries Fund (EMFF) is the smallest and least relevant program in Austria.

To implement both innovative inner-city and urban-regional initiatives in Austria the ESIF plays a decisive role. The scope of urban regional action according to integrated multi-level approaches in the administration (multi-level governance) in Austria would be considerably lower without start-up funding from the EU.

However, the current funding structures and frameworks (complex intervention logic, multiple funding authorities/agencies, lack of coherence between the various EU funds and instruments) as well as the lack of long-lasting rollover funding or follow-up investments, hinder the sustainable use of EU funds both for the integrated development of urban regions and for bridging the urban-rural gap.

¹⁷⁸ European Commission, 'Country Data for Austria' (*European Structural and Investment Funds*, last updated 2021) <<https://cohesiondata.ec.europa.eu/countries/AT#>> accessed January 2021.

¹⁷⁹ Peter Mayerhofer, Julia Bachtrögler, Klaus Nowotny, and Gerhard Streicher, 'Quantitative Wirkungen der EU-Struktur- und Kohäsionspolitik in Österreich – ein Beitrag zu 25 Jahre Österreich in der EU' (WIFO 2020) 11.



Description of the Practice

A recently published study¹⁸⁰ on quantitative effects of ESIF-funding in Austria has shown that EU funding in Austria clearly contributed to reduce spatial disparities in Austria over the last 25 years. According to the EU Rural-Urban-Typology the highest funding intensity – spending per capita – of the ESIF funds was found in peripheral rural areas (see figure below). This also indicates that RLGs ultimately benefited more from the funding than ULGs due to the different thematic and geographical orientation of the single ESIF programs.

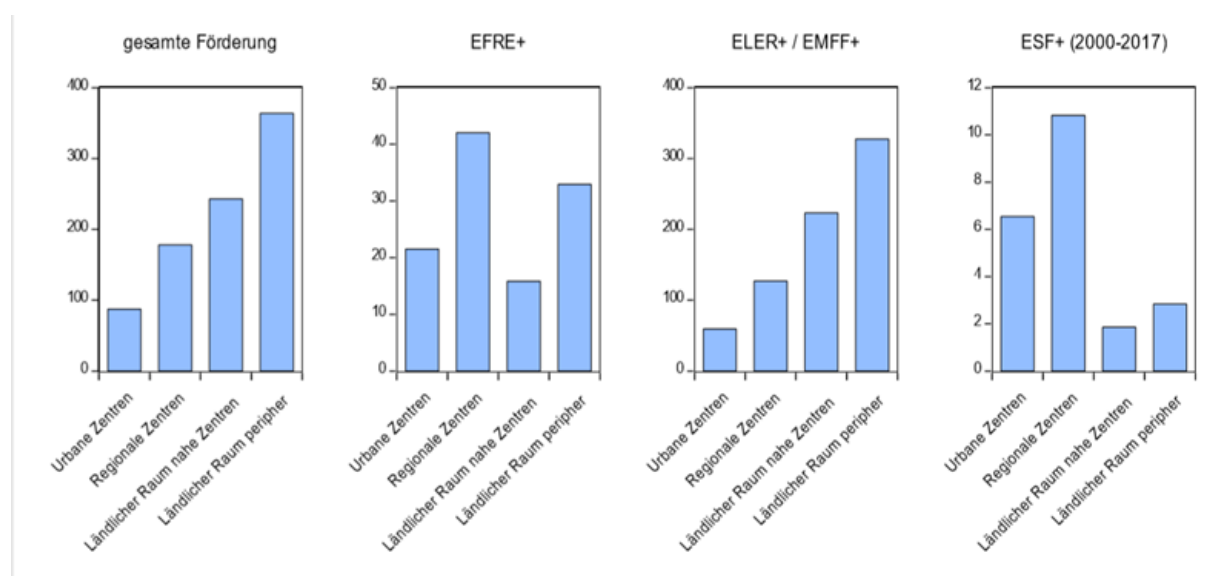


Figure 8: Funding intensity of ESI in Austrian districts 1995-2017¹⁸¹

Since social, ecological and economic processes and challenges correspond less and less to administrative borders, also in Austria with the 2014-2020 funding period EU funds have been increasingly dedicated to functional areas as well as to the cooperation of ULGs with their - often rural - surrounding areas in order to strengthen territorial and social cohesion.

For urban-regional (urban-rural) measures it has been mostly resources from the European Structural and Investment Fund that come into effect; respectively from the ERDF and the EAFRD. Thus, the Austrian program 'Investment in Growth and Jobs' (Article 7 - Integrated and sustainable urban development) has supported, for instance, the Upper Austrian urban regions and urban-rural cooperation in Tyrol (CLLD)¹⁸². The cooperation between the City of Villach and its surrounding regions works with LEADER¹⁸³ resources from the EAFRD. Other functional spaces that go beyond the Austrian national borders, such as the cooperation in the area of the Lienz Valley with Bruneck in South Tyrol, are supported by the EU's Interreg programs.

However, EU funding shall not and cannot replace national funding. In order to be able to continue successful EU initiatives and projects even after EU funding has phased out, the 'EU

¹⁸⁰ Mayerhofer and others, 'Quantitative Wirkungen der EU-Struktur- und Kohäsionspolitik in Österreich', above.

¹⁸¹ *ibid.*

¹⁸² Community Led Local Development Instrument.

¹⁸³ *Liaison entre actions de développement de l'économie rurale* – instrument of the EAFRD.



start-up funding' needs to be secured in the long term through national (reform) programs. This applies above all to the integrated development of functional areas. A good example of how EU funds contribute to sustainable investment both in ULGs and RLGs is the Styrian Regional Development Law that came into force in 2018. The purpose of this law is to create the best prerequisites for a targeted cooperation between all governmental authorities (*Land*/region/local governments) concerned with economic and social development. A yearly amount of EUR 12 million is available for these tasks, distributed among the seven Styrian regions and spent on their own responsibility. The law incorporates citizens' participation as an essential issue for the regions. The main superordinate goal is to equalize regional imbalances and to govern structural spatial development. The tasks are set on two levels:

- the regional government level (*Land* Styria): Development strategy framework for the entire province, coordination of regional strategies and spatial policies, tuning of flagship projects;
- the regional level: Coordination and enforcement of inter-municipal cooperation within the region, elaboration and realization of regional development strategies, proposals for appropriate projects, permanent monitoring.

The regional tasks are performed by so-called *Regionalverbände* (regional authority associations) and their authority independent bodies, the president, the board and the assembly. In the assembly the mayors and councilors of the participating municipalities are represented. There are currently seven *Regionalverbände*. Financial resources can be used for management tasks as well as for projects to benefit the regional populations (e.g. mobility improvement, logistic concepts, social procurement etc.). Since the available regional budget can also be used as co-financing for EU projects, there is additional funding for local projects and investments. Furthermore, the potential and willingness of both ULGs and RLGs to use EU funds for their local projects increases.

Assessment of the Practice

Although EU funding plays a minor role in Austria in relation to national funding, it has successively become more important in the last decades, especially in regional policy and development. Local governments have benefited from ESIF-funding through many different projects and conjoint initiatives and EU-funded projects have been crucial catalysts and promoters for starting innovative processes and implementing new and cooperative government structures especially on the regional level both in Austria and cross-border.

However, there are differences between ULGs and RLGs in absorbing EU-Funds. While RLGs benefit from the largest ESIF program in Austria – the EARDF – the funding opportunities for ULGs are limited for two reasons: the ERDF funds in Austria, where ULGs are potential beneficiaries, still focus on economic support for SMEs and research measures, while funds for sustainable urban development measures and investments are very limited. On the other side



the majority of the EAFRD funds go to small RLGs, although ULGs with up to 30,000 inhabitants would be eligible.¹⁸⁴

With the new approach on supporting functional areas since the last funding period 2014-2020 it seems that also ULGs will benefit better from EU-funding in future and that this territorial approach could not only strengthen cooperative regional governance but also cushion the urban-rural divide.

However, to successfully and sustainably use EU funding for functional areas improvements are still needed. This demand is also in line with both the current position paper of the Austrian Association of Cities and Towns¹⁸⁵ for the funding period 2021-2027 and the findings of a recent Austrian Conference on Spatial Planning (ÖROK) study¹⁸⁶ that requests to strengthen the resource potentials of regions as actors for the attainment of programming objectives in order to improve the effectiveness of funding on local and regional level.

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¹⁸⁴ Ministry of Agriculture, Regions and Tourism, 'Austrian Programme for Rural Development 2014-2020' 73.

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¹⁸⁶ Österreichische Raumordnungskonferenz ÖROK, 'Die regionale Handlungsebene stärken – Status, Impulse und Perspektiven' (publication series no 208, ÖROK 2020) 12.



Österreichische Raumordnungskonferenz ÖROK, 'Die regionale Handlungsebene stärken – Status, Impulse und Perspektiven' (publication series no 208, ÖROK 2020)
<https://www.oerok.gv.at/fileadmin/user_upload/OEROK_SR_NR.208_2020_Reg_HE_online-Version.pdf>



7. Local Financial Arrangements in Poland

7.1 The System of Local Government in Poland

Andżelika Mirska, *University of Warsaw*

Types of Local Governments

Poland is a unitary state without any autonomous entities. As a consequence, a uniform system of territorial self-government exists throughout Poland. The traditions of territorial self-government date back to 1918 when, after 123 years of political oblivion, the Polish state was established. After World War II, Poland was an undemocratic and centralized state which led to, among other things, the liquidation of territorial self-government. The reconstruction of territorial self-government began in Poland with the political transformation after 1989. The first stage was the restoration of territorial self-government in communes (*gmina*) in 1990, then in 1999 the self-government in counties (*powiat*) and in voivodeships (*województwo*) was introduced.

The current Constitution of the Republic of Poland of 1997 introduces two types of territorial self-government, namely *local* self-government and *regional* self-government (Article 164). Currently in Poland (since 1999), territorial self-government is three-tier and it is structured as follows:

- self-government in communes as the basic level of local self-government;
- self-government in counties the second level of local self-government;
- self-government in voivodeships as regional self-government.

In addition, large municipalities (over 100,000 residents) may be granted the status and tasks of a counties (city with *powiat* rights/cities with *powiat* status).

Therefore, there are four levels of political representation in Poland: the state and three levels of territorial self-government.

At present (2020), there are 2,477 communes (*gmina*), including 1,555 rural *gminas*, 621 urban-rural *gminas* and 302 urban *gminas*. The population of *gminas* ranges from 1.7 million (the Capital City of Warsaw) to 1,300, and the average population of a Polish *gmina* amounts to 15,000. It means that in the comparison to other European countries, Poland's *gminas* are relatively large. If we take into account only urban *gminas*, the average population is 61,000, whereas in rural *gminas* the average population amounts to approximately 7,000. At the beginning of the political transformation in Poland in 1990, there were 2,383 *gminas*. It means that modifications introduced in the division into *gminas* have been rather minor.

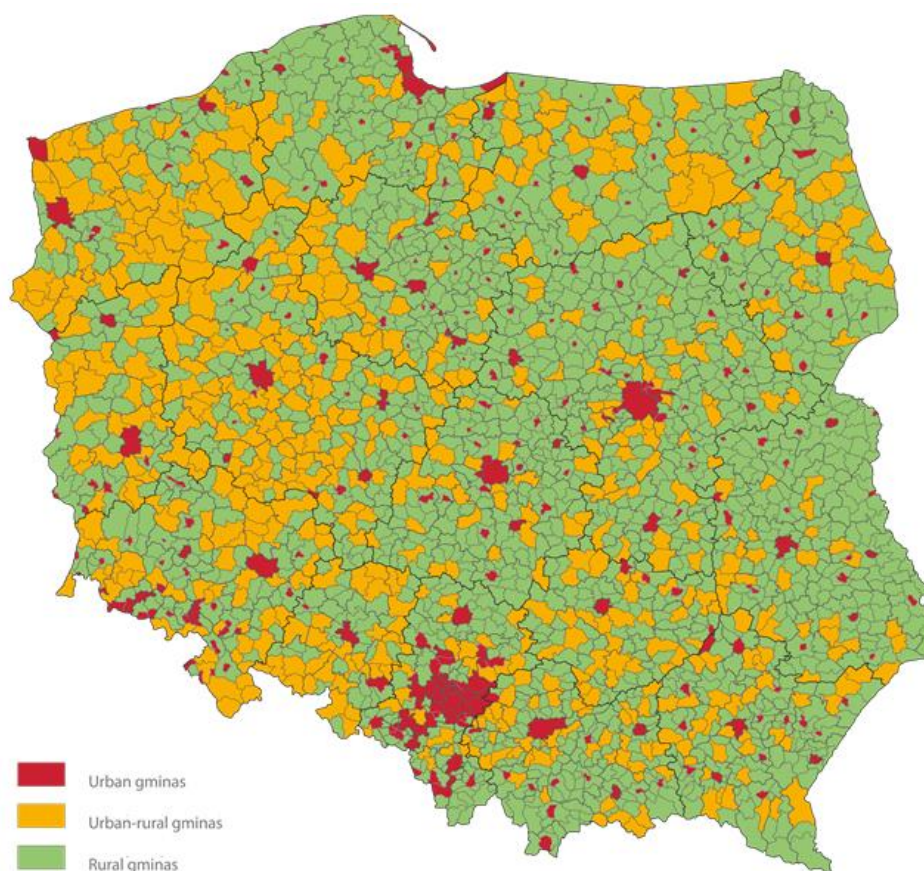


Figure 1: Spatial delimitation of *gminas* in Poland¹⁸⁷

The second tier of the local government, i.e. the level of counties (*powiat*), was established in Poland in 1999. At present, there are 314 *powiats* and 66 cities with *powiat* status. The population of *powiats* range from 21,500 to 373,500. The average population of a Polish *powiat* amounts to 82,000, whereas cities with *powiat* status have on average 191,000 inhabitants. When the territorial reform was being prepared in 1999, it was the establishment of *powiats* (as intermediate units between *gmina* and voivodeship) which gave rise to the greatest controversies. Dissenting voices against the introduction of an additional level of territorial structure (and, in consequence, a local government unit) were not rare. Even now the issue of *powiats* is under public debate, mainly due to the problem of the financing of *powiat* local government as well as functional weakness of smaller *powiats* (Polish *powiats* are small units in comparison to their counterparts in other European countries). The formation of seven new *powiats* in 2002 was the last major modification in the map of *powiats*.

The third level of territorial structure applies to voivodeships (*województwo*). The voivodeships correspond to the NUTS-2 regions (according to the European Nomenclature of Territorial Units for Statistics),¹⁸⁸ which are the basis for regional operational programs co-financed by

¹⁸⁷ 'Types of *gminas* and urban and rural areas' (*Statistics Poland*, 2020) <<https://stat.gov.pl/en/regional-statistics/classification-of-territorial-units/administrative-division-of-poland/types-of-gminas-and-urban-and-rural-areas/>> accessed 2 November 2019.

¹⁸⁸ Eurostat, 'Background' <<https://ec.europa.eu/eurostat/web/nuts/background>> accessed 2 November 2019.



the European Union. The year 1999 marked a crucial point in shaping the territory and political system of voivodeships. After lengthy preparations accompanied by political disputes, it was decided to form 16 voivodeships. It meant a departure from territorial fragmentation on a regional level (in the years 1975-1999 there were as many as 49 voivodeships in Poland). As a result of an enlarged territory, voivodeships as regions gained the right to self-government—thus, another stage of decentralization of Poland was reached. So far, the number of voivodeships has not been changed.¹⁸⁹

Legal Status of Local Governments

The inclusion of the principle of subsidiarity¹⁹⁰ in the preamble to the Constitution of the Republic of Poland of 1997 and the principle of decentralization¹⁹¹ in the first chapter of the Constitution is of key importance for the legal status of self-government in Poland. Article 16 provides legal guarantees for local authorities: '(i) The inhabitants of the units of basic territorial division shall form a self-governing community in accordance with law. (ii) Local government shall participate in the exercise of public power. The substantial part of public duties which local government is empowered to discharge by statute shall be done in its own name and under its own responsibility.'

A comprehensive regulation concerning territorial self-government is contained in Chapter VII ('Local government') of the Constitution of the Republic of Poland of 1997.

Territorial self-government is based on democratic legitimacy. At each level, residents elect a representative body (the number of councilors currently ranges from 15 to 51, with the exception of Warsaw with 60 councilors). In addition, the head of the executive body (mayor) has been elected directly by the residents at the *gmina* level since 2002. Moreover, the Constitution of Poland guarantees residents of *gminas*, *powiats* and voivodeships the right to directly settle matters through the institution of a local referendum. A referendum on self-taxation of residents for public purposes is a special type of the local referendum. However, such a referendum can only be held at the *gmina* level.

Local government shall perform public tasks not reserved by the Constitution or statutes to the organs of other public authorities (Article 163 of the Constitution of the Republic of Poland of 1997). *Gmina* self-government, which has been granted the presumption of competence in matters of territorial self-government, is of fundamental importance. Article 164 establishes the following: '(i) The commune (*gmina*) shall be the basic unit of local government. (ii) Other units of regional and/or local government shall be specified by statute. (iii) The commune shall perform all tasks of local government not reserved to other units of local government.'

¹⁸⁹ Mirska Andżelika, 'State policy on the formation and modernisation of Polish territorial structure' in Europäisches Zentrum für Föderalismus-Forschung Tübingen EZFF (ed), *Jahrbuch des Föderalismus 2018: Föderalismus, Subsidiarität und Regionen in Europa* (Nomos 2018).

¹⁹⁰ 'Hereby establish this Constitution of the Republic of Poland as the basic law for the State, based on respect for freedom and justice, cooperation between the public powers, social dialogue as well as on the principle of subsidiarity in the strengthening the powers of citizens and their communities'.

¹⁹¹ Article 15: 'The territorial system of the Republic of Poland shall ensure the decentralization of public power'.



Territorial self-government units are subject to the Constitution of the Republic of Poland and the Acts of the Polish State. Three system acts are of fundamental importance:

- the Act of 8 March 1990 on *Gmina* Self-Government,
- the Act of 5 June 1998 on *Powiat* Self-Government,
- the Act of 5 June 1998 on Voivodeship Self-Government.

The only criterion of supervision over the activity of self-government is the criterion of legality, supervision is exercised by government administration authorities (the Prime Minister, voivodes¹⁹² and regarding financial matters - regional audit chambers). However, any disputes between the government administration and territorial self-government shall be settled by an administrative court. There are no authoritative interrelations between the tiers of territorial self-government – only voluntary cooperation is possible.

The Constitution divides public tasks performed by self-government into own tasks (financed from the budget of a self-government unit) and commissioned tasks (financed from the state budget).

Gmina self-government performs a wide range of public tasks which include, among others, issues related to local technical infrastructure, social infrastructure, education, health and order protection and safety. In accordance with the principle of subsidiarity, the *powiat* self-government 'assists' *gmina* in performing local tasks that exceed the capacity of a *gmina* ('supra-communal' local tasks). While the self-government of *gmina* and *powiat* implements a number of public services for local communities on an ongoing basis, the main role of voivodeship self-government is to facilitate economic development of regions. Among other things, the task of the voivodeship self-government is to manage EU structural funds.

(A) Symmetry of the Local Government System

There are three types of *gminas*:

- urban *gminas* (their boundaries correspond with the boundaries of the city forming the municipality);
- urban-rural *gminas*, which include both cities within administrative boundaries and areas outside city boundaries;
- rural *gminas* without cities within their territory.

Cities in Poland are towns and cities with city rights (granted by the central government). However, it is a formal classification based solely on an administrative criterion. The Act on *Gmina* Self-Government does not differentiate the tasks of according to this classification – all *gminas* have the same scope of activity. The exceptions are large urban *gminas* which also have the status of *powiat* (city with *powiat* rights). They carry out the tasks of both *gmina* and *powiat*. Currently, there are 66 of them and the general criterion for their establishment is a

¹⁹² The voivodes (16) shall be the representative of the Council of Ministers in voivodeships. They are appointed by the Prime Minister. *Voivodeships* are the highest-level administrative subdivision of Poland.



population over 100,000. However, some local government politicians claim that this threshold should be reduced to 50,000¹⁹³.

On the other hand, the need is recognized to merge the cities with the *powiat* rights and *powiats* whose authorities are seated in the said cities due to significant disproportions in the institutional potential of *powiats*. Government analyses indicated a significantly higher potential of cities with *powiat* rights and a particularly low potential of *powiats* without large urban centers. The data show that *powiats* without large cities have significantly scarcer resources allocated to the fulfilment of public tasks of *powiats*¹⁹⁴.

Public tasks may be performed by individual self-government units independently or by way of cooperation with other self-government units (inter-municipal cooperatives). Self-governments of a given level may cooperate with each other (cooperation between *gminas*, between *powiats*, between voivodeships). Moreover, cooperation between the levels is also possible: since 2016, unions of *powiats* and *gminas* may be established. The form of the *powiat-gmina* union is intended for the implementation of tasks that exceed the competence of one tier of self-government. The aim was to enhance the independence and operational flexibility of territorial self-government units. It can also be interpreted as an attempt to address the problems occurring mainly in metropolitan areas.

The legal form of the union of *gminas* (union of *powiats*, union of *gmina* and *powiat*) requires the establishment of a new legal person to perform part of the tasks of the self-government. Unions of *gminas* are a very popular form of performing self-government tasks (currently there are 313 of them in Poland and they include from 2 to 49 *gminas*). There are 7 *powiat* unions and 8 *powiat-gmina* unions. Their tasks involve mainly the organization of common local public transport. The same applies to education as only a uniform system of education from primary schools (which is the responsibility of *gminas*) to secondary schools (which are subject to *powiats*) can resolve demographic problems or fulfil the expectations of the local labor market.

The performed public tasks may also be modified through 'delegating' public tasks by a territorial self-government unit to another territorial self-government unit. This is done by way of a voluntary agreement.

'Commissioning' tasks to the self-government by the government administration is a different matter – if they are commissioned by virtue of the law, they are imposed on the self-government 'from the top' (together, of course, with financial resources from the Polish state budget). Polish self-governments indicate that those funds are often insufficient.

¹⁹³ 'Interpelacja nr 5867 do Ministra Spraw Wewnętrznych i Administracji' (*Sejm Rzeczypospolitej Polskiej*) <<http://orka2.sejm.gov.pl/IZ5.nsf/main/2AE373E5>> accessed 1 July 2019.

¹⁹⁴ 'Zasadniczy, trójstopniowy podział terytorialny państwa' (*Ministerstwo Spraw Wewnętrznych i Administracji*, 31 May 2001) <<https://archiwum.mswia.gov.pl/pl/aktualnosci/1644,dok.html>> accessed 1 July 2019.



Political and Social Context in Poland

Compared to other countries, the national political parties are in Poland not very strongly represented at the local government level.¹⁹⁵ To gain a stronger voice, self-governments attempted to create a nationwide political movement of mayors of large cities. For example, in 2011 Union of Mayors – Citizens to the Senate¹⁹⁶ (*Unia Prezydentów – Obywatele do Senatu*) was established and it put forward its candidates in the elections to the upper house of the Polish Parliament – Senate (majority voting system applies). The Local Government Movement ‘Non-Partisans’ (*Ruch Samorządowy ‘Bezpartyjni’*) was also established, consisting of mayors and councilors. The purpose of the movement is to be an alternative to political parties in local government elections (primarily at the level of the voivodeship self-government).

However, if we analyze the results of local government elections, the influence of national political parties clearly diminishes, the lower the level of government. Starting from the highest level, i.e. the 16 voivodeship self-governments, it is basically political parties that dominate the elections to the voivodeship assemblies. In the local government elections of 2018, candidates of national parties received a total of 89.4 per cent of votes. The Local Government Movement ‘Non-Partisans’ gained 5.28 per cent of the country's vote. Regional groupings received marginal support, except for three voivodeships. In the Opolskie Voivodeship, ‘The German Minority Electoral Committee’ traditionally receives strong support (in 2018 – 14.64 per cent). In two other voivodships, regional movements concentrated around local politicians obtained: 8.29 per cent of votes (the Lower Silesian Voivodeship: Electoral Committee of Voters ‘*With Dutkiewicz for Lower Silesia*’¹⁹⁷) and 5.26 per cent of votes (the Świętokrzyskie Voivodeship: Electoral Committee of Voters ‘*Wenta*’¹⁹⁸s *Świętokrzyskie Project*’).

At the *powiat* level, the presence of parties in the elections is weaker, in the 2018 elections the national parties won about 62 per cent of votes. At the level of *gminas*, the parties have obviously the smallest influence – local election initiatives prevail. In *gminas* with up to 20,000 inhabitants (single-mandate constituencies) national parties won about 27 per cent of votes. In *gminas* with over 20 000 inhabitants the figure was approx. 50 per cent.¹⁹⁹ In rural *gminas*, traditionally, the peasants’ party – the Polish People’s Party (*Polskie Stronnictwo Ludowe*) – has played an important role. In the last elections, the importance of the Law and Justice Party

¹⁹⁵ Bukowski Michał, Jarosław Flis, Agnieszka Hess and Agnieszka Szymańska, *Rządzący i opozycja, partie sejmowe i lokalne w małopolskich wyborach samorządowych 2014* (Attyka 2016) 24.

¹⁹⁶ The Senate is the upper house of the [Polish Parliament](#), the lower house is the [Sejm](#). The Senate and the Sejm exercises legislative power in Poland. The Members of both houses are elected by direct election. The Senate consists of 100 senators, the Senate - 460 deputies.

¹⁹⁷ Rafał Dudkiewicz was from 2002 to 2018 the Mayor of Wrocław, the capital city of the Lower Silesian Voivodeship.

¹⁹⁸ Bogdan Wenta having run from his own committee and was *elected* as Mayor of Kielce, the capital of the Świętokrzyskie Voivodeship. For years related with handball, first as a player of the Polish national team and Germany. 2004 - 2012 was the coach of the Polish national handball team. One of the best handball player in history of Polish handball.

¹⁹⁹ National Electoral Commission, ‘The Results of Local Elections 2018’ (*Local Government Elections 2018*, 30 June 2018) <<https://wybory2018.pkw.gov.pl/pl/dane-w-arkuszach>> accessed 14 December 2019.



(*Prawo i Sprawiedliwość*) has increased, reflecting the situation at the national government level.

The number and share of rural population in the total population of the country is declining. At the end of 2017, the rural population accounted for 39.9 per cent (in 1950 over 63 per cent)²⁰⁰. The *gminas'* population forecasts of the Polish Central Statistical Office (GUS) for 2017-2030 indicate, above all, a strong development of major urban agglomerations with adjacent areas. They will continue to attract people from more peripheral areas. At the same time, a continuation of the suburbanization process should be expected, which will lead to a significant increase in population in the *gminas* adjacent to big cities.²⁰¹ These changes are caused by lower prices of flats or house building costs and reflect the growing economic status which enables inhabitants to move to an area more beneficial in terms of being a 'greener environment'.²⁰² In 2018, 55 cities with *powiat* rights (there are 66 cities of this type in total) recorded a decrease in population compared to the previous year. These included cities that aspire to play the role of a metropolis (Poznań, Łódź, Bydgoszcz). Warsaw, the capital city of Poland recorded an increase. The number of *gminas* with less than 5,000 inhabitants is steadily growing. There are already approx. 800 of them.

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²⁰⁰ Stańczak Joanna and Znajewska Agnieszka, 'Population in Poland: Size and Structure by Territorial Division as of June 30, 2017' (Central Statistical Office, 2017)
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²⁰¹ 'Prognoza ludności gmin na lata 2017-2030' (*Statistics Poland*, 31 August 2017) <<https://stat.gov.pl/obszary-tematyczne/ludnosc/prognoza-ludnosci/prognoza-ludnosci-gmin-na-lata-2017-2030-opracowanie-eksperymentalne,10,1.html>> accessed 1 December 2019.

²⁰² Małgorzata Waligórska, Zofia Kostrzewa, Maciej Potyra and Longina Rutkowska, 'Population Projection 2014-2050' (Central Statistical Office 2014) <<https://stat.gov.pl/obszary-tematyczne/ludnosc/prognoza-ludnosci/prognoza-ludnosci-na-lata-2014-2050-opracowana-2014-r-,1,5.html>> accessed 1 December 2019.



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7.2 Local Financial Arrangements in Poland: An Introduction

Andżelika Mirska, *University of Warsaw*

Legal Basis

The issue of financing the activities of local government in Poland was addressed in Article 167 of the Polish Constitution: 'Units of local government shall be assured public funds adequate for the performance of the duties assigned to them. Alterations to the scope of duties and authorities of units of local government shall be made in conjunction with appropriate alterations to their share of public revenues. The revenues of units of local government shall consist of their own revenues as well as general subvention and specific (targeted) grants from the State Budget of Poland. The sources of revenues for units of local government shall be specified by act.'

Since the reactivation of local government in 1990, the fourth act in this respect has been in force. Currently, it is the Act of 13 November 2003 on the Revenues of Local Government Units. It introduces a separate system of financing of *gminy* [communes, municipalities] (including cities with *powiat* rights), *powiats* [counties], voivodships and regulates the mechanism for the elimination of income disparities between local government units.

General Structure of Public Finances

In Poland, the ratio of revenues and expenditures of local governments (*gmina*, *powiat* and voivodeship self-governments) to GDP is fairly high. In 2018, the revenue of all local government units calculated according to the methodology adopted by the European Union amounted to PLN 251.8 billion, which corresponded to 11.9 per cent of GDP (in 2008 – 13.9 per cent, in 2015 – 12.7 per cent, in 2016 – 11.5 per cent, in 2017 – 11.6 per cent)²⁰³. This clear downward trend in the years 2008-2017 was primarily attributable to the effects of the global economic crisis. The Polish local government sub-sector is also characterized by an expenditure-to-GDP ratio higher than the EU average. Again, there is a downward trend in the value of the ratio (from 14.1 per cent in 2009 to 12.7 per cent in 2015).²⁰⁴

In comparison to other EU countries, in Poland the ratio of local government units' revenues to GDP is higher than the EU average. Out of the 21 EU unitary states with a significant range

²⁰³ All statistical data prepared by the author on the basis of official documents of state authorities: Annual 'State Budget Execution Analysis' prepared by the Supreme Audit Office, <<https://www.nik.gov.pl/kontrola/analiza-budzetu-panstwa>>; Annual reports of the Statistics Poland (the Central Statistical Office), 'Financial Economy of Local Government Units', <<https://stat.gov.pl/en/topics/national-accounts/general-government-statistics/financial-economy-of-local-government-units-2018,2,15.html>>; Annual reports of the Ministry of Finance, <<https://www.gov.pl/web/finanse/sprawozdania-roczne>> and Annual reports of Regional Accounting Chambers, <https://www.rio.gov.pl/modules.php?op=modload&name=HTML&file=index&page=publ_sprawozdania> accessed 1 December 2019.

²⁰⁴ Poniatowicz Marzanna, 'Stabilność finansowa jednostek samorządu terytorialnego w aspekcie nowej perspektywy finansowej Unii Europejskiej i zmian w systemie dochodów samorządowych' (2016) 125 *Ekonomiczne Problemy Usług* 7 <<https://wnus.edu.pl/epu/file/article/view/2740.pdf>> accessed 1 December 2019.



of local government activities²⁰⁵, Poland ranks sixth in terms of local government's revenues in relation to GDP. However, this does not mean that public finances in Poland have been decentralized. Despite relatively high income of the local government, it is still mostly derived from the transfer of funds from the Polish state budget.²⁰⁶

The financial situation of local government units varies depending on the type of local government (*gmina*, *powiat* or voivodship). Cities with *powiat* rights take a special position. In addition, we observe spatial diversity in the prosperity of *gminas* attributed to local conditions (e.g. the location of industrial plants which pay part of CIT to *gminas*' budgets). The financial situation of the local government in Poland is also significantly influenced by access to financial resources from the European Union. At present, the financial condition of local governments is strongly affected by the state policy in terms of determining tasks and public finances. Moreover, changes in the financial situation of local governments in metropolitan areas (regions) may be observed.

Revenue Structure of Local Government

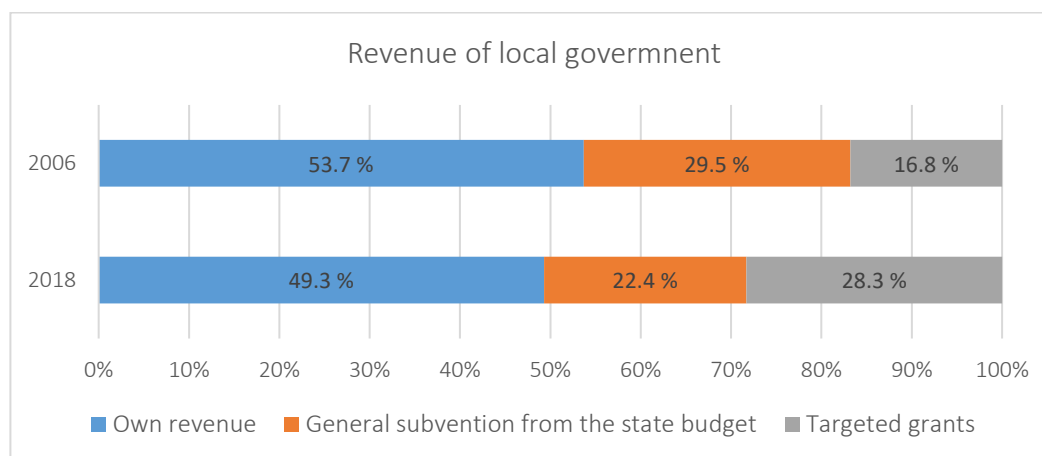


Figure 2: Structure of local government revenue (*gmina*, *powiat* and voivodship) in 2006 and 2018.

The largest category in the structure of revenue of local governments in Poland is own revenues which in 2018 constituted 49.3 per cent of total revenues. The remaining funds are transferred from the state budget: the share of general subvention in the revenue of the local government amounted to 22.4 per cent, while targeted grants – 28.3 per cent.²⁰⁷

In the structure of own revenue of local government units, in 2018, the largest share was represented by income from the share in personal income tax (PIT) revenues – 41.0 per cent, property tax – 18.2 per cent, from the share in corporate income tax (CIT) revenues – 7.8 per cent.

²⁰⁵ Excluding Cyprus, Malta and Luxembourg, where the scope of local government activity is fairly limited.

²⁰⁶ College of the Supreme Audit Office, 'Analysis of State Budget Execution and Monetary Policy Objectives in 2015' (Supreme Audit Office 2016) 260 <<https://www.nik.gov.pl/plik/id,11415,vp,13764.pdf>> accessed 1 December 2019.

²⁰⁷ Mirosław Błażej and others, 'Financial Economy of Local Government Units 2018' (Statistics Poland 2019) 33 <<https://stat.gov.pl/obszary-tematyczne/rachunki-narodowe/statystyka-sektora-instytucji-rzadowych-i-samorzadowych/gospodarka-finansowa-jednostek-samorzadu-terytorialnego-2018,5,15.html>> accessed 1 December 2019.



Local government units in Poland are, next to enterprises, the most important category of beneficiaries of funds from the European Union. In 2007-2013, approximately 25 per cent of all funds from the EU budget allocated to Poland were used by local governments.²⁰⁸ In 2018, EU funds constituted 6.7 per cent of total revenue of local government (they are classified as subsidies). In relation to the total revenue of particular types of local government units, income from the EU constituted: in *gminas* – 5.1 per cent, in cities with *powiat* rights – 5.0 per cent, in *powiats* – 6.4 per cent, in voivodships – 26.9 per cent. It should be emphasized that the absorption capacity of local government remains in close correlation with the financial standing and state of local finances.

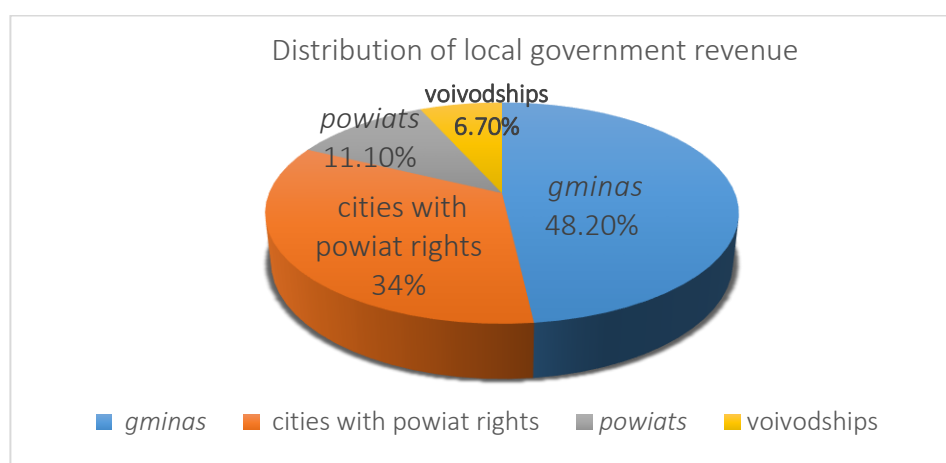


Figure 3: Distribution of local government revenue among *gminas*, cities with *powiat* rights, *powiats* and voivodships.

In the structure of revenue of all three tiers of local government (*gminas*, *powiats* and voivodships), the highest income is allocated to the first tier of local government, i.e. *gminas* and cities with *powiat* rights – 82.2 per cent in total²⁰⁹.

Gminas and cities with *powiat* rights are and will continue to be the key to achieving such objectives as equalizing the standard of living in different regions of Poland and creating conditions for local development. For this reason, the next part of the study will examine the basic level of local government in Poland, i.e. the financial situation of *gminas* (including cities with *powiat* rights).

Structure of *Gminas'* Revenue

The changes in the state of the *gmina's* finances indicate that the revenue of *gminas* is increasing annually, in 2018 it reached the level of PLN 121.4 billion. Compared to 2002, when

²⁰⁸ Patrycja Chrzanowska, 'Wykorzystanie funduszy europejskich przez samorzady terytorialne w kontekście rozwoju ekonomiczno-gospodarczego gminy [Use of European Funds by Local Authorities in Economic Development Context]' (2015) 106 Zeszyty Naukowe Uniwersytetu Przyrodniczo-Humanistycznego w Siedlcach 23 <https://repozytorium.uph.edu.pl/bitstream/handle/11331/535/Chrzanowska.P_Wykorzystanie_funduszy_europejskich_przez_samorzady_terytorialne.pdf?sequence=1> accessed 15 October 2020.

²⁰⁹ Ministry of Finance, 'Report on the Execution of the State Budget for the Period from 1 January to 31 December 2018. Information on the Execution of Budgets of Local Government Units' (Council of Ministers 2019) 11 <<https://www.gov.pl/web/finanse/zestawienia-zbiorcze>> accessed 2 November 2019.



the total revenue of *gminas* amounted to PLN 37.3 billion, this means an increase of 225 per cent over 16 years.

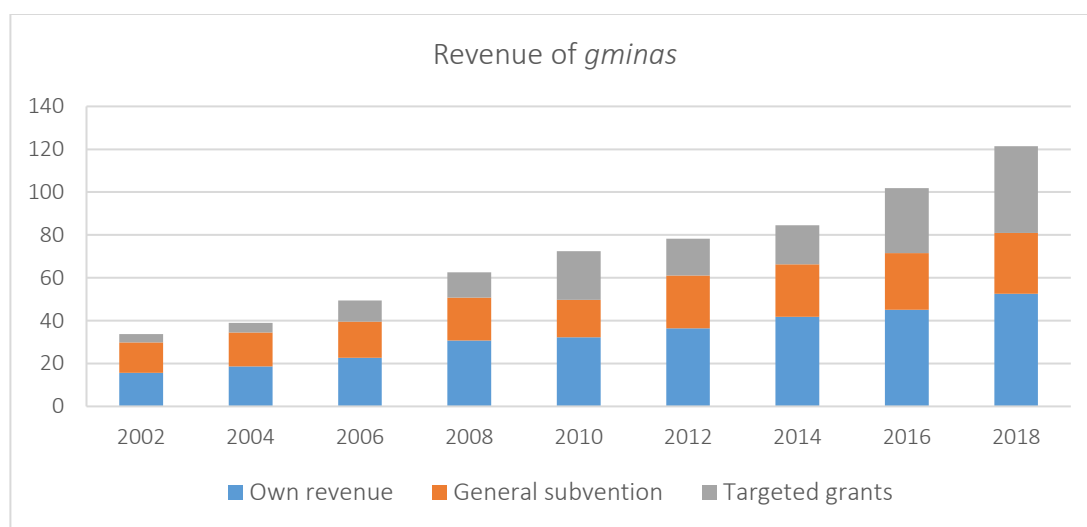
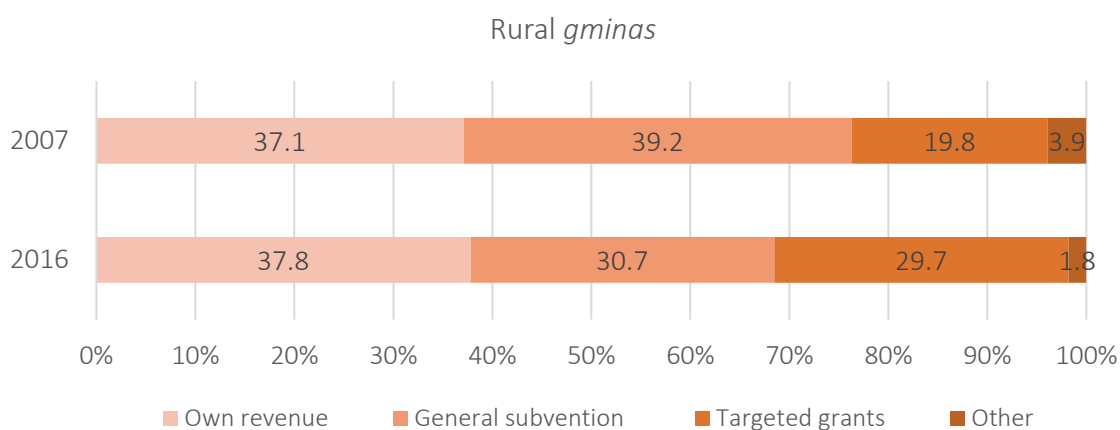


Figure 4: Revenue of *gminas* 2002-2018.

The 2018 revenue structure of all *gminas* and cities with *powiat* rights was as follows: own revenues 43.2 per cent, general subvention 23.4 per cent, targeted grants for commissioned tasks – 33.4 per cent.

If we divide *gminas* into rural *gminas*, urban and rural *gminas*, urban *gminas* and separately cities with *powiat* rights, the following picture emerges.



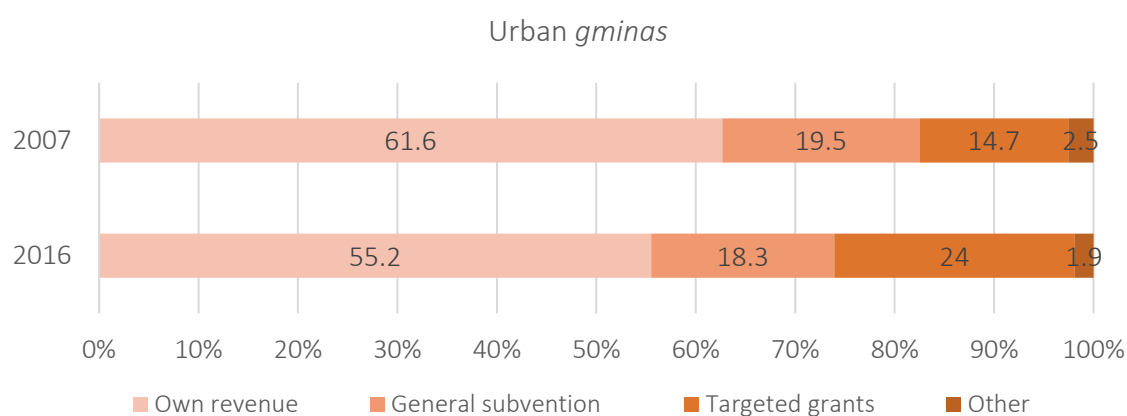
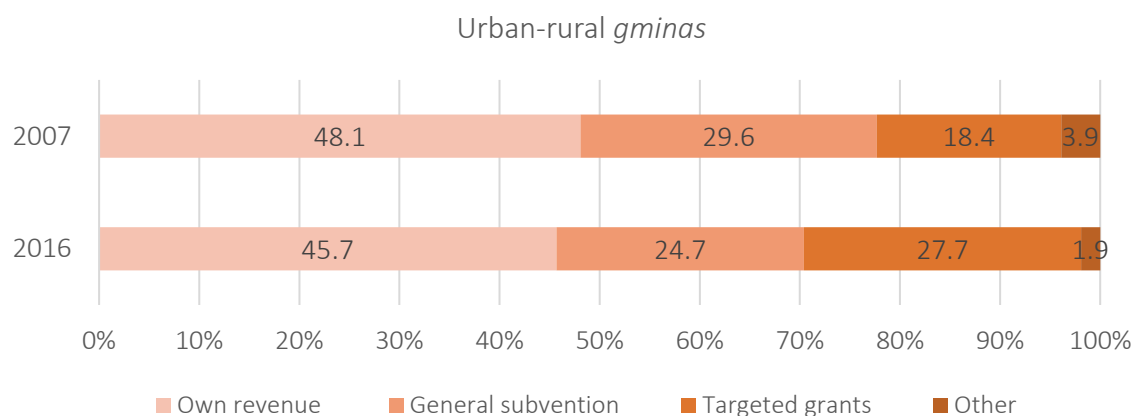


Figure 5: Structure of revenue of *gminas* (rural, urban-rural and urban) in 2007 and 2016.

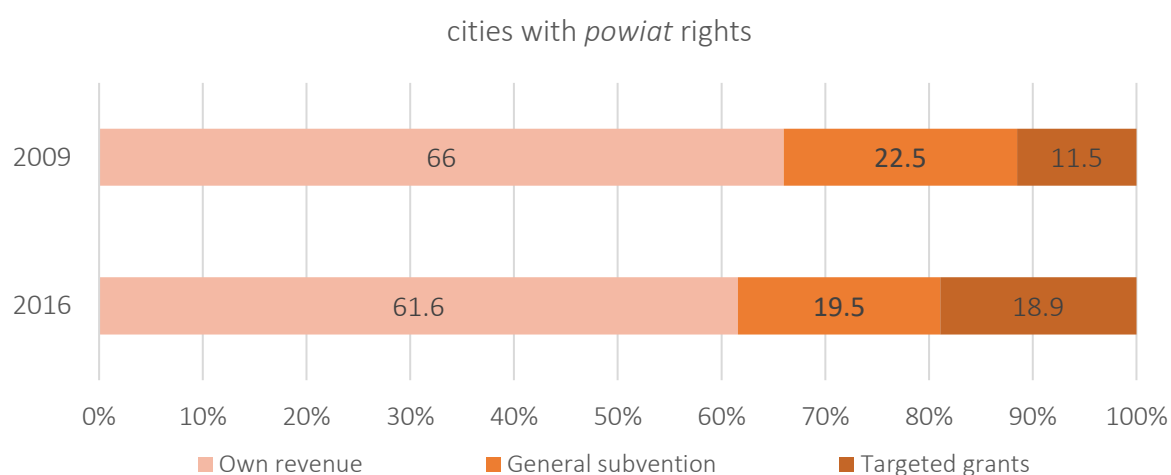


Figure 6: Structure of revenue of cities with *powiat* rights in 2007 and 2016.

The general trend concerning the sources of financing of *gminas* suggests an increase in financial transfers from the state budget. In particular, the amount of targeted grants related to the social policy of the state has increased (e.g. the government program ‘Family 500 plus’,



introduced on 1 April 2016, which involves financial benefits for families with children). In 2018, the grant for the ‘Family 500 plus’ program accounted for 13.8 per cent of the *gminas*’ revenue (targeted grants in total constituted 24 per cent of the *gminas*’ revenue).

The second noticeable tendency is greater dependence of rural *gminas* on financial transfers from the state budget. It pertains to general subvention intended to support *gminas* with low own revenue. Its purpose is to eliminate disproportions in the distribution of own revenue of the local government.

Categories of *Gminas*’ own Revenue

Gminas’ own revenue includes: local taxes (mainly: agricultural tax, forestry tax, tax on real estate, tax on means of transport). *Gminas* enjoy financial autonomy in this respect – they can set tax rates on their territory (within the limits set by law). Additionally, a part of the income from PIT²¹⁰ and CIT²¹¹ is transferred to the *gmina*’s budget. PIT and tax on real estate are of fundamental importance in financing the *gmina*’s budget. The basis for taxation of real estate in Poland is its area and not its value. This has been a matter of dispute – the proposal to introduce a real estate cadaster and a cadastral tax has long been under discussion.

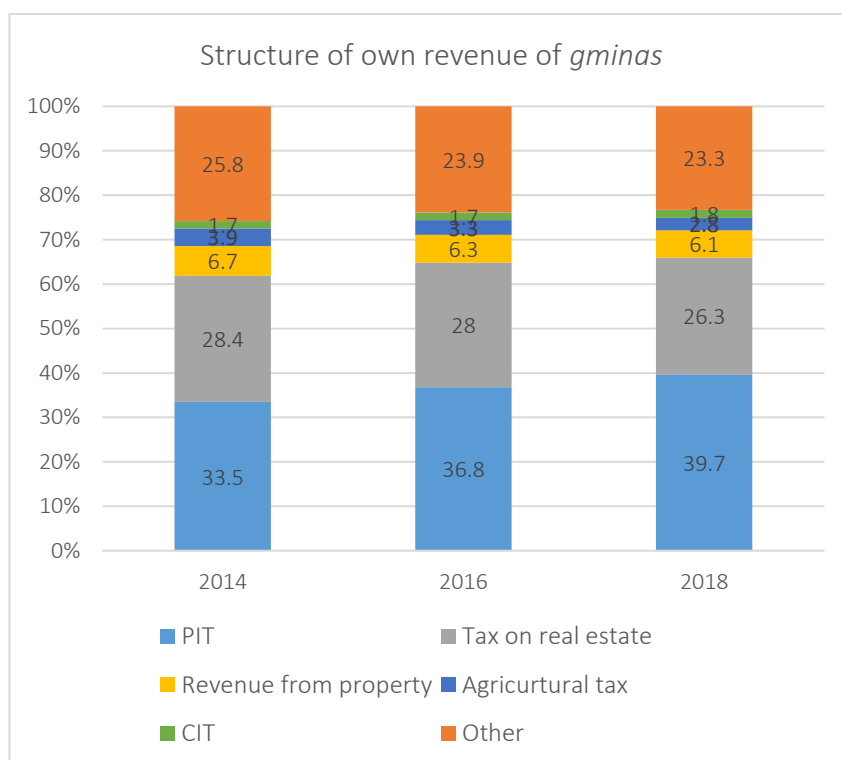


Figure 7: Structure of own revenue of *gminas*.

The main problem in the area of *gmina*’s revenue from PIT is the introduction of a number of tax reliefs in recent years which cause a decrease in the *gmina*’s income from this source. These

²¹⁰ Revenue from PIT contributes towards the budgets of *gminas* (39.34%), *powiat* budgets (10.25%), voivodship budgets (1.60%) and the state budget (49.81%).

²¹¹ Revenue from CIT contributes towards the budgets of *gminas* (6.71%), *powiat* budgets (1.4%), voivodship budgets (14.75%) and state budget (77.14%).



are decisions taken by the government and the parliament – without the participation of *gminas*. This causes great dissatisfaction and protests of local governments.

General Subvention for *Gminas*

A general subvention is a form of non-refundable financing of the local government budgets by the state budget. These are funds transferred to equalize the level of own revenue of local governments. The subvention is an instrument for eliminating income disparities between local governments. The funds from the subvention may be disbursed by the local authorities at their own discretion.

The general subvention for *gminas* consists of three parts: education, compensatory and offsetting part. In 2019, the educational part (for running schools) accounted for 77.2 per cent of the total subvention. One of the factors used for the determination of the compensatory part (apart from the amount of tax revenue per capita) is the population density in a *gmina* which is lower than the Polish average. It is an aid for rural *gminas* – sparsely populated.

The funds which are transferred to poorer *gminas* in the form of a general subvention are derived from the state budget but also from payments made by wealthy *gminas* with high income from local taxes. Such a system of redistribution of *gminas'* revenue has been objected by wealthy *gminas* for a long time. In 2011, a citizen bill ('citizens' legislative initiative')²¹² was prepared the aim of which was to reduce the amount of payments made by wealthy *gminas* to the general subvention. The bill was not seconded in parliament. In 2018, 88 *gminas* made payments to the state budget for the benefit of poorer ones (in Poland there are 2477 *gminas* in total). This means that 3.5 per cent of *gminas* in Poland participate in the system of co-financing poorer *gminas*.²¹³

The subvention is certainly a more predictable source of finance than other types of own revenue which are tax-related and thus largely determined by the dynamics of economic growth. During the economic slowdown, the general subvention is therefore intended to stabilize the income situation of the local government. However, its critics claim that the general subvention decreases the motivation of the *gmina's* self-government to rationalize expenditures.

Targeted Grants for *Gminas*

Targeted grants are granted *gminas* from the state budget for the execution of additional tasks (unused grants must be returned to the budget). Local government units do not have any actual influence on the grant amount. For several years, local governments have been suggesting that targeted grants are insufficient to fulfil the commissioned tasks. As a result, in order to ensure the performance of these tasks, local governments finance them from their own resources.

In recent years, the local governments of large cities have decided to file claims in civil courts against the Polish State Treasury for payment of the missing funds for the performance of commissioned tasks (the funds are primarily needed for the tasks related to keeping

²¹² The right to submit a bill is granted in Poland to a group of at least 100 000 citizens having the right to vote in elections to the Sejm (Art 118(2) of the Polish Constitution 1997).

²¹³ A similar mechanism of revenues redistribution applies at the level of *powiats* and voivodeships.



population registers, issuing identity cards, adjudicating in registration cases and keeping vital records). These are long and costly proceedings, however, more and more large cities are deciding to go to court. The precursor of such an action was Cracow²¹⁴ which after 5 years obtained a court judgement ordering the Polish State Treasury to return the funds that Cracow allocated for co-financing of commissioned tasks.²¹⁵ The increasing number of court cases may possibly result in a change in the methods of determining the costs of tasks commissioned by the Polish Government and Parliament.

Expenses of *Gminas*

In recent years, there has been a significant increase in local government expenditure, both in the group of current and capital expenditure.²¹⁶ On the one hand, it results from an increase in the scope of tasks and the realization of local government investments, however, on the other hand, it is an effect of a significant increase in the costs of performing public tasks.

The most important items of the *gminas'* expenditure include 'education and upbringing' and 'family' – in total they constitute over half of the *gminas'* budget expenditure (51.4 per cent). The budget of *gminas* also disburses funds for agriculture and hunting – 2.7 per cent. Compared to 2017, expenditure on agriculture and hunting increased by 48.8 per cent. It resulted from, inter alia, the implementation of the sub-measure 'Support for investments in agricultural holdings' under the Rural Development Program for 2014-2020 financed from the EU.

Salaries for employees, including teachers (approx. 34 per cent of *gmina's* expenditure) constitute a relatively considerable part of expenditures. Considering that between 2015 and 2018 salaries in the local government increased by 15.8 per cent, this places a heavy burden on the local government budget. This is a particularly difficult problem for small rural *gminas* which experience financial difficulties and propose that the financing of teachers' salaries should be assumed by the Polish state.

²¹⁴ Cracow (Kraków) - the second largest city in Poland.

²¹⁵ Weber Maria, 'Miasta w sądzie walczą o pieniądze z rządem [Cities fight in court with the government for money]' (*Rzeczpospolita*, 22 October 2019) <<https://regiony.rp.pl/prawo/22244-zadania-trafiaja-do-sadu> > accessed 1 December 2019.

²¹⁶ In the structure of *gminas'* expenditures in 2018, current expenditures constituted 79.4% whereas capital expenditures 20.6%. If we consider rural *gminas* separately, current expenditure amounts to 78.3% and capital expenditure to 21.7%.

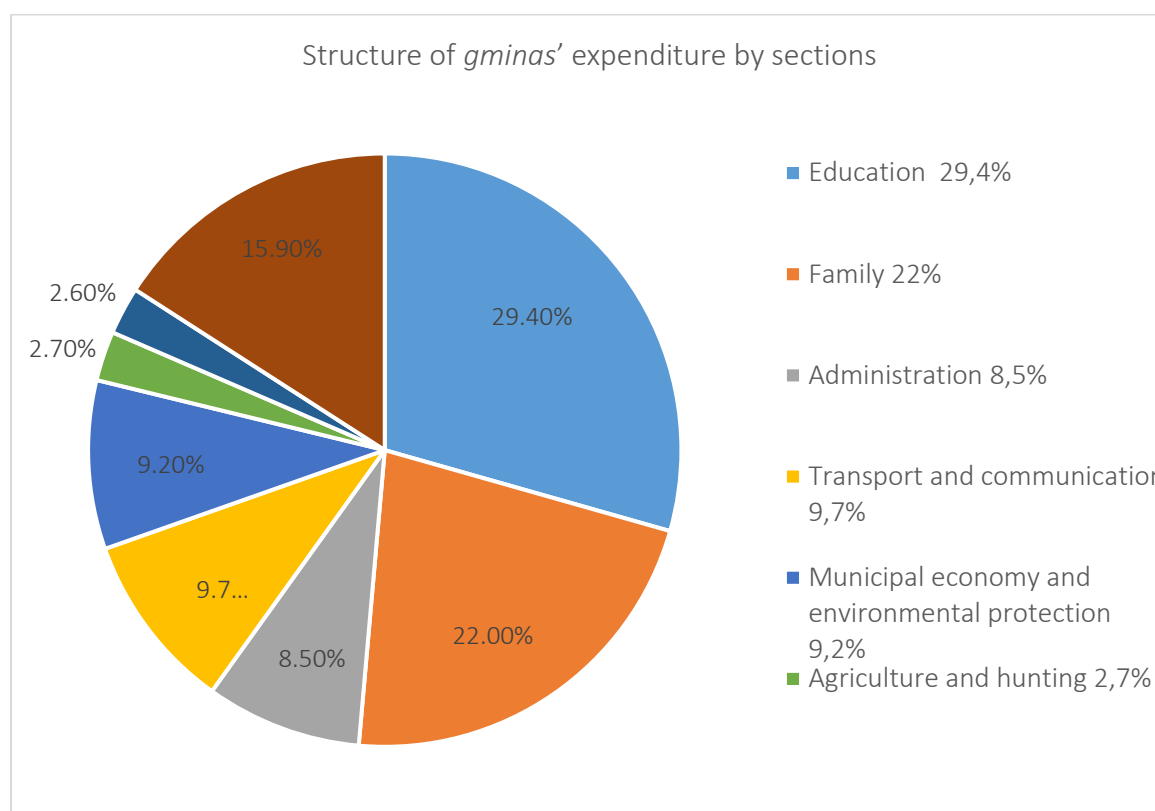


Figure 8: *Gminas'* expenditure.

Capital Expenditures of *Gminas*

The main determinant of the state of local government finances, related to its role in the development policy, is the investments made. The increase in PIT revenues contributed to the achievement of an operating surplus²¹⁷ in 2018 in the local government budgets which was entirely allocated to development – i.e. investments. It was also possible thanks to subsidies of 21.5 billion from the European Union and incurring new liabilities (mainly loans) for a total amount of approx. PLN 16.2 billion. Even more investments were planned for 2019.

Investment priorities have evolved over the years. In the 1990s particular importance was attached to the provision of telecommunications infrastructure and development of gas network. Then there was the period of water supply and sewage investments. For some time, transport investments, including road and purchase of rolling stock have been high in the hierarchy of needs. However for over a decade, more and more local governments have been focusing on cultural, sporting and recreational activities.²¹⁸

²¹⁷ The operating surplus is the positive difference between current revenue and current expenditure. Accordingly, the negative result between current revenue and current expenditure represents an operating deficit.

²¹⁸ Swianiewicz Paweł and Łukomska Julita, 'Liderzy inwestycji. Ranking wydatków inwestycyjnych samorządów 2015-2017' (*Wspólnota*, 20 January 2020)

<[https://www.wspolnota.org.pl/fileadmin/user_upload/Andrzej/11_2017/Nr_19_Ranking - Wydatki inwestycyjne 2015-2017.pdf](https://www.wspolnota.org.pl/fileadmin/user_upload/Andrzej/11_2017/Nr_19_Ranking_-_Wydatki_inwestycyjne_2015-2017.pdf)> accessed 2 November 2019.



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7.3 Investment Expenditure of Local Governments: The Role of European Funds in the Financial Strategies of Rural *gminas*

Andżelika Mirska, *University of Warsaw*

Relevance of the Practice

The consequence of Poland's accession to the EU was, among others, the access of local governments to new financial resources. Polish local governments take this opportunity on a mass scale – there are many good practices in this area. Undoubtedly, the European Union funding contributes significantly to the development and modernization of local government.

The rural settlement fragmentation is a significant problem of many communes in Poland. The fact that localities with up to 200 residents constitute almost 50 per cent of all these units is evidenced by the scale of this phenomenon. The most fragmented rural settlement network can be found in north-eastern and central Poland. This conditioning is a factor limiting the possibility of implementing many linear investment projects. Therefore, there is a limited possibility of applying for EU funding by units located in typical rural areas despite the existing investment needs, both for financial reasons (low own capability, high investment implementation costs) and technical reasons (investment in large sections without buildings)²¹⁹.

The problem of reducing the differences in development and living standards between microregions also concerns the development disproportions equalization in urban and rural areas in Poland. One of the ways to increase the development opportunities of communes in rural areas is to improve their competitiveness. EU funds are the most important financial instruments of the EU regional policy influencing the increase in the communes' competitiveness.

Additional external financial means may have significant multiplier effects in communes located in rural areas in case of affecting the multifunctional development of such areas. These funds should be invested primarily in the widely understood infrastructure, i.e. public facilities enabling economic and social development and environmental protection.

Poorly developed technical, social and environmental infrastructure is one of the most serious barriers to the communes' competitiveness growth in rural areas. The weak infrastructure level leads to worse living standards and these areas are not made an interesting place to live and invest. Infrastructure is the fundament of any business. The appropriate infrastructure level in the area is a necessary condition for economic activation. Therefore, improving the

²¹⁹ Jacek Sierak, 'Alokacja funduszy unijnych a wydatki inwestycyjne gmin' (2018) 93 *Optimum*. *Economic Studies* 195, 206
<https://repozytorium.uwb.edu.pl/jspui/bitstream/11320/7372/1/Optimum_3_2018_J_Sierak_Alokacja_funduszy_unijnych.pdf> accessed 2 November 2019.



communes' competitiveness in rural areas requires greater saturation with the infrastructure of rural areas. On the one hand, the grounds for investor interest are created whereas the residents' life quality is increased in a given area²²⁰. Rural areas with a weak infrastructure level are mostly depopulated areas. Infrastructure-neglected communes are characterized by the highest percentage of people employed in agriculture, and the lowest in non-agricultural sectors of the economy.

According to the research, infrastructure investments are also highly anticipated by local communities.

Due to EU funds, the local government units are able to implement investments significantly exceeded their financial capabilities, limited by the level of their own income, especially with regards to rural communes.²²¹

Description of the Practice

The Polish local government is facing growing expectations of the residents, who are demanding faster construction and modernization of local infrastructure and improved quality of local public services. Therefore, the main problem for the local government is to raise funds for investments and local development.

At the end of 2019, all *gminas* in Poland implemented EU projects (under the 2014-2020 Financial Perspective). In respect of absolute values, Warsaw is unrivalled. The value of project co-financing agreements in the capital city approached PLN 20 billion (approx. EUR 5 billion). The list of *gminas* where investments have the highest value per capita is topped by rural *gminas*.

The projects structure detailed analysis presents the significant difference considering the activities co-financed from EU funds in communes representing different types. Rural and urban-rural area communes' activities are targeted at the social infrastructure modernization (mainly culture centers), and then at the technical infrastructure development and modernization. However, the technical infrastructure was primarily developed and modernized by the urban communes as well as the scholarship programs organization for pupils and students.

The investments in cultural facilities such as the community centers renovation, the cultural centers equipment, etc. are the most common activities undertaken in rural areas. Projects depending on the construction or modernization of water and sewage networks, and roads were considered in what follows. The sports facilities development (mainly sports fields, gyms)

²²⁰ Anna Katoła, 'Wpływ wykorzystania funduszy unijnych na wzrost konkurencyjności gmin' (2006) 25 *Studia i Prace Wydziału Nauk Ekonomicznych i Zarządzania* 161 <https://wneiz.pl/nauka_wneiz/sip/sip25-2012/SiP-25-161.pdf>.

²²¹ Maciej Stawicki, 'The Use of European Funds by Communes in 2004–2009' (2011) 14 *EJPAU*, 91; Małgorzata Dudzińska and Barbara Prus, 'Level of Socio-Economic Conditions of Municipalities and Effectiveness and Quantity of Procurement of Support with EU Funds for Projects Infrastructure Investment. Case Studies' (2017) 1 *Infrastruktura i Ekologia Terenów Wiejskich* 155 <http://www.infraeco.pl/pl/art/a_18193.htm?plik=2051>.



and recreational facilities (e.g. playgrounds), as well as the public spaces and facilities renovation played a crucial role.

Assessment of the Practice

The investment potential of *gminas* consists of three elements:

- own potential (operating surplus);
- external support (subsidies, especially from EU funds);
- credit financing, depending on creditworthiness.

It follows from the above that EU funds may be used by *gminas* which have their own financial reserves. In addition, there are legal provisions in force that prohibit *gminas* from over-indebtedness. Without an increase in their income, they will not be able to benefit from subsidies from EU funds and this will reduce investments. The key question is what strategies are adopted by local governments based on their financial situation and what factors determine the selected investments. Do rural self-governments implement programs dedicated to them, e.g. Rural Development Program 2014-2020 financed by the EU?

According to the research, investments provided by rural communes' local governments financed with EU funds made no significant difference in creating conditions for stimulating the local economy in rural areas.

It emerges that the European funds were mainly used to improve the residents' quality of life by implementing municipal investments in education, culture, leisure or environmental protection areas (infrastructure expenditure aimed at improving the rural quality of life). Furthermore, to a small extent the investments were allocated to create better conditions for rural economic activity.

The increasing number of residents by several per cent was also observed in rural areas using on the widest-ranging scale from European funds. Due to EU funds, it was certainly crucial to improve technical and social infrastructure in rural areas.²²²

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²²² Agnieszka Cyburt, 'The Activity of Local Governments in the Absorption of EU Funds as a Factor in the Development of Rural Communes' (2014) 13 *Oeconomia* 31; Magdalena Wojarska and Renata Marks-Bielska, 'Fundusze Unii Europejskiej jako źródło finansowania rozwoju lokalnego gmin województwa warmińsko-mazurskiego' (2015) 76 *Optimum. Economic Studies* 103; Adam Czudec, 'Fundusze europejskie a rozwój gospodarczy w skali lokalnej' (2017) 49 *Nierówności Społeczne a Wzrost Gospodarczy* 35.



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7.4 Integrated Territorial Investment (ITI)

Andżelika Mirska, *University of Warsaw*

Relevance of the Practice

Poland faces a serious problem which is enormous cost of uncontrolled urbanization of suburban areas (effects of a bad law on spatial planning and development), which makes it necessary to invest in spatial development, infrastructure and public transport. These investments should often be carried out by neighboring local governments. Often there are insufficient financial resources and no willingness to cooperate between local governments.

The latest instrument to help solve this problem is Integrated Territorial Investment (ITI). ITIs appeared for the first time in draft EU regulations on European funds for the years 2014-2020. In order to increase the involvement of cities in the implementation of cohesion policy, the European Commission has committed the Member States of the European Union to devote a minimum of 5 per cent of the resources allocated to them under the European Regional Development Fund (ERDF) to measures to address the economic, environmental, climate, demographic and social challenges faced by urban areas. ITI allows cities and areas functionally connected with them (across city administrative borders) to implement joint ventures combining activities financed by the European Regional Development Fund and the European Social Fund.

The key objectives of ITI include:

- promoting a partnership model of cooperation between different administrative units in urban functional areas;
- increasing the effectiveness of the interventions undertaken through the implementation of integrated projects addressing in a comprehensive manner the needs and problems of cities and their functionally related areas.²²³

Description of the Practice

ITIs are the result of a new approach to development planning which involves departure from perceiving the areas only in terms of administrative borders that separate them.

Pursuant to Poland's agreement with the EU, the ITI is implemented obligatorily in the 16 largest cities (voivodeships' capitals and their functional areas). Optionally, they may be implemented in other regional/sub-regional cities and their functional areas. In total, ITIs are implemented in Poland in 24 functional areas of cities.

²²³ 'Zintegrowane Inwestycje Terytorialne' (*Portal Funduszy Europejskich*, 11 May 2016)

<<https://www.funduszeuropejskie.gov.pl/strony/o-funduszach/zasady-dzialania-funduszy/zintegrowane-inwestycje-terytorialne/>> accessed 14 November 2019.



The ITI primarily supports projects in the field of:

- sustainable development, efficient transport connecting the city and its functional area;
- restoring the socio-economic functions of degraded areas of an urban functional area;
- improvement of the natural environment in the functional area of the city;
- support energy efficiency and promote low-carbon strategies;
- stimulating the development of symbolic functions building the international character and supra-regional rank of the urban functional area and improving access and quality of public services in the whole functional area;
- extending research, enhancing technological development and innovation.

Assessment of the Practice

The implementation of the ITI is a new undertaking of Polish local government. This is certainly an answer to the problems arising from the bottom-up metropolitan processes. The main challenge is to encourage local governments to cooperate in order to jointly perform public tasks. Financial incentives are intended to encourage partnership and cooperation. The creation of areas where ITIs are implemented has been preceded by lively social discussions and research by professionals. Institutionalization and defining the rules of cooperation and co-financing was a great challenge for local governments. Joint projects and investments are currently under way. This provides new and extensive research material. It will certainly be a determinant of further actions of local governments in metropolitan areas. The practice of local governments will show which actions have contributed to the improvement of the situation of cities and their functional areas.

The first studies indicate that ITIs are a modern and properly utilized instrument facilitating cooperation between local governments, co-financed by the European Union. Effects of ITIs implementation may be observed in the metropolitan area of the Capital City of Warsaw which includes Warsaw and 39 functionally connected *gminas*.

The 'Warsaw Functional Area for ITI' consists of one city with county rights (the Capital City of Warsaw), 14 urban communes, 12 urban-rural communes and 13 rural communes. Administratively, these communes belong to 10 counties. It concentrates over half of the voivodeship's residents (50.5 per cent) despite the fact that this area covers a relatively small part of the Mazowieckie voivodeship (8.3 per cent). Due to the specificity of the area, especially the number and size of settlement centers, the urbanization rate for the 'Warsaw Functional Area for ITI' (87.5 per cent) is significantly higher than the value for the Mazowieckie Voivodeship (64.2 per cent), as well as the entire territory of Poland (60, 6 per cent). Moreover, the 'Warsaw Functional Area for ITI' is the most densely populated area of the voivodeship (912 people / km²). This value is over six times higher than in the entire Mazowieckie Voivodeship case (149 people / km²).

Contracts were signed for 115 projects for the grant amount of PLN 606.5 million. What is more, they will be implemented individually by communes in partnership with communes around Warsaw, in partnership with Warsaw, as well as by non-governmental organizations



operating in the metropolitan area and private entrepreneurs. Everything is connected with the partnership resulting from the 40 communes' agreement signed in February 2014 and the joint ITI investment strategy.

The projects concern both the problems of rural areas (e.g. educational programs for rural schools in the commune to provide equal educational opportunities for children) and the metropolitan problems (the provision of childcare facilities for children in nurseries in one of the districts of Warsaw with the highest birth rate²²⁴). There are also projects implemented jointly by several municipalities, such as the construction of bicycle paths connecting 6 communes. Projects with impact on all local governments i.e. in the field of e-services are also distinguished. For instance, the project entitled 'Construction and implementation of an integrated support system for care services in the Warsaw Functional Area (E-Care)'.²²⁵

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²²⁴ Statistics of Warsaw, 'Population Figure Monitoring 2015' (*Urząd Statystyczny w Warszawie*, 2015) <<https://warszawa.stat.gov.pl/monitoring-stanu-ludnosci/>> .

²²⁵ 'ZIT metropolii warszawskiej' (*Metropolia Warszawska*) <<https://omw.um.warszawa.pl/zintegrowane-inwestycje-terytorialne/zit-metropolii-warszawskiej-cele-i-korzysci/>>.



7.5 The Importance of the ‘Village Fund’ for the Mobilization of Rural Residents to Civic Participation

Andżelika Mirska, *University of Warsaw*

Relevance of the Practice

The practice of participatory budget initiated in Porto Alegre is widely known in the world. The democratic discussion and decision-making process was developed primarily in municipalities. In Poland, the participatory budget occurs in cities.²²⁶ Yet, there is also a similar instrument in rural areas.

The fundamental difference is that the participatory budget for rural areas was introduced by virtue of the Act of 21 February 2014 on the ‘Village fund’, which regulates its functioning in a uniform manner throughout Poland.

The differences between the participatory budgeting procedure and the ‘Village fund’:

First, the participatory budget was created as an informal bottom-up initiative of city residents. Local governments of particular cities decided to conduct it in order to present themselves as friendly to residents and open to their needs. There was no top-down regulation in the form of a central parliamentary act. Each city decided on its own about introducing a participatory budget and the procedure form.

There was a difference with ‘Village fund’ as it was established by a central parliamentary act, which introduced the same procedure for all local governments in Poland. However, the decision concerning the village council fund establishment in a given commune is voluntary - it is passed by the commune council.

Second, the participatory budget in cities is financed only from the local government's own funds. The different situation occurs in the case of the ‘Village fund’. The part of the financial resources comes from the communes’ budgets, while some funds are transferred from the central (state) budget.

Contrary to the idea that the participatory budget is not regulated from the top-down by a law, the central parliament passed an act in 2018 stating that the creation of a participatory budget is obligatory in cities with county rights. The act also regulates the participatory budget procedure and the minimum amount of funds allocated from the city budget to the participatory budget.

²²⁶ See report section 6.4. on the Participatory Fund in Cities.



The 'Village fund' means the financial resources which can be separated from the budget of the rural communes and the urban-rural communes and guaranteed for the *sołectwo*²²⁷ (an auxiliary unit of a rural or urban-rural *gmina*) in order to carry out projects falling within the category of the *gmina*'s own tasks, aimed at improving living conditions of residents of rural areas. From the point of view of rural residents, it is an instrument of budgetary participation, i.e. co-decision on expenditures of determined parts of public resources included in the municipality budget and aimed at supporting grassroots initiatives of rural residents.

'The Village fund' may be interpreted as:

- a democratic discussion and decision-making process by rural community;
- an element of financial management of rural and urban-rural *gminas*;
- an instrument of direct task accomplishment by rural residents.

Gminas that separate financial resources from their budget in order to establish the 'Village fund' receive a financial bonus from the Polish government budget which amounts to 20 per cent, 30 per cent or 40 per cent of the expenditure made by *sołectwos*. The bonus amount depends on the wealth of *gmina*. *Gminas* with the *lowest income* receive the *highest subsidies*.

Description of the Practice

The 'Village fund' implemented according to the act requires compliance with procedures and time limits. However, the entire process is not complicated.

The establishment of the fund is the right of the *gmina* council, the resolution on granting the consent to separate the fund applies to the subsequent budgetary years, however, the resolution on not granting the consent to separate it applies only to the budgetary year following the year in which the resolution was adopted.

Therefore, the first step is the 'Village fund' establishment decided by the *gmina* council in a particular rural or urban-rural *gmina*. The amount of the resources assigned to the given *sołectwo* is calculated on the basis of a formula determined in the act where the wealth of the municipality and the number of the village residents are the primary variables.

The second step is the decision of the *sołectwo* to benefit from the financial resources of the 'Village fund'. The condition for granting the resources from the fund in the given budgetary year is that a request is submitted by the given *sołectwo* to the executive body (to the mayor).

For this purpose, the residents of the *sołectwo* must convene a village meeting at which such a request is adopted, including the description of an objective on which the financial resources from the municipality budget are to be spent (construction of a playground, repairs, construction of pavements, equipping of a voluntary fire brigade etc). As a general rule, the village meeting is convened by the village leader (*sołtys*) on his/her own initiative, and also on

²²⁷ A *sołectwo* is an auxiliary unit of the *gmina* that does not have the status of local government unit and legal personality. The *sołectwo* has its own elected bodies: village meeting, village leader, village council. The *sołectwo* are established, transformed and liquidated independently by the *gmina*. The *sołectwo* operate in the area of rural *gminas* and rural-urban *gminas*. By contrast, in the area of cities, auxiliary units are usually entitled 'districts' (*dzielnica*).



at the request of a certain numbers of residents entitled to attend the meeting (usually about 10 per cent).²²⁸

The request can be made on the initiative of the village leader, village council or at least 15 adult *sołectwo* residents. Then the request is put to the vote of the village meeting. Voting procedures are determined by the statutes of each *sołectwo*.

The *gmina* council while adopting the municipality budget may refuse the *sołectwo* request when it considers that the tasks which the *sołectwo* is planning to implement do not meet the conditions determined in the act.

The following conditions should be met:

- the arrangements fall within the scope of the *gmina*'s own tasks;
- the arrangements comply with the *gmina*'s development strategy;
- the arrangements contribute to the improvement of residents living conditions.

If the following conditions are met the *gmina* council shall adopt the resolution on the inclusion of the financial arrangements from the 'Village fund' resources contribute to the *gmina*'s budget.

The tasks from the 'Village fund' resources are implemented as described in the request. The 'Village fund' is a part of the *gmina*'s budget for which implementation the mayor is responsible.

The role of village leader (*sołtys*) and residents is not limited to adopting and submitting requests. It involves:

- controlling the implementation term and the arrangements quality;
- participation in the arrangements implementation if it was decided during the village meeting. It may be their work or contribution in-kind.

Residents have the right to ask the mayor about the implementation term. This is guaranteed by the Polish Constitution, in Article 61. The mayor must respond within 14 days.

Assessment of the Practice

The aim of the Act on the Village Fund was to ensure opportunities for the village residents to decide independently and jointly their environment and life quality.

The *sołectwo* may spend – in accordance with their needs – the financial resources but the residents must show initiative and cooperate with each other. The decision is made by the village meeting. It must be held democratically and lawfully. Such a possibility mobilizes leaders or groups of residents who not only initiate concrete actions but persuade others to implement them as well.

²²⁸ These issues are regulated in the *sołectwo* statute. The statute of the *sołectwo* is adopted by the *gmina* council. Each *gmina* defines the text of the statute for all *sołectwo*s that have been established on its territory. Therefore, the content of the statutes of various *sołectwo*s may differ from each other.



The data show large dynamics in the use of this instrument of public participation. In 2009 the number of *gminas* in which the Village fund was separated amounted to 1178, then, it increased steadily to reach the number of 1596 municipalities in 2018 where the authorities allow the village residents to take over a part of responsibility for the village development. The number of municipalities where the Village fund was established amounted in per cent: in 2009-2013 – 55 per cent, in 2015 – 65 per cent, in 2016 – 68 per cent, in 2017 - 71,3 per cent. In 2018 the number of *gminas* in Poland is 2478, the number of municipalities with (rural and urban-rural) *sołectwo* is 2174, and the number of *sołectwo* - 40 725. The amount of the return of a part of expenditures executed within the framework of the Village fund from the state budget increased steadily, in 2011 the return amounted to approx. PLN²²⁹ 44 million, but in 2018 - PLN 124 million.

It was 10 years ago that this participation instrument of village residents was launched. This may enable the assessment of 'Village fund' function and the collection of a catalogue of good practices as well as the indication of possible weaknesses which should be eliminated. Certainly, the 'Village fund' will be continued by rural and urban-rural *gminas*, also because of the financial bonus from the government budget. The second factor will certainly be the desire to maintain the image of a 'residents-friendly commune', i.e. one that leaves part of the decisions directly to residents.

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²²⁹ 1 PLN (Polish zloty) is 0.23 Euro.



8. Local Financial Arrangements in Croatia

8.1 The System of Local Government in Croatia

Dario Runtic, *NALAS Network of Associations of Local Authorities of South-East Europe*

Types of Local Governments

Croatia has 21 units of regional self-government (*zupanija*), 20 counties and the Croatian Capital City of Zagreb. Each county is divided into a number of local government units. Also, each county has its own representative and executive body elected by popular vote for a term of four years. The City of Zagreb is a special territorial and administrative unit whose responsibilities are regulated by a separate Act on the City of Zagreb. The City of Zagreb has a dual status as a unit of local and regional government unit and thus performs activities within the scope of the city and as a county. It also carries out responsibilities of the state administration. In doing so administrative bodies of the City of Zagreb have the powers and obligations of state administration bodies.

There are 556 units of local government, that is 128 towns (*grad*) and 428 municipalities (*općina*). Towns are local government units typically of urban character with more than 10,000 inhabitants. Exceptions apply in case of historical, economic or geospatial reasons. Municipalities are local government units of rural character with less than 10,000 inhabitants. Each town and municipality has its own representative and executive body elected by popular vote for a term of four years. Each local government unit is further divided into one or more settlements regardless urban or rural. One or more settlements are represented by sub-local government entities called neighborhood councils with elected representatives which serve on non-professional terms. Some towns and some municipalities have only one neighborhood council. Towns and municipalities have basically the same responsibilities, except for towns in which counties have their administrative seat and towns with a population above 30,000 inhabitants. The latter are referred to as 'large towns' and have additional responsibilities. Seats of county are generally the largest towns within a county. There are only four large towns which are not the seat of a county.

Legal Status of Local Governments

The right to local and regional self-government is guaranteed by Article 128 of the Croatian Constitution, according to which '[c]itizens shall be guaranteed the right to local and regional self-government' and this right 'shall be exercised through local and/or regional representative bodies', as well as citizens' direct participation in the administration of local affairs. The rights specified in this Article shall be exercised by Croatian and European Union nationals in compliance with law and EU *acquis communautaire*.



The right to local government is further prescribed in national legislation such as the general Local Government Act, Local Government Financing Act, etc. The Croatian system of local self-government is based on the principle of autonomy of government and the principle of subsidiarity. The European Charter of Local Self-Government has been fully ratified by the Croatian Parliament. Croatian local governments have a judicially enforceable right to local self-government before the Constitutional Court and other judiciary bodies.

(A)Symmetry of the Local Government System

Local authorities have comprehensive responsibilities which are enumerated in the Constitution and further prescribed by the general Local Government Act. Local government units perform tasks of local importance which directly affect needs of the citizens and which are not assigned to state bodies by the Constitution or other laws, and especially the tasks referring to organization of settlement and housing; spatial and urban planning; utility services; child-care; primary health protection; social welfare; elementary education; culture, physical culture and sports; consumer protection; environment protection; fire and civil protection; maintenance of municipal roads and traffic management. In addition to these competences, large towns also have responsibilities related to maintenance of local public roads and construction permits.

Regional government units carry out affairs of regional importance which are not assigned to central bodies by the Constitution or other laws. The scope of counties' responsibilities can be self-managing and entrusted (government affairs). Counties are tasked with performing the following tasks: general public administration services; primary and secondary education; healthcare; regional and urban planning; economic development; environmental protection; transport and traffic infrastructure; management of the network of educational, medical, social welfare, and cultural institutions; administration pertaining to agriculture, forestry, mining, and industry; management of road transport infrastructure; construction permitting, excluding the area of big cities and a county seat city.

Re-assignment of responsibilities between individual local and regional governments is allowed pending approval of the representative bodies of both government units. Out of 556 local government units some 8-10 local governments have taken over such responsibilities. Certain restrictions apply such as the ability to fund a specific responsibility (in case of most of responsibilities) and a minimum number of inhabitants (8,000 inhabitants for management of elementary education).

Political and Social Context in Croatia

The Croatian population of 4.2 million is predominantly urban with 71 per cent of the total population living in towns which cover 39 per cent of total territory. The remaining 29 per cent of the total population are scattered through municipalities which cover 61 per cent of Croatian territory. According to the 2011 Census, 19 per cent of the population lives in Zagreb,



the capital city of Croatia. Population density is 76 inhabitants per square kilometer (139 inhabitants per square kilometer in towns, 36 in municipalities).

National parties dominate local level of government. In 2009, direct elections of a mayor were used for the first time, replacing the former system in which a representative body elected a mayor. But this did not significantly change the political landscape at the local level. The share of incumbents who lost in the 2017 elections was 40 per cent in towns and 30 per cent in municipalities, but national parties still dominate local level of government. In the 2017 elections a group of non-aligned mayors raised, making them the second largest 'political' group at the local level with a share of 15 per cent of the total number of town/municipal mayors.

References to Scientific and Non-Scientific Publications

Legal Documents:

Constitution of the Republic of Croatia, 2014

Law no 110/2015 on Territories of Counties, Cities and Municipalities

Law no 98/2019 on Local and Regional Self-Government

Scientific and Non-Scientific Publications:

Ministry of Administration of the Republic of Croatia, 'Local and territorial (regional) Self-Government' <<https://uprava.gov.hr/o-ministarstvu/ustrojstvo/5-uprava-za-politicki-sustav-i-organizaciju-uprave-1075/lokalna-i-podrucna-regionalna-samouprava/842>>



8.2 Local Financial Arrangements in Croatia: An Introduction

Dario Runtic, *NALAS Network of Associations of Local Authorities of South-East Europe*

Total local government revenue in Croatia equals to 12.1 per cent of GDP as reported to Eurostat with local governments units managing on their own only 7.3 per cent of GDP. The most important group of revenues is shared taxes which generate about 47 per cent of consolidated local government revenues.

The single most important source of revenue is the Personal Income Tax (PIT) which generates 41 per cent of consolidated local and regional government revenues. National government sets PIT rates, levels, exemptions and credits. Local governments are allowed to impose a surcharge of up to 18 per cent on the amount of PIT taxpayers owe to the government. The surcharge currently constitutes 10 per cent of all local PIT revenues.

Since the income tax is shared between local and regional governments and also used for funding two local government equalization schemes, frequent changes of tax rates undertaken by the national government significantly affect local budgets and the predictability of revenues. This in turn affects the local governments' ability to provide uninterrupted services and demotivates any longer term planning.

About 31 per cent of local budgets come from own-sources. Most own-source revenue comes from Land Use Fees and Land Development Fees. Croatian local governments also derive a significant amount of own-revenue from the sale and rental of municipal assets and other local taxes. Fees are considered earmarked revenues, while taxes and proceeds from asset management are non-earmarked revenues. Both fees are mandatorily collected and enforced by the local government.

Local taxes include, but are not limited to: PIT surcharge, gift and inheritance tax, vehicle and vessels tax, amusement machines tax, real-estate transfer tax, second home tax, beverage sale tax, tax on use of public space, etc. Most of the taxes are either set or capped by national legislation, except for the Tax on Use of Public Space. PIT surcharge and amusement machines taxes are mandatorily collected by the National Tax Administration (NTA) and the other local taxes can be collected either by the NTA or the local government itself, pending local council decision. Croatia does not collect real-property tax, although the tax was introduced into the tax system in late 2016, but repealed by the government in September 2017, just three months shy of its effective date.

General and investment grants comprise the remainder of local government revenues. These include grants for decentralized functions, transfers of EU funds and intergovernmental transfers. Grants for decentralized functions are distributed to counties, large towns, seats of counties and a few other towns who have taken over some of the previous central government responsibilities. Grants are based on so-called minimal standards for service provision which are calculated according to measurable indicators related to service (e.g. number of pupils in school, etc.). Funding levels for decentralized functions are rather stable and incrementally increased over the past four years. Transfers of EU funds have increased tenfold from 2014.



Over the course of last ten years, in the aftermath of the financial crisis, local government revenues dropped from EUR 3.4 billion to 2.8 billion and steadily recovered to current 3.1 billion Euro. Due to budgetary and fiscal restrictions set by law, local governments had to manage their expenditures in line with the available funding, borrowing only for investment projects. In order to maintain stable relative levels of funding for specific functions, local governments reduced funding for Housing and Community Amenities while keeping stable or increasing funding levels for social protection and education.

Current local government expenditure structure is as follows: 8.5 per cent wages and benefits, 22.8 per cent material expenditures (38 per cent of which is current and capital maintenance), 4 per cent subsidies, 24,7 per cent current and investment grants, 5.3 per cent household grants, 17.9 per cent investments in long term assets and 16.8 per cent other expenditures.

Fiscal capacities of local governments vary significantly although most of local governments have equal or similar responsibilities in terms of service provision. Rural local governments therefore provide essential public services and urban local governments provide same or similar services but in a broader scope by establishing public institutions which provide advanced level of those services (e.g. libraries, museums, etc.). The government tried to address the disparity of fiscal capacities through a complex PIT sharing mechanism which essentially failed and was replaced with new fiscal equalization scheme in 2018.

References to Scientific and Non-Scientific Publications

Legal Documents:

Local Taxes Act no 115/2016 (*Zakon o lokalnim porezima*)

Law no 127/2017 on Financing of Local and Regional Self-Government Units (*Zakon o financiranju jedinica lokalne i područne [regionalne] samouprave*)

Scientific and Non-Scientific Publications:

Bajo A and M Bronić, 'Fiskalna decentralizacija u Hrvatskoj: problemi fiskalnog izravnjanja' (2004) 28 *Financijska teorija i praksa* 445

Stafa E and others, 'Fiscal Decentralization Indicators for South East Europe: 2006-2017' (NALAS 2018)



8.3 The Fiscal Equalization Fund

Dario Runtic, *NALAS Network of Associations of Local Authorities of South-East Europe*

Relevance of the Practice

The local government fiscal equalization practice directly addresses some of the key questions of urban-rural relations, specifically the differentiation of a financing system to take into account the size and fiscal capacity of local governments. The practice responds directly to the challenge of increasingly depopulated rural local governments (RLGs) experiencing a decrease in taxpayers.

Description of the Practice

The equalization system is conceived as a simple mechanism which provides funding to local governments of different size and unrelated to fiscal capacity in order to enable them to provide public services of the same level and quality to their residents. Croatian RLGs are facing depopulation due to lack of jobs, quality education and limited social infrastructure, all of which are the responsibility of RLGs. Prior to establishing an actual fiscal equalization system, difference in fiscal capacity for public service provision was 1:29 in rural areas and 1:6 in urban areas.

With such a tremendous difference in funding levels many rural and some urban local governments were struggling to sustain basic public services, while others were able to provide good public services, economic incentives and develop social infrastructure. This motivated taxpayers from underdeveloped RLGs to relocate either abroad or into more developed local governments thus leaving underdeveloped RLGs with even less taxpayers – a downward spiral which led to even greater depopulation.

On the other hand, the relocation of taxpayers to the economic centers and the ability of these centers to boost the local economy, including tourism activities, created in some cases enormous pressure on communal and traffic infrastructure, health and education facilities and distorted real-estate markets. Supposedly, road traffic congestion coupled with substandard public transport and the lack of quality of social infrastructure inhibits relocation of taxpayers to adjoining or surrounding municipalities with more affordable housing but significantly lower fiscal capacities.

Increase of fiscal capacities of underdeveloped local governments could supposedly lead to improvement of social infrastructure for residents and creation of economic stimulus for expanding companies to relocate outside of centers of economic activity with more affordable and available land and real estate thus relieving economic centers of pressure on infrastructure and institutions.

Up until 2017 there was a quasi-fiscal equalization mechanism in place. Personal Income Tax revenues were redistributed between three levels of government through a complex set of



shares depending on the local government development index with the aim of equalizing funding levels, enabling economic development and addressing demographic issues in underdeveloped local governments. This effort was coupled with higher tax credits and other tax incentives for residents. However, the scarce evidence available did not support the efficiency of this mechanism. The local government development index, the backbone of the system, was highly criticized for misinterpreting the actual development capacity of individual local governments.

In 2016 and 2017 the Ministry of Finance worked with research institutions, academia, local government associations and other branches of government on restructuring the fiscal equalization mechanism. In 2017 the parliament legislated changes to the Law on Local Government Financing to simplify PIT redistribution and introduce a non-earmarked Fiscal Equalization Fund. As of 2018, local governments receive 60 per cent of PIT collected in their jurisdictions area; regional governments 17 per cent; another 6 per cent are allocated to local/regional governments for decentralized functions and 17 per cent are paid into the Fiscal Equalization Fund. Central government does not receive any share of the PIT.

Fiscal Equalization Fund is an automatic redistributive transaction account which delivers funding to the recipients daily, based on individual shares of local and regional governments in the Fiscal Equalization Fund which are set in advance of the budget year. Individual shares are calculated based on the type of local government (urban, rural or regional) and its historical five-year fiscal capacity (PIT revenue per capita) as compared to national averages (target PIT revenue per capita). Target fiscal capacity for rural local governments is currently EUR 262 per capita and EUR 343 per capita for urban local governments.

All key elements of the Fund (total funding, target levels, share calculation formula, automatic distribution) are prescribed by national legislation which is a subject to urgent review by the Constitutional Court should a local government unit address it. Benefits of such a system, aside of eliminating PIT revenue disparities, are transparent and predictable revenue streams, improved liquidity of local governments, better advocacy position for Local Government Associations and efficient judicial protection. The national government's budgeting process and individual bylaws have virtually no influence over the Fund, but economic trends and national taxation policies can affect funding levels.

Assessment of the Practice

Currently, EUR 283 million (7.5 per cent of total local government revenue) gets distributed through the fiscal equalization mechanism. According to the data from the Ministry of Finance, in the first year of operation of the fiscal equalization fund, differences in fiscal capacity were reduced from 1:29.1 to 1:6.8 in rural municipalities and from 1:6 to 1:3.2 in urban towns.

Whether or not the fiscal equalization achieved aforesaid goals may be too early to tell just yet, but this certainly needs to be thoroughly researched. According to data from the Ministry of Finance processed by the Association of Cities in Croatia, 4 out of 92 towns who currently participate in fiscal equalization will no longer receive equalization funding in 2020 and funding levels will decrease for additional 13 towns compared to 2019 projections. Data on



municipalities was not processed. This data alone implies that those 17 towns are on upward economic trajectory and 4 of them have already crossed the national average PIT revenue per capita. However, further research should take into account other relevant indicators such as relocation of taxpayers and (creation of new) businesses, investments in social infrastructure, demographic trends, etc.

The apparent success of the fiscal equalization system can be attributed to the fact that it solely observed fiscal capacities of local government units and provided local governments with autonomy in setting their own spending priorities, unlike measures which tried to solve a number of issues with a one-size-fits-all solution for 566 different urban and rural local governments. The Ministry of Finance played a pivotal role in the creation of the successful system by merging existing equalization funding streams into one and providing additional funding on top of it.

This practice has a direct impact on some of the issues tackled in other report sections. Fiscal capacity is prerequisite for local governments in Croatia to request devolution or decentralization of functions from regional or national governments. There is anecdotal evidence of municipalities already requesting decentralization of education function but the formal evidence is yet to surface. Media outlets report that local governments are providing additional social welfare support for elderly citizens, constructing new nursery facilities or providing fiscal incentives for young families, an effect of that is yet to be researched.

Participatory budgeting had been present to varying extent in Croatian local governments over the last 20 years or more, but struggling local governments were not engaging in it due to very limited funding available and local demographics. Some of the local governments which are beneficiaries of fiscal equalization are taking a proactive stance in participatory budgeting.

References to Scientific and Non-Scientific Publications

Legal Documents:

Law no 127/2017 on Financing of Local and Regional Self-Government Units (*Zakon o financiranju jedinica lokalne i područne [regionalne] samouprave*)

Scientific and Non-Scientific Publications:

A Bajo and M Bronić, 'Fiskalna decentralizacija u Hrvatskoj: problemi fiskalnog izravnjanja' (2004) 28 *Financijska teorija i praksa* 445

— Bronić M and Primorac M, 'Oblikovanje modela vodoravnog fiskalnog izravnjanja u Republici Hrvatskoj' (Association of Cities 2012)



9. Local Financial Arrangements in Albania

9.1 The System of Local Government in Albania

Elton Stafa, NALAS – Network of Associations of Local Authorities of South-East Europe

Types of Local Governments

With the 2014 Territorial and Administrative Reform (TAR)²³⁰, in Albania there are two types of local self-governments, i.e. the basic level of local self-government consisting in 61 municipalities (*Bashkia*), and the second tier of local self-government made up of 12 regions (*Qarku*).

Municipalities comprise also administrative units, which can be towns and/or villages. In most cases, the administrative units are the former rural communes that were amalgamated with the TAR with their closest and cultural and historical urban centers. The Municipality of Tirana, for example, is subdivided in 24 administrative units, i.e. 11 subdivisions of the former (urban) municipality and 13 (rural) communes that were amalgamated to Tirana with the TAR. The administration of these units is part of the municipal administration and is directed by an administrator who is appointed and dismissed by the mayor. Towns may be divided into smaller units called quarters (*lagje*). As a rule, a quarter can be established in territories with over 20,000 residents. A town's division into quarters and its territory shall be approved upon a decision of the municipal council.

The regions, the second-tier local self-governments in Albania, were and continue to be entrusted with only few general responsibilities for 'coordination and harmonization' of regional policies with national policies and they may also perform any function that is mandated to them by one or more municipalities within the region or the central government. In practice, the regions do not perform any significant responsibility, other than some administrative tasks delegated by the national government.

Legal Status of Local Governments

The right of local governments to self-government is enshrined in Article 13 of the Constitution of Albania and the Law on Local Self-Government. The constitution prescribes that local government in Albania is based on the principle of decentralization of powers and is exercised according to the principle of local autonomy. The constitutional standing of the second-tier of local self-government, the regional council (*Këshilli i Qarkut*), is the same as for municipalities, regardless of the fact that they have only a few 'coordination' own responsibilities. Only the

²³⁰ Law no 115/2014 on the Administrative-Territorial Division of Local Government Units in the Republic of Albania.



municipal council (*Këshilli Bashkiak*) is directly elected. The regional council is composed of members from the elected bodies of the municipalities that make up the region, i.e. mayors and other members that are elected from among municipal councilors of the municipalities that compose the region.

The Law on Local Self-Government prescribes the right and the ability of local governments in Albania to regulate and manage public affairs under their own responsibility, within the limits of the law. The exercise of the right of self-government is guaranteed by additional rights of local governments as juridical persons, the right to own and dispose of property, to raise revenues and make expenditures, to perform economic activity, to cooperate with other local governments, etc. The Law on Local Self-Government prescribes also the basic principles of local government finances, according to which, local governments 'shall be entitled, within national financial policies, to adequate financial resources, commensurate with the responsibilities provided for by the Law' (Article 34).²³¹

(A) Symmetry of the Local Government System

All municipalities are entrusted with general competences to carry out all responsibilities relevant to the local community (as prescribed by law), and any other responsibility that is not specifically assigned (by law) to another level of government. Local governments are entrusted with own and delegated functions and responsibilities. Local self-governments have own responsibilities in the core public services and public infrastructure, in the field of education, social protection, culture, recreation and sports, environmental protection, agriculture, rural development, forests and pastures and protection of nature and biodiversity, local economic development and public order and safety including fire protection. Although these are all 'own' local matters, the degree of political and administrative and fiscal powers decentralized to local governments varies significantly from function to function and in any case, in performing these functions, local governments should also respect regional and national policies and standards for service delivery.

The spirit of the new Law on Local Self-Government entails symmetric decentralization of exclusive functions to all new 61 municipalities, regardless of size, capacity or any other condition that may affect service delivery for particular functions. However, the law introduces also the possibility of asymmetrical decentralization to specific municipalities. However, the transfer of specific responsibilities to specific local governments shall be regulated through a separate law.²³² In practice there are a number of cases of asymmetries through transfers of competences to specific local governments for specific purposes, either through a specific law, government decree or a more simple Memorandum of Cooperation between different central and local governments. Examples include the transfer of responsibilities for operating and maintaining pre-university students' dormitories, the operation of certain social service centers that were previously operated by a specific line ministry and public order, as the

²³¹ Law no 139/2015 on Local Self-Government, Art 34.

²³² Law no 139/2015, dated 17 December 2015, on Local Self-Government, Official Gazette No 249, p16963, Art 21.



municipal police in Tirana may impose fines for the irregular parking within the territory of the municipality, which is a national police competence.

Political and Social Context in Albania

Albania has a relatively young history of democratic local self-government. While an independent country since 1912, for about half a century (1944-1990), Albania suffered a severe totalitarian regime, during which local government meant simply 'local structures of the (central) government'. Albania began the journey of political and administrative decentralization in 1992 with the first local democratic elections. As in many other ex-communist countries, the early reform processes simply focused on laying down the basic concepts and legal framework for decentralization and local self-government to counter a half century legacy of repressive and non-democratic institutions.²³³ In the early 2000s Albania adopted decentralization reforms that saw the consolidation of local responsibilities and the introduction of basic instruments for the financing of local responsibilities. The reforms enacted between 2014 and 2017, have been even more impactful. In 2014, the Government of Albania (GoA) consolidated 373 urban and rural local governments into 61 municipalities. In 2015, Parliament passed a new Law on Local Self-Government (LSGL)²³⁴ and a new Law on Local Self-Government Finance (LGFL).²³⁵ These laws were considered as critical components of a larger strategic plan to expand the role of democratically-elected local governments in Albania by creating larger municipalities and giving them more responsibilities and resources.²³⁶

Following the collapse of the communist regime, the political landscape is dominated by two major parties, the Democratic Party (DP) and the Social Party (SP). The third largest political party is the Socialist Movement for Integration (SMI). The 2013 general elections were won by a coalition between the SP and the SMI that governed together until the general elections of 2017, since when the SP is governing alone. Local politics is controlled by these three major parties. There have been only a few cases of an independent candidate running a local government as a mayor. The latest case when independent mayors run and took office is the local elections of 2007. Between 2007 and 2011 there have been 12 independent mayors out of 373. After 2011, there have been no cases of independent mayors taking office in Albania.

Regarding the social context of local government, it is important to note the massive number of Albanians that have left the country (but that still have Albanian citizenship) since the early 1990s. Only between 2014 and 2018, about 200,000 Albanians have emigrated while about

²³³ Stafa Elton and Xhumari Merita, 'Albania: Aligning Territorial and Fiscal Decentralisation' in William Bartlett, Sanja Kmezić and Katarina Đulić (eds), *Fiscal Decentralisation, Local Government and Policy Reversals in Southeastern Europe* (Palgrave Macmillan 2018).

²³⁴ Law no 139/2015 on Local Self-Government (LSGL).

²³⁵ Law no 68/2017 on Local Self-Government Finance (LSGFL).

²³⁶ Government of Albania, 'National Crosscutting Strategy for Decentralization and Local Government' (adopted by Decision of the Council of Ministers no 691 of 29 July 2015).



100,000 have immigrated.²³⁷ As for internal population movements, the 2011 census ascertained that the population living in urban areas for the first time exceeded the population living in rural areas. The resident population in urban areas was 53.5 per cent, while 46.5 per cent lived in rural areas.

References to Scientific and Non-Scientific Publications

Legal Documents:

Law no 115/2014 on the Administrative-Territorial Division of Local Government Units in the Republic of Albania

Law no 139/2015 on Local Self-Government

Government of Albania, 'National Crosscutting Strategy for Decentralization and Local Government' (adopted by Decision of the Council of Ministers no 691 of 29 July 2015)

Law no 68/2017 on Local Self-Government Finance

Scientific and Non-Scientific Publications:

Stafa E and Xhumari M, 'Albania: Aligning Territorial and Fiscal Decentralisation' in William Bartlett, Sanja Kmezić and Katarina Đulić (eds), *Fiscal Decentralisation, Local Government and Policy Reversals in Southeastern Europe* (Palgrave Macmillan 2018)

²³⁷ Instat, 'Migration and Migrant Integration' (Instat Institute of Statistics)
<<http://www.instat.gov.al/al/temat/treguesit-demografik%C3%AB-dhe-social%C3%AB/migracioni-dhe-integrimi-i-migrant%C3%ABve/#tab2>>.



9.2 Local Financial Arrangements in Albania: An Introduction

Elton Stafa, *NALAS – Network of Associations of Local Authorities of South-East Europe*

The framework for local government financial arrangements in Albania is provided by the Constitution, the Law on Local Self-Government, the Law on Local Self-Government Finance and the Law on the Local Tax System. This legal framework guarantees local governments' rights to raise sufficient revenues on its own through local taxes and fees, the management of their assets; borrowing etc.; the right to benefit from sufficient stable, predictable and equitable freely disposable intergovernmental transfers; the right to revenues from shared taxes; the right to earmarked/competitive based grants that support the development of local infrastructure; the right to conditional/earmarked grants to perform central government functions delegated at the local level; the right to be compensated in case the national government makes any changes to local government taxing powers or their entitlement to freely disposable transfers.

Local government revenue constituted 14 per cent of total public revenue and 4 per cent in GDP terms in 2018.²³⁸ Compared to previous years, local government revenues have increased significantly, as a result of the increased responsibilities (transferred with the new Law on Local Self-Government adopted in 2015), increased funding from the general-purpose unconditional grant and the increase in own revenues.

The intergovernmental finance system in Albania is composed of: own revenues raised by local governments themselves which includes fees and charges amounting in 2019 to 43 per cent of total own revenues; freely disposable transfers received from the state budget in the form of general-purpose unconditional grants and shared taxes; and conditional transfers from specific bodies of the central government such as the specific sectoral block grants and investment grants.

On average, local governments raised on their own 39 per cent of total local government revenues in 2018; the second largest single revenue source is the general purpose unconditional grant, which provided for 27 per cent of total local government revenues in 2018; shared tax revenue provided for only 2 per cent of local government budgets; while conditional grants constitute the remaining 33 per cent of local budgets, where sectoral block grants for the new functions decentralized with new Law on Local Self-Government constitute 12 per cent of total local government revenues while conditional competitive based investment grants constitute 21 per cent of total local revenues in 2018.

In terms of financial autonomy, local governments control and manage in an autonomous manner about two thirds (64 per cent) of local government revenues. The different types of intergovernmental transfers constitute up to 61 per cent of local government revenues²³⁹ of

²³⁸ NALAS, 'Statistical Brief: Local Government Finance Indicators in South-East Europe' (2019).

²³⁹ This is similar to the other countries in the SEE region, where about 65% of local expenditures are financed through intergovernmental transfers, in the form of shared taxes and unconditional and conditional grants (NALAS, 2019).



which half is directly managed in an autonomous manner by local governments themselves and the remaining half is directly influenced or managed by the central government bodies that provide the conditional grants.

The most important sources of own revenue are the recurrent property tax, the tax on the infrastructure impact of new construction and local fees and charges for local services; taken together these three revenue sources constitute up to two thirds of own local revenues. Albania has recently reformed the property tax, by moving closer to a market-value based tax assessment (for urban buildings only). The tax rate is set at 0.05 per cent of the assessed value for household taxpayers and 0.2 per cent of the assessed value for business taxpayers. Nevertheless, in most cases, municipalities continue to charge a lump sum payment for the property tax.

The Unconditional Grant is the main source of revenue for local government units. Even with the territorial consolidation, this grant constitutes more than 50 per cent of revenues for more than 70 per cent of the newly established municipalities.²⁴⁰ A new formula for the allocation of Unconditional Grants was adopted in October 2015. The new formula ensures that the allocation of funds is based on concrete, tangible and verifiable criteria, increasing therefore the fairness and transparency, while at the same time ensuring the harmonization of the allocation of funds with the new reality imposed by the territorial and administrative reform. Officially, there is no distinction between urban and rural local governments. All municipalities have an urban center (town) and administrative units (former rural communes). But the unconditional grant is allocated to local governments based on their relative population, population density and number of pre-university pupils. The component based on population density discriminates positively the more 'rural' municipalities – those that have more rural territory. In simple terms, this component provides funding only for those municipalities that have a population density smaller or equal to the national average population density. In practice, half of the municipalities receive extra funding for having a lower population density and - presumably - higher than average costs in service delivery and fewer fiscal capacity.

In 2017, Albania adopted for a first time a comprehensive Law on Local Self-Government Finances (LGFL). The LGFL constitutes a monumental achievement and a major milestone in Albania's progress toward decentralization. The law provides for a more logical and efficient framework for local taxing powers, intergovernmental transfers, public finance management, and intergovernmental dialogue and consultation.²⁴¹ With the approval of this law, local government revenues from the unconditional grant for 2019 were 42 per cent higher than in 2015, creating a huge opportunity for local governments to improve local services.

²⁴⁰ Tony Levitas and Elton Stafa, 'Creating an Equitable, Transparent, and Predictable Unconditional Grant Formula', (USAID's Planning and Local Governance Project PLGP 2015) <https://www.plgp.al/wp-content/uploads/2.-Unconditional-Grant-Policy-Paper-September-30-2015-Clean_eng-2.pdf> accessed 18 May 2019.

²⁴¹ Tony Levitas and Elton Stafa, 'Key Recommendations for the Development and Discussion of the Law on Local Government Finances' (USAID's Planning and Local Governance Project PLGP 2016) <https://www.plgp.al/wp-content/uploads/3.-LGFL_Draft-Policy_Brief_Key_Recommendations_print-FINAL_eng.pdf> accessed 18 May 2019.



References to Scientific and Non-Scientific Publications

Legal Documents:

Government of Albania, Ministry of Finance and Economy, Annual Budget Laws (2016-2020), Annex 1 – The Allocation of the Unconditional Grant to Local Governments

Law no 68/2017 on Local Self-Government Finance

Scientific and Non-Scientific Publications:

Levitas T and Stafa E, 'Creating an Equitable, Transparent, and Predictable Unconditional Grant Formula', (USAID's Planning and Local Governance Project PLGP 2015) <https://www.plgp.al/wp-content/uploads/2.-Unconditional-Grant-Policy-Paper-September-30-2015-Clean_eng-2.pdf> accessed 18 May 2019

NALAS, 'Statistical Brief: Local Government Finance Indicators in South-East Europe' (2019)



9.3 The Allocation of the General-Purpose Unconditional Grant and Fiscal Equalization

Elton Stafa, *NALAS – Network of Associations of Local Authorities of South-East Europe*

Relevance of the Practice

The general-purpose unconditional grant funds more than 50 per cent of the budget for 70 per cent of municipalities in Albania. From this perspective it is the single most important financing mechanism for the vast majority of local governments. The allocation formula of the grant treats differently densely populated municipalities and municipalities with a population density below the national average. By the same token, local governments with 'lower than average fiscal capacity' are compensated, by 'taxing' more those municipalities that have 'higher than average fiscal capacity'. The practice directly addresses some of the key questions of report section 3 on local finances, in particular the differentiation of the financing system to take into account the size and fiscal capacity of local governments. The practice responds directly to the challenge of increasingly depopulated rural local governments and commuters from suburbs.

Description of the Practice

The concept of the general-purpose unconditional grant for local governments was introduced in 2001, providing local governments with freely disposable funding that they could use for the implementation of their own and shared functional responsibilities. The funding was allocated to local governments according to a formula whose criteria and coefficients were stipulated in the annexes of the annual budget law. The formula provided for a differentiated treatment of urban and rural local governments, through coefficients that provided extra revenues to mountainous rural local governments or economically distressed municipalities. The formula also included a differentiated treatment for the Capital City of Tirana, which incurred additional costs in providing services for large numbers of populations that migrated to Tirana – but that were not officially registered in Tirana (as taxpayers) and to commuters from neighboring municipalities that put additional pressure on service provision and infrastructure in Tirana.

Changes in the political landscape in 2005 had a huge impact on the way in which the formula was allocated to local governments. The most relevant change was the elimination of the differentiated treatment of the capital city Tirana, on the grounds of an 'equal treatment' of local governments; and the frequent changes of the weights of the criteria and coefficients used for the allocation of funding. Nevertheless, the major weaknesses of the general-purpose unconditional grant in Albania were its historical underfunding, when compared to other counterparts in the region whose local governments had a similar bundle of responsibilities as in Albania;²⁴² and the downward instability and unpredictability over time. All these changed

²⁴² NALAS, 'Fiscal Decentralization Indicators for Southeast Europe, 2006–2017' (2018).



between 2015 and 2017 when the government of Albania adopted a new formula for the allocation of the general-purpose unconditional grant to local governments, and a new law on Local Self-Government Finance.²⁴³

Currently, the general-purpose unconditional grant for local governments is regulated by the Law on Local Self-Government Finance and the annual budget law annexes. This law constitutes a major milestone for Albania's path towards decentralized government. For the first time, the criteria and coefficients used for the allocation of the unconditional grant to local governments are incorporated in a permanent piece of legislation. Before the adoption of the law, the rules were written and explained only in the annexes of the annual budget laws, where the government and parliament had significant room to change them from year to year, with adverse consequences to the planning and implementation of local services.

The new formula allocating the unconditional grant to municipalities follows three criteria. First, up to 80 per cent of the total pool is allocated to local governments on the basis of their resident populations, as measured by the last Census and corrected with 30 per cent of the difference with the population data of the Civil Status Register data; The 'consolidation' of the population number utilized for the allocation of funding was necessary to ensure a rationalization of funding to where the needs for local services actually 'are', supposedly better captured by the CENSUS, and not where the need is 'registered' – which is what the Civil Status Register provides for. It should be considered that Albania is not the only country in the region to utilize different population numbers when allocating funds to local governments.

Second, up to 15 per cent of the total pool is allocated on the basis of population density, reflecting differences in service delivery costs among local self-government units; Territorial consolidation changed reality by making most local government units similar in size, with a central city that should be capable of supporting new functions. From this perspective the former 'surface area' criteria of the former formula introduced in 2002 is no longer relevant, as there could be municipalities of similar territorial size but with different populations.

Third, no less than 5 per cent of the pool is allocated on the basis of the number of enrolled pupils in the pre-university education system; chosen because of the importance of education as a function, and also to compensate for potential inaccuracies in the number of resident populations.

The unconditional grant allocation formula provides also for the fiscal equalization between local self-government units that have different fiscal capacities. Fiscal equalization in Albania is based on:

- the fiscal capacity of every municipality, calculated as the total actual revenues that local governments have received in the former year from shared taxes;
- the equalization threshold, calculated as the national average revenues of local governments from shared taxes, above or below which the municipality benefits from or contributes to the equalization fund of the unconditional grant;

²⁴³ Tony Levitas and Elton Stafa, 'Creating an Equitable, Transparent, and Predictable Unconditional Grant Formula', (USAID's Planning and Local Governance Project PLGP 2015) <https://www.plgp.al/wp-content/uploads/2.-Unconditional-Grant-Policy-Paper-September-30-2015-Clean_eng-2.pdf> accessed 18 May 2019.



- the equalization coefficient calculated as the amount that municipalities with per capita revenues from shared taxes above or below the equalization threshold should give or receive in terms of equalizing funds;
- the equalization fund calculated as the amount of funds necessary to ensure that all municipalities arrive at in the chosen equalization threshold. Local self-government units, with fiscal capacity lower than the equalization threshold are compensated as per the pre-set equalization coefficient and the available equalization fund resulting from the contributions of those municipalities which have a fiscal capacity above the threshold. In practice the equalization fund is created by taking funds from local governments that have higher than average per capita revenues from shared taxes, through specific calculations, explained in detail in annual budget laws.

The new Law on Local Self-Government Finance made possible also for the first time in Albania, the anchoring of the annual size of the unconditional grant to a macroeconomic variable, a practice adopted frequently at international and regional level. In fact, according to this law, the size of the unconditional grant can be no less than 1 per cent of the GDP and no less than the total amount that was allocated the previous year. This wording creates a double safety for local governments. Firstly, the size of the grant is more stable and predictable and it also increases with the economy over time; and secondly, being a novelty also on public finance theory, the size of the grant cannot be lower than the amount allocated the year before – which literally means that even if the economy goes down, the size of the unconditional grant cannot be lower than the amount that was allocated the former year.

The main institutions involved in the determination and allocation of the general purpose unconditional grants to local governments are: the Ministry of Finance and Economy, responsible for the implementation of the formula for the allocation of unconditional grants to local governments, the development of the annual budget law that explains in details how the formula works, the development of the macroeconomic projections of the GDP; the General Tax Administration, that collects the national taxes whose yield is shared with local government; the Council of Ministers and Parliament that shall approve the allocation and amounts of grants for local governments as part of the approval of the annual budget law. However, it has to be specified that over the past three years, the Economy and Finance Committee of Parliament has made ad hoc decision to add some additional funding to select local governments. The logic behind this practice is not explained in the budget law annex or justification reports, nor in any other official public document. The lack of transparency has been accompanied by concerns over political favoritism of select local governments.

Legally speaking, there is not any differentiation in terms of urban and rural municipalities in Albania. Municipalities incorporate both the urban center and the rural areas (former communes that were amalgamated with the urban center with the Territorial and Administrative Reform TAR) around it. However, local governments are differentiated in an indirect manner. The first type of differentiation is done through the implementation of the population density criteria, where local governments that have a population density below the national average are treated preferentially. In fact, the lower the population density of a municipality, the better it is treated by the formula. The rationale for such treatment is the assumption that larger municipalities which have fewer people face higher costs in service delivery (because of the lack of economies of scale and the large territory to be served). Larger



municipalities with few inhabitants, in particular in the aftermath of the territorial consolidation reflect also those municipalities that have incorporated large rural and mountainous areas. On the other hand, those municipalities that have a population density above the national average, not only do not receive any preferential treatment, but they do not receive any funding at all from the second component of the unconditional grant formula – population density. In fact, 15 per cent of the overall size of the unconditional grant is allocated to 39 out of 61 municipalities. Municipalities with small or average territory and large population numbers have higher opportunities to reach economies of scale, and therefore, it is assumed that they have lower service delivery costs. However, this assumption does not reflect at all the additional costs imposed on service delivery and infrastructure of more urban municipalities from commuters from suburban areas or internal migration movements of people that formally continue to be registered in their hometowns but have chosen to live in the capital city – without becoming a taxpayer of the capital city. Indeed, public finance theory and research show that service delivery costs follow a U-shaped pattern with regards to population, where municipalities with few inhabitants have higher costs to serve them because of the lack of economies of scales and municipalities with too many inhabitants have higher costs because of significant pressure on infrastructure and on services from commuters or other persons that use their services and infrastructure without contributing through taxes.

The second type of differentiation is performed through fiscal equalization. In practical terms, those local governments that have a lower tax base and fewer taxpayers – in most cases coinciding with municipalities that have a smaller urban center and large rural areas with few taxpayers – receive some equalizing funds which are paid by those local governments that have ‘higher than average’ fiscal capacity, - which in most cases are municipalities with larger urban centers hosting more economic activities and therefore more taxpayers.

Assessment of the Practice

The reform of the general-purpose transfer introduced by the new Law on Local Self-Government Finance in 2017 aimed at increasing the stability and predictability of the local government finance system in Albania and help local authorities in planning and delivering on their responsibilities through more stable and predictable local budgets. The commitment of the national government in Albania to implement the provisions of the reform and provide local governments with increased transfers (as foreseen by the reform) even in the background of the devastating effects of the 2019 earthquakes and the 2020 Covid-19 crisis needs to be praised as it has helped Albanian municipalities in responding to these crises.

On the effectiveness of the general grants it is important to clarify that they aim to provide local governments with freely disposable –unconditional—revenue for two basic aims: (i) to provide local governments with ‘the difference between the costs of their own responsibilities (expenditure needs) and the revenues they can raise from own sources (fiscal capacity)’ (vertical gap); and (ii) to provide local governments with ‘lower than average fiscal capacity



additional funds so they can provide public services of a reasonably equal standard' (horizontal gaps).²⁴⁴

The extent to which the general purpose unconditional grant is able to fill the vertical gap is debatable, in that indirectly, the formula treats in a preferential manner only one of the two categories of local governments that have higher costs of service provision – municipalities that have more rural areas in their territory and fewer inhabitants. From this perspective, it should be taken into account also the additional costs for service delivery and infrastructure maintenance and development incurred by larger and more urbanized local governments, as indicated by other regional and international best practices in financing local governments.

Secondly, the extent to which the grant is able to fit the horizontal gap is debatable too. In practice, fiscal equalization is paid by local governments themselves, reshuffling funds that are provided by the unconditional grant. This is a typical 'Robin Hood' system, taking additional resources from 'more urbanized' local governments that have higher than average revenues from shared taxes, to allocate them to more 'rural' local governments with lower than average fiscal capacity. Ultimately, over the past 17 years, the 'poorer' municipalities have been subsidized by only a small group of larger municipalities, where more than 85 per cent of the funds necessary to 'equalize' shared tax revenues of local governments came from the Capital City of Tirana and 10 per cent from the second largest city in the country – Durres. From this perspective, 95 per cent of the funds necessary to bring all local governments closer to a predetermined share of the national average of revenues are raised by 'taxing' Albania's two largest cities. Nevertheless, it is important to highlight that the horizontal fiscal equalization component of the general-purpose transfer for local governments in Albania is small, as is the pool against which equalization is calculated. Local governments are equalized on their shared revenues (which constitute less than 5 per cent of local revenues) and the amount of funds that are redistributed to 'poorer' municipalities make up no more than 2 per cent of total local government revenues. In short, all municipalities benefiting from the equalization receive only a trivial amount of funds which are not able to account for the significant disparities across local governments as regards their fiscal capacity and territorial development. On the other hand, it is important to highlight also that Albania has a very strong equalization component in the calculation of the expenditure needs of local governments that provides for additional funds for smaller and less dense municipalities which have higher than average costs in providing services and lower than average fiscal capacities.

References to Scientific and Non-Scientific Publications

Blöchliger H and Charbit C, 'Fiscal Equalisation' (2008) 44 OECD Economic Studies 1

Kim J and Lotz J, 'Measuring Local Government Needs' (The Korea Institute of Public Finance and the Danish Ministry of Social Welfare 2008)

²⁴⁴ Hansjörg Blöchliger and Claire Charbit, 'Fiscal Equalisation' (2008) 44 OECD Economic Studies 1
<<https://www.oecd.org/norway/42506135.pdf>>.



Levitas T and Stafa E, 'Creating an Equitable, Transparent, and Predictable Unconditional Grant Formula' (USAID's Planning and Local Governance Project PLGP 2015) <https://www.plgp.al/wp-content/uploads/2.-Unconditional-Grant-Policy-Paper-September-30-2015-Clean_eng-2.pdf>

NALAS, 'Fiscal Decentralization Indicators for Southeast Europe, 2006–2017' (2018)



10. Local Financial Arrangements in Moldova

10.1 The System of Local Government in Moldova

Viorel Girbu, *Congress of Local Authorities from Moldova, NALAS - Network of Associations of Local Authorities of South-East Europe*

Types of Local Governments

The Republic of Moldova is organized in *rayons*, cities, villages and the Autonomous Region of Gagauzia. The administrative and territorial organization of the country is based on two levels: villages (communes), sectors (of the Chisinau municipality) and cities (municipalities) constitute the first level; *rayons*, Chisinau municipality and Balti municipality constitute the second level. Chisinau municipality is the capital city of the country and its status is regulated by the organic law. Urban localities are classified on four ranks according to a list of indicators that describe their level of social and economic development. Cities that meet specific requirements established by law could be assigned with the status of a municipality.

A total number of 32 *rayons* and 1495 localities (from which 32 are part of the Autonomous Region of Gagauzia) exist in Moldova (excluding the breakaway Transnistrian Region of Moldova). From the total list of localities, 66 are urban localities, including 53 cities and 13 municipalities and 832 are rural localities. 597 localities do not have own administration as they are part of a bigger administrative entity.

Legal Status of Local Governments

In fulfilling their competences, the local public administration authorities have autonomy, enshrined and guaranteed by the Constitution of the Republic of Moldova, the European Charter of Local Self-Government and by other treaties to which the Republic of Moldova is a party. According to Article 109 of the Constitution of the Republic of Moldova, 'public administration in the administrative-territorial units is based on the principles of local autonomy, decentralization of public services, eligibility of the local public administration authorities and consultation of citizens in the local issues of special interest.'

The public administration authorities, through whom local autonomy is exercised in villages and cities, are the elected local councils and the elected mayors. Local councils and mayors act, under the conditions of the law, as autonomous administrative authorities and manage public affairs of villages and cities. The *rayon* council coordinates the activity of the village and city councils in order to realize the public services of district interest. The *rayon* council is elected and functions according to the law.

The relations between the local public authorities are based on the principles of autonomy, legality and collaboration in solving common problems. In order to ensure local autonomy, the



local public administration authorities elaborate, approve and manage autonomously their budgets and have the right to implement local taxes and to establish their amount according to the law.

(A) Symmetry of the Local Government System

For the first-level local authorities, the following own fields of activity are established:

- urban planning and management of green areas of local interest;
- collection and management of household waste, including the cleaning and maintenance of land for their storage;
- distribution of drinking water, construction and maintenance of sewage and wastewater treatment systems;
- construction, maintenance and lighting of local public streets and roads, local public transport;
- arrangement and maintenance of cemeteries;
- administration of goods from local public and private domains;
- construction, management, maintenance and equipping of pre-school and out-of-school institutions (nurseries, kindergartens, art schools, music);
- development and management of urban gas and heat distribution networks;
- cultural, sporting, recreational and youth activities, as well as the planning, development and management of the infrastructures necessary for these types of activities;
- arranging agricultural markets, commercial spaces;
- carrying out any other measures necessary for the economic development of the administrative-territorial unit;
- establishment and management of municipal enterprises and organization of any other activity necessary for the economic development of the administrative-territorial unit;
- the construction of houses and the granting of other types of facilities for the socially vulnerable population, as well as for other categories of the population;
- organization of territorial services (stations) of rescuers and firefighters, contributing, in accordance with the law, to the protection of the cultural heritage and monuments in the administered territory.

For the second-level local public authorities, the following own fields of activity are established:

- administration of assets in the public and private areas of the district;
- planning and administering the construction, maintenance and management works of some public objectives of *rayon* interest;
- construction, administration and repair of the roads of district interest, as well as of the road infrastructure;
- organization of passenger car transport, administration of buses and car stations of *rayon* interest;
- establishing a general framework for the development of the territory at *rayon* level and the protection of the forests of *rayon* interest;



- supporting and stimulating the initiatives regarding the economic development of the administrative-territorial unit;
- elaboration and implementation of the projects of construction of the interurban gas pipelines (including the medium pressure gas pipelines), of other thermo-energetic objectives with local destination;
- maintenance of primary schools, kindergartens and high schools, vocational secondary education institutions, boarding schools and boarding schools with special regime, other institutions in the field of education that serve the population of the respective district, as well as other methodical activities from the field;
- administration of cultural, tourism and sports institutions of *rayon* interest, other cultural and sporting activities of *rayon* interest;
- administration of municipal enterprises of district interest;
- administration of social assistance units of district interest;
- development and management of community social services for socially vulnerable categories, monitoring the quality of social services;
- contribution, under the conditions of the law, to the protection of the cultural heritage and monuments in the administered territory.

Local public authorities of the first and second levels, within the limits of the law, have full freedom of action in the regulation and management of any matter of local interest which is not assigned to another authority. Other competences specific to the local public authorities can only be assigned to them by law.

The competences pertaining to the central public authorities can be delegated to the local public authorities by the first and second levels, respecting the criteria of efficiency and economic rationality. The delegation of powers may be performed by the parliament. The delegation of powers may concern all local public authorities of the first and second levels (general delegation) or only some local public authorities. The delegation of powers shall be accompanied by the provision of the necessary and sufficient financial resources for their realization.

Political and Social Context in Moldova

The resident population of the Republic of Moldova at the beginning of 2019 was 2.68 million, decreasing by 1.8 per cent compared to the same period of 2018. The main reason for the decrease in the number of the resident population is negative net migration that increased from –24,600 people in 2014 to –48,600 people in 2018. As far as internal population movements are concerned, about 57 per cent of the population lives in rural areas. According to the 2014 census, about 17 per cent of the population lives in the capital city of the country, Chisinau municipality.

The general local elections, the 7th electoral exercise since the proclamation of the independence of the Republic of Moldova, took place in 2019 throughout the territory of the country, including in the localities of Gagauzia, except for the settlements under the control of the unrecognized administration in Transnistria. The highest number of mayors come from the



social-democratic Democratic Party of Moldova (261), the former ruling party of Moldova, followed by the Party of Socialists of the Republic of Moldova (206) that are currently governing the country and representatives of the opposition electoral block ACUM (172) and SOR party (43). A total number of 112 city halls are led by independent candidates and a remaining 99 city halls are led by extra-parliamentary political parties.

References to Scientific and Non-Scientific Publications

Constitution of the Republic of Moldova, 1994

Law no 764/2001 on Administrative-Territorial Organization of the Republic of Moldova

Law no 435/2006 on Administrative Decentralization

Law no 436/2006 on Local Public Administration



10.2 Local Financial Arrangements in Moldova: An Introduction

Viorel Girbu, *Congress of Local Authorities from Moldova, NALAS - Network of Associations of Local Authorities of South-East Europe*

At first glance Moldova has a highly decentralized public sector with second and first level local authorities responsible for preschools, primary and secondary education, social assistance etc. Local governments in Moldova are responsible for about a fourth of total public revenue, the highest levels in South-East Europe. However, this picture may be misleading. In practice, the central government and its deconcentrated structures continue to hold substantial decision-making powers over local functions and finances. Considering that freely disposable grants and local own revenue together constitute about a fourth of total local revenues, most local governments' functions, besides being severely underfunded, remain de-facto delegated, rather than decentralized.

Given the significant (delegated) responsibilities that Moldovan local governments have to carry out, the budgetary system in Moldova is dominated by intergovernmental transfers. The current framework for own local government revenue mobilization remains largely ineffective because it provides little incentives to local governments for improving revenue collection. The educational sector receives the lion's share of the intergovernmental transfers (77 per cent). Other local government functions, although quite expensive, like the collection and management of household waste, including sanitation and maintenance of land for their storage, or, water supply, construction and maintenance of sewage and wastewater treatment systems, do not get any significant financial support from the state budget.

Shared tax revenues are allocated directly to local governments based on the residence of the employer, in different proportions: 100 per cent for villages, cities (excepting capital cities of *rayons*) and municipalities (excepting Chisinau and Balti); 50 per cent for the capital of Moldova - Chisinau municipality, Balti municipality and cities and municipalities that are also capital cities of a *rayons*; 25 per cent for *rayons*.

The remaining part of the shared tax revenues is withheld and transferred to the Balancing Fund,²⁴⁵ which is the source of the General-Purpose Transfer received by local governments. Both, cities and villages (Local Public Administration level 1 [LPA1]) and municipalities (excepting Chisinau and Balti municipalities) and *rayons* (Local Public Administration level 2 [LPA2]) can benefit from general purpose transfers, which are allocated from the balancing fund, 45 per cent in favor of LPA1 and 55 per cent in favor of LPA2. General purpose transfers are distributed to local governments on the basis of fiscal capacity per inhabitant data, multiplied by a coefficient of 1.3 and then on the basis of the population and size of territory of each LPA1. Fiscal capacity per inhabitant is determined by taking into consideration incomes

²⁴⁵ A recent legislative initiative approved by Parliament presumes the allocation of additional resources for the Balancing Fund, through a share of revenues generated by the income tax. However, the precise share of the revenues generated by the income tax that are directed into Balancing Fund will have to be determined by the annual state budget law as it is not prescribed by the law on local finances, leading to even more confusion in the local budgets' formation.



generated only by the wage tax, regardless of the type of the locality (rural, urban). For LPA2, the allocation criteria refer to population and territory (except for the municipalities of Chisinau and Balti that cannot benefit from general purpose transfers). General purpose transfers are limited to the total amount of the balancing fund. Rules for the general-purpose transfers' distribution do not take into consideration the total amount needed in order to meet the average fiscal capacity per inhabitant for all local public authorities (LPAs) which can lead to a situation when available funds are lower than needed.

The third, and larger, type of intergovernmental transfer is the Special Purpose Conditional Transfer, financed directly from the central government budget. These transfers are allocated to local governments to fund expenditure needs of the educational sector, road infrastructure, delegated functions and capital investment. These transfers do not finance *rayon* or local level social protection services provided by municipalities and *rayons*. Additionally, LPA1, have no competences in the distribution of the funds allocated for the development of the road infrastructure, which limits local financial decentralization.

References to Scientific and Non-Scientific Publications

Law 397/2003 on Local Public Finances



10.3 General Purpose Transfers as a Key Feature of the Local Financial System

Viorel Girbu, *Congress of Local Authorities from Moldova, NALAS - Network of Associations of Local Authorities of South-East Europe*

Relevance of the Practice

General purpose transfers represent one of the major sources of freely disposable income for local authorities. For 2018, they constitute about 10 per cent of total local revenues. The current system of allocation of general-purpose transfers across local authorities in Moldova can be characterized as been two-fold. Specific regulations are applied for Local Public Administration level 1 (LPA1) and level 2 (LPA2). We intend to assess how this practice influences development and autonomy at local level and whether current settings of the system are sensitive enough to existing differences between large and small localities in Moldova and how it affects the urban-rural divide and interplay.

General purpose transfers are particularly important for smaller and more rural communities, and therefore they play a crucial role in the ability of such municipalities to provide services to citizens. The general-purpose transfer provides for differentiation of the financing of local governments based on their fiscal capacity.

Description of the Practice

The new legislation adopted in 2013 introduced significant changes to the allocation of transfers to local governments. The new system is focused on incomes at the level of locality, although little has been done since the introduction of the new system in order to empower local authorities with improving their constituencies' income opportunities. The principle of balancing local expenditures to a certain minimum level, established nationwide, was replaced with a new formula focusing on local fiscal capacity, measured by the actual per capita revenues generated in each locality by the wage tax solely. On the other hand, local governments' powers over taxes on economic activities, (income and wage taxes), have been removed, eliminating local governments' interest and incentives on improving the business enabling environment at the local level.

The size and the method of distribution of the general-purpose transfers to local governments is prescribed by law, which makes the system immune to subjective political involvement, and in theory, also more predictable over time, although the changes in the macroeconomic and fiscal environment and the income tax policies may generate vulnerabilities.

Simulations based on 2018 data show that the revenues received by smaller (and more rural) communities from the general-purpose transfer are up to 63 times higher than the revenues they receive by the shared tax revenues that are allocated directly to them. On average, revenues that small communities with population up to 2000 inhabitants, constituting more



than half of the localities in the country, receive from the general-purpose transfer are about 7 times higher than the revenues they receive from the shared taxes allocated directly to them. The described situation is a consequence of the concentration of economic activities in the capital city of Moldova, Chisinau municipality and other larger and more urbanized local governments. About 62 per cent of the wage tax is collected solely in the Chisinau municipally and is partially redistributed to the rest of the country through the general-purpose transfers system.

The allocation system does not make direct differential treatment to urban or rural localities. However, in relative terms, considering that smaller and more rural local governments have smaller fiscal capacities (and therefore smaller direct revenues from the shared wage tax), on average, they are 'compensated more' than the other medium to larger sized municipalities through the general purpose transfers. Chisinau and Balti municipalities are excluded from the system and so is the autonomous region. Still, reference to just one dimension in part related to determination of the fiscal capacity per inhabitant looks simplistic and is questionable.

Assessment of the Practice

The purpose of the financing system is to assign to local governments sufficient financial resources so that they may comply with their obligations. The method of determination and allocation of general-purpose transfers in Moldova seems not to be able to respond to this major objective. The main reasons are the following. First and foremost, the size of general-purpose transfer is simply inadequate, when compared to the expenditure needs and functional responsibilities of local governments in Moldova, as compared to their counterparts in South-East Europe.²⁴⁶ Secondly, the way in which the size of the general-purpose transfer is determined, as a residual of the revenues of a single tax, does not guarantee the stability and predictability of funds, necessary for local governments to plan and implement effectively local services. Instead, it increases the vulnerability of local governments to the slightest change in both internal and external factors affecting the revenues from the wage tax. Thirdly, the allocation system is designed over criteria such as population and territory that in theory 'measure' local governments needs and actual per capita revenues from the wage tax, which in theory 'measures' fiscal capacity. The fact that fiscal capacity is measured on the results of a single tax only is a major weakness of the system. Ultimately, the system of allocating general purpose grants produces high disparities across local governments, when compared to the revenues that local governments receive directly from shared taxes. In this respect, the system can be regarded also as disincentivizing the development of localities with existing economic potential and providing a quasi-irrelevant financial incentive to vulnerable localities which are assisted to 'survive' but that are not able to develop.²⁴⁷

²⁴⁶ NALAS, 'Fiscal Decentralization Indicators of South East Europe' (9th edn, 2019).

²⁴⁷ Dumitru Budianschi, 'Autonomia financiară în Republica Moldova: evoluția veniturilor bugetelor locale' (Expert Group Centru Analitic Independent 2019) <<https://www.expert-grup.org/ro/biblioteca/item/1835-autonomia-financiara-in-republica-moldova-evolutia-veniturilor-bugetelor-locale&category=184>>.



There are also huge disparities and inequalities in the revenue options for autonomous region. In fact, with reference to Local Budgets, in the Republic of Moldova there are practically two parallel local budgetary systems. The autonomous region can benefit from an enlarged list of shared taxes that include also income tax, VAT and excise, although are not covered by general purpose transfers. From this perspective, the autonomous region benefits from more revenue raising options, which are denied to the other local governments in the country. The evolution of revenues compared to 2014 clearly shows that the income formation system for Gagauzia (autonomous region) is more advantageous than that applied in the rest of the country as it provides a broader fiscal base for the local authorities, specifically with respect to the taxes on economic activity. A direct link is created in this respect between the effort to economically develop a locality and subsequent potential financial benefits for the local authorities.

Finally, shared taxes represent a major source of income for the small municipalities in Moldova. Nevertheless, the system presents numerous shortcomings that refer mainly to its simplicity, disconnection from the realities of the municipalities, specifically small ones and inability to provide incentives to local governments and strengthen the link between efforts to improve the business enabling environment and actual financial benefits.

References to Scientific and Non-Scientific Publications

Legal Documents:

Law no 397/2003 on Local Public Finances

Scientific and Non-Scientific Publications:

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11. Local Financial Arrangements in South Africa

11.1 The System of Local Government in South Africa

Tinashe Carlton Chigwata, *Dullah Omar Institute, University of the Western Cape*

Types of Local Governments

South Africa has a multilevel system of government organised at national, provincial and local level. There are nine provincial governments while the local sphere of government is constituted by 257 municipalities. The 1996 Constitution of South Africa recognises three categories of municipalities – Category A, B and C.²⁴⁸ Metropolitan municipalities (Category A) have exclusive municipal executive and legislative authority in their respective areas of jurisdiction. Local municipalities (Category B), which currently total 205, share their municipal executive and legislative authority with district municipalities (Category C) within the relevant area they fall. District municipalities exercise their municipal executive and legislative authority in an area that covers more than one local municipality. These umbrella municipalities (currently 44) were established, among other reasons, to provide support and maximise on economies of scale in areas where there are low capacity municipalities. At policy level, the three broad categories of municipalities (A, B and C) are further broken down into seven sub-categories namely:

- A - metropolitan municipalities;
- B1 - secondary cities, local municipalities with the largest budgets;
- B2 - local municipalities with a large town as core;
- B3 - local municipalities with small towns, with relatively small population and significant proportion of urban population but with no large town as core;
- B4 - local municipalities which are mainly rural with communal tenure and with, at most, one or two small towns in their area;
- C1 - district municipalities which are not water services authorities; and
- C2 - district municipalities which are water services authorities.

National departments often make use of this sub-classification when dealing with municipalities.

The Constitution assigns to local government service delivery responsibilities and a development mandate. It equips local government with a variety of powers – legislative (the power to adopt by-laws), executive, fiscal, budget and administrative powers - to enable the delivery of these responsibilities and obligations. The functional areas of local government are enumerated in Schedule 4 (part B) and Schedule 5 (part B) of the Constitution. These schedules list matters, such as water supply, and electricity reticulation, land use planning, municipal health, local roads, and refuse removal. The principles of subsidiarity and assignment

²⁴⁸ See Sec 155(1) of the Constitution.



recognised in the Constitution provide opportunities for municipalities to exercise additional functions.

Legal Status of Local Governments

Unlike in many countries, local government is recognised in the Constitution of South Africa as a sphere of government.²⁴⁹ Thus, the existence of the institution of local government is not dependent on the goodwill of the national and provincial governments. This security of existence is extended to individual municipalities which may not be arbitrarily abolished or merged. Such abolishment or merger can only take place in terms of law and subject to oversight procedures that include the role of an independent body, the Municipal Demarcation Board.

The autonomy of municipalities is constitutionally recognised and can be enforced through the courts. Municipalities have a right to govern their respective areas and this right is only limited by the Constitution. The national and provincial governments may, however, regulate the exercise of this right but subject to limitations imposed by the Constitution. For instance, such regulation mainly takes the form of framework legislation that may not go to the 'core' of municipal functions as that is reserved for the legislative authority of municipal councils. National and provincial governments are further prohibited from impeding or compromising a municipality's ability to exercise this right whether by legislative or other means (Section 151(4) of the Constitution). Thus, it can be observed that unlike in many other countries, the Constitution of South Africa entrenches the existence and autonomy of local government that is jealously guarded by the courts in practice.

(A) Symmetry of the Local Government System

As explained above, there are three categories of municipalities in South Africa – metropolitan, local and district. The Constitution allocates to all metropolitan municipalities equal powers and functions. As opposed to metropolitan municipalities that have exclusive executive and legislative authority in their areas of jurisdiction, legislation and policy defines the division of responsibilities between district and local municipalities. As stated above, within the category of district municipalities there are those that have been designated as water services authorities and those that are not.

The Constitution entrenches the principles of subsidiarity and assignment which if implemented can also result in municipalities within and across categories exercising varying powers. Section 156(4) of the Constitution requires the national and provincial governments to assign to a municipality any of their functions if the function can 'most effectively be administered locally and the municipality has the capacity to administer it'. This provision is being implemented with respect to some functional areas of the national and provincial governments. For example, metropolitan municipalities, which tend to have significant

²⁴⁹ See Sec 40(1) of the Constitution.



capacity, are already involved in the delivery of housing even though it is a national and provincial competence. Thus, there is a fair degree of asymmetry in the South African system of local government.

However, the Constitution does not explicitly state that the asymmetry at local level is strictly there to respond to the urban-rural distinction. In practice, nonetheless, district municipalities generally operate in rural and semi-rural areas while metropolitan municipalities and secondary cities (B1) govern in mostly urban areas. Thus, it can be concluded that the local government system is designed in such a way that enables it to respond or adjust to the urban-rural interplay, among other differences present at the local level.

Political and Social Context in South Africa

The ushering of a democratic era in 1994 brought hope to a country that had been ravaged by years of apartheid. Under apartheid, the state, economy and society were organised strictly on the basis of race.²⁵⁰ The system benefited whites while the majority black population, as well as the minority Indian/Asian and coloured minority groups, were marginalised, deprived of equal economic opportunities and political representation to a different degree, and the former relegated to third class citizens. Since coming to power in 1994, under the leadership of Nelson Mandela, the majority led government of the African National Congress (ANC) has been confronted with a major challenge of undoing or redressing the injustices and legacy of apartheid. A variety of transformation interventions have been adopted in line with the demands of one of the most transformative constitutions in the world, the 1996 Constitution.

These interventions have recorded successes in some areas while failures are common in a number of areas, such as spatial transformation, with apartheid spatial landscape largely remaining intact 27 years after the end of apartheid.²⁵¹ Corruption and skills deficit, among other problems, continue to undermine the capability of the state to meet its obligation and development priorities at all levels of government.²⁵² The slow growth of one of Africa's largest economies has not made the situation any better. South Africa's GDP is estimated to grow by merely 1,5, 1,7 and 2,1 per cent in 2019, 2020 and 2021, respectively.²⁵³ The unemployment rate, which in the second quarter of 2019 stood at 29 per cent, is another indicator of an economy in trouble.²⁵⁴ It is thus without doubt that the economy is failing to generate sufficient resources, at a faster rate, for the state to cater for the needs of its estimated 58,78 million population (mid 2019 estimate).²⁵⁵ This partially explains why poverty remains

²⁵⁰ See Nico Steytler and Jaap de Visser, *Local Government Law of South Africa* (LexisNexis 2009) 1-3 to 1-9.

²⁵¹ Tinashe C Chigwata, Jaap de Visser and Lungelwa Kaywood, 'Introduction' in Tinashe C Chigwata, Jaap de Visser and Lungelwa Kaywood (eds), *The Journey to Transform Local Government* (Juta 2019) 1.

²⁵² See Patricia Ntliziywana, 'Professionalisation of Local Government in South Africa' in Tinashe C Chigwata, Jaap de Visser and Lungelwa Kaywood (eds), *The Journey to Transform Local Government* (Juta 2019) 59.

²⁵³ National Treasury, 'Municipal Budget Circular for the 2019/20 MTREF' (MFMA Circular no 94, Municipal Finance Management Act No 56 of 2003, May 2019) 2.

²⁵⁴ Statistics South Africa (2019) <<http://www.statssa.gov.za/>> accessed 30 July 2019.

²⁵⁵ *ibid.*



widespread, inequalities continue to deepen and universal access to basic services remains a dream for many South Africans.

The citizens have been impatient with the ANC government's performance in the last few years.²⁵⁶ The political dominance of the ANC, reflected by, among other things, its two-thirds majority in the National Assembly in the early years of the democratic era, has slowly been eroded. In the 2019 elections, the ruling party won by 56 per cent of the national vote and narrowly won Gauteng province while the opposition, Democratic Alliance, kept its majority in the Western Cape province. At local government level, after the 2016 local government elections, the ruling party is no longer in control of four key metropolitan municipalities. Of the four, one is the legislative capital (City of Cape Town), the other is the administrative capital (Tshwane) while the City of Johannesburg is the economic hub of the country. Some form of coalition governments were formed in Johannesburg, Tshwane and Nelson Mandela Bay following the failure by any of the political parties to acquire a majority in these municipalities.

The metropolitan regions and cities remain key attraction points for people from rural areas in search for better economic opportunities. By 2017, over 67 per cent of the total population of South Africa was already residing in urban areas, including cities.²⁵⁷ Consequently, rural areas have been left with a thin base to tap resources such as skilled manpower, a development which undermines their capacity to deliver. On the other hand, the infrastructure in these metropolitan areas is overwhelmed by the large-scale inward emigration and is failing to cope, as a result. For instance, a significant number of the population in these metropolitan regions still resides in informal settlements with no or limited access to basic public services. Even if such services were to be provided, a large portion of people in these areas are not able to pay due to incapacity. Thus, local government, which is positioned at the heart of state public service delivery in South Africa,²⁵⁸ continues to face a variety of challenges, which are both within and outside of its control.

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Chigwata TC, De Visser J and Kaywood L, 'Introduction' in Tinashe C Chigwata, Jaap de Visser and Lungelwa Kaywood (eds), *The Journey to Transform Local Government* (Juta 2019)

²⁵⁶ See Ntliziywana, 'Professionalisation of Local Government in South Africa', above, 59, 61, 63.

²⁵⁷ See Statista, 'South Africa: Urbanization from 2009 to 2019' (*Statista*, 2020)

<<https://www.statista.com/statistics/455931/urbanization-in-south-africa/>> accessed 9 December 2019.

²⁵⁸ See Steytler and De Visser, *Local Government Law of South Africa*, above, 1-3.



Ntliziywana P, 'Professionalisation of Local Government in South Africa' in Tinashe C Chigwata, Jaap de Visser and Lungelwa Kaywood (eds), *The Journey to Transform Local Government* (Juta 2019)

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11.2 Local Financial Arrangements in South Africa: An Introduction

Tinashe Carlton Chigwata, *Dullah Omar Institute, University of the Western Cape*

South Africa has a uniform system of public finance for local government. The framework for local government finance (revenue-raising, expenditure of revenue and financial management) is provided for by the Constitution. The Local Government: Municipal Finance Management Act of 2003 (MFMA) is the main piece of legislation that gives effect to this framework. There are also several other pieces of legislation that have been enacted to implement the constitutional framework on municipal finance. This section provides an overview of the sources of revenue for municipalities and the expenditure of revenue.

Taxing Powers

Section 229(1) of the Constitution empowers municipalities to impose property rates and user charges on fees for services provided. In addition, the Constitution permits the national government to decentralise other taxes, levies and duties with the exception of income tax, value-added tax, general sales tax and customs duty. The Municipal Property Rates Act of 2004 and the Municipal Fiscal Powers and Functions Act of 2007 have been enacted to give effect to the municipal fiscal powers. The latter introduces additional revenue streams for municipalities. In practice, the exploitation of taxing powers varies within and across categories of municipalities. However, a big difference exists between urban and rural municipalities. Urban municipalities, particularly metropolitan municipalities, get most of their revenue from property rates and surcharges on fees for services. Metropolitan municipalities raise about 75 per cent of their budget from their own sources, thus are largely self-financing. On the other hand, rural municipalities, which are often poor, rely heavily on intergovernmental grants for operations. As a sector, local government raises 70 per cent of its own revenue,²⁵⁹ which is high in comparison to local governments in the region.

Intergovernmental Grants

Various forms of intergovernmental grants complement municipalities' own sources of revenue. Section 214(1)(a) of the Constitution provides for the equitable sharing of revenue raised nationally among the national, provincial and local spheres of government in each financial year. The allocation takes place through an annual enactment which determines the share of each sphere, provincial government and municipality – the Division of Revenue Act (DORA). The DORA may only be enacted after organised local government (which is the South African Local Government Association - SALGA) and the Finance and Fiscal Commission (FFC) have been consulted and any recommendations of the latter considered. The equitable share is an unconditional grant designed to enable every municipality to provide basic services and perform its constitutional and legislative mandates in its area (Section 227(1)(a) of the Constitution). Its allocation is based on an objective formula that takes into account factors such as population, fiscal capacity and disparities. In addition, metropolitan municipalities also

²⁵⁹ National Treasury, 'Municipal Budget Circular for the 2019/20 MTREF' (MFMA Circular no 94, Municipal Finance Management Act No 56 of 2003, May 2019) 3.



get a share of the general fuel levy as an unconditional grant. Besides these unconditional grants, there are various forms of conditional grants that are allocated to municipalities. Such '[c]onditional grant funding targets delivery of national government's service delivery priorities' in areas such as infrastructure development.²⁶⁰

Borrowing

Section 230A of the Constitution permits municipalities to borrow money to finance current and capital expenditure. Borrowing to finance current expenditure is however restricted for bridging purposes during a fiscal year. These borrowing powers can only be exercised in accordance with national legislation, which is the MFMA. When borrowing money, the Constitution states that a municipal council binds itself and future councils in the exercise of securing loans or investments for the relevant municipality. Section 218(1) of the Constitution provides that the 'national government, a provincial government or a municipality may guarantee a loan only if the guarantee complies with any conditions set out in national legislation'. In practice, the national and provincial governments are reluctant to guarantee municipal loans. As a result, municipal borrowing largely depends on the creditworthiness of a municipality, which is often determined by the private sector actors. When municipalities borrow from the private sector, they often render their assets and revenue streams as surety. This means that high category municipalities, such as metropolitan municipalities, which tend to have a variety of assets and high fiscal capacity, often exercise borrowing powers relative to poor and often rural municipalities because of their financial position.

Expenditure of Revenue

In general, municipalities have the discretion to spend their own revenue and non-conditional grants. There are, however, rules on how municipalities should spend certain funds. For instance, as stated above, the equitable share is there to finance the delivery of basic services to the poor. Municipalities are also required to budget sufficiently for operating expenditure to avoid having a deficit. The repairs and maintenance budget in each financial year should be at least 8 per cent of the value of property, plant and equipment. The consequence of non-compliance with some of the spending requirements can be severe. The national treasury can, for instance, suspend the transfer of intergovernmental grants to the relevant municipality.²⁶¹ Municipal officials, who have key responsibilities in budget formulation and implementation, can also be held individually liable for non-compliance.

References to Scientific and Non-Scientific Publications

Constitution of the Republic of South Africa, 1996

Municipal Finance Management Act 56 of 2003

Municipal Property Rates Act 6 of 2004

Municipal Fiscal Powers and Functions Act 12 of 2007

²⁶⁰ *ibid* 4.

²⁶¹ See Sec 216(2) of the Constitution.



National Treasury, 'Municipal Budget Circular for the 2019/20 MTREF' (MFMA Circular no 94, Municipal Finance Management Act No 56 of 2003, May 2019)



11.3 The Amalgamation of Municipalities in 2016

Tinashe Carlton Chigwata, *Dullah Omar Institute, University of the Western Cape*

Relevance of the Practice

Rural municipalities throughout the world often face a different set of challenges than their urban counterparts. In South Africa, the government has adopted and implemented many interventions to improve the state of local government. In 2016, some of the municipalities were disestablished and/or amalgamated to address challenges related to financial viability and functionality. The 2016 amalgamation process is an interesting practice that is relevant for the LoGov-project in many ways. It has implications on all the report sections from structures, finance, responsibilities, intergovernmental relations and citizen participation. It is therefore likely to be useful for comparative purposes relating to the urban-rural interplay in the participating member countries in the LoGov-project.

Description of the Practice

The number of municipalities in South Africa has gradually decreased since the ushering in of the democratic era in 1994. There were 1262 racially segregated municipalities in 1994, which were reduced to 843 transitional municipalities by 1996. The 843 transitional municipalities were consolidated to 284 municipalities ahead of the 2000 local government elections. After the elections, the 284 wall-to-wall municipalities became the first democratic local government units in the history of South Africa. Of the 284, 16 were cross border municipalities designed to integrate linked communities and economies on different sides of a provincial boundary. The 1994 to 2000 establishment, disestablishment and amalgamation processes were primarily aimed at democratising municipalities by, among other ways, bringing to an end racial division as the basis for the establishment and functioning of municipalities.²⁶²

The 284 municipalities were reduced to 283 ahead of the 2006 local government elections primarily to do away with the notion of cross border municipalities.²⁶³ Provincial boundaries had to be amended to realise this objective. The 283 municipalities were further reduced to 278 ahead of the 2011 local government elections. A municipal boundary review process ahead of the 2016 local government elections culminated in the disestablishment and/or amalgamation of 21 municipalities resulting in the number of municipalities going down to the current 257. The process of disestablishing and/or amalgamating municipalities in 2016 was initiated by the national Minister responsible for Cooperative Governance and Traditional Affairs in 2015.

²⁶² Municipal Demarcation Board (MDB), 'Twenty Years Later: The Municipal Demarcation Board Reflects on its Contributions, Experience and Lessons Learnt' (MDB 2019) 8-9.

²⁶³ *ibid* 15.



A government review of the state of local government in 2014 had revealed that only 37 per cent of the municipalities were functional and viable.²⁶⁴ The other 32 per cent were almost dysfunctional and required support to get the basics right whereas the remaining 31 per cent were dysfunctional and required significant work before they could get the basics right.²⁶⁵ Some of the worst performing municipalities faced viability and functionality problems. The Minister, relying on his powers under Section 22(2) of the Municipal Demarcation Act, requested the Municipal Demarcation Board (MDB) to re-determine the boundaries of about 93 municipalities to address these and other problems.²⁶⁶ This request attracted ‘much criticism, protest and litigation, with opposition parties arguing that it was gerrymandering (ANC using demarcation to influence the outcome of the 2016 local government elections) and that the board was dancing to the Minister’s tune’.²⁶⁷ This is against the background that the proposed re-demarcation exercise was to take place outside the ordinary boundary redetermination cycle of the MDB.

After considering views from the public and other stakeholders, the MDB proceeded with 21 out of 34 requests/proposals from the Minister.²⁶⁸ The main reasons for pursuing the 21 requests was to define boundaries so as to improve financial viability.²⁶⁹ As has been the case over the years, the process of re-demarcating municipal boundaries involved a number of actors as required by the Constitution and the Municipal Demarcation Act 27 of 1998. The key actors included: the MDB, the relevant municipal councils, Member of the Executive Council responsible for local government in the relevant province, Minister responsible for COGTA, affected communities, organised local government, and traditional authorities, where applicable. While several actors were involved, it is the MDB that had/has the final authority pertaining to matters to do with the demarcation process. The process culminated in the disestablishment and/or amalgamation of the 27 municipalities in 2016.

Assessment of the Practice

One of the pertinent challenges that have confronted the South African local government system in the past two decades is that a significant number of municipalities are not financially viable and not functional. Despite being empowered by various resource-raising powers, they are not in a position to raise revenue sufficient enough to meet the majority of their needs and obligations. As a result, service delivery in these municipalities, which are generally in rural areas, semi-rural areas and in poor towns, is mostly substandard or non-existent. Some of these municipalities are located in the former homelands, which were reserved for the black population under the apartheid era.

²⁶⁴ Department of Cooperative Governance and Traditional Affairs (COGTA), ‘Local Government Back to Basics: Serving Our Communities Better’ (COGTA 2014) 6.

²⁶⁵ *ibid* 6.

²⁶⁶ MDB, ‘Twenty Years Later’, above, 34.

²⁶⁷ *ibid*.

²⁶⁸ *ibid* 37.

²⁶⁹ *ibid* 38.



The (re)demarcation of municipal boundaries ahead of the 2016 local government elections was aimed at improving the financial viability of municipalities and ultimately, functionality. Yet, more than five years later most of the newly created or amalgamated municipalities remain financially unsound and dysfunctional. This can be attributed to the fact that these municipalities inherited poor tax bases. The amalgamation process brought together a large number of poor households, most of whom are unable to pay for the services provided, under the same municipal jurisdiction. The implication is that most of these municipalities have to provide services to a wider geographical area but to people who cannot pay for those services. The amalgamation process could also have impacted negatively on democratic participation in some municipalities given the expanded boundaries and largely dispersed communities, which may make democratic participation and accountability difficult to attain. The South African experience may suggest that the amalgamation of municipalities is not necessarily a panacea for addressing municipal viability and functionality concerns.

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National Treasury, 'Municipal Budget Circular for the 2019/20 MTREF' (MFMA Circular no 94, Municipal Finance Management Act No 56 of 2003, May 2019)

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Steytler N and De Visser J, *Local Government Law of South Africa* (LexisNexis 2009)



11.4 Metro Open Budget Survey

Yonatan Fessha, *Dullah Omar Institute, University of the Western Cape*

Relevance of the Practice

As local governments go about implementing their service delivery duties, budget accountability has emerged as one of the key issues. Budget accountability stands on the three pillars of public participation, oversight, and transparency. Although formal oversight of the budget by elected representatives is essential, it is not enough. It needs to be supplemented with direct public participation throughout the budget process. While councillors are elected formally to represent their wards in the budget process, it is also important that local government tap directly into the preferences of ordinary citizens when planning, implementing and evaluating the budget process. Equally important is also that the budget process is transparent. Literature suggests the existence of a strong connection between budget decision-making that involves the public and is subject to systematic oversight, on the one hand, and enhanced public trust in government and a deepening commitment to accountability in the use of public resources to provide basic services on the ground, on the other. The findings of the Metro Open Budget Survey (Metro OBS) for 2019 shed light on accountability and the budgeting process in South Africa's five metropolitan municipalities.

Description of the Practice

The Metro OBS is modelled on the global Open Budget Survey (OBS), an independent, comparative assessment of budget accountability, initiated by the International Budget Partnership in 2006. To date, the International Open Budget Survey has been conducted six times to evaluate national government budget processes in 115 countries across six continents. In 2019, IBP South Africa, in partnership with the Dullah Omar Institute (DOI) at the University of Western Cape, applied the OBS methodology to objectively assesses the availability of budget information, public participation opportunities, and strength of oversight in five of the eight metropolitan municipalities (metros) in South Africa: City of Cape Town, City of Johannesburg, City of Ekurhuleni, eThekweni Municipality, and Nelson Mandela Bay Municipality. Budget information, transparency and oversight was assessed based on generally accepted good practice for public financial management. The survey sought to determine whether budget accountability is reflected in all the four phases of the budget process (i.e. budget formulation, budget approval, budget implementation and audit/oversight).

In so far as transparency is concerned, most metros, according to the findings of the survey, perform better in the approval and audit phases of the budget process. It must be noted that none of the metros fully complied with transparency in budget formulation. A key finding is that the metropolitan cities of Cape Town and eThekweni performed well in the approval phase. Not only were the documents of the two metros relatively comprehensive, they published their Medium Term Revenue and Expenditure Frameworks (MTREFs) on time, thus facilitating



transparency in the budget approval phase. Although all metros, with the exception of the City of Johannesburg, published their monthly budget statements on their websites, it is only the City of Cape Town that fully facilitated transparency during the implementation phase. This is because it is the only metro that published all of its monthly budget statements on time for the twelve months preceding the assessment. The City of Cape Town has not, however, performed as well as the metropolitan cities of Ekurhuleni and Nelson Mandela Bay in the audit phase. The latter two 'provided more budget information (comparing budgeted estimates and actual outcomes) than what the audited financial statements require'.²⁷⁰ The Metro OBS also ranked the Nelson Mandela Bay top of the group for a transparent public procurement process that published information on awards of contracts and on procurement deviations and extensions timely. Unlike the other metros that limited the information available about their Bid Adjudication Committee meetings to the time, date and venue for the meetings, Nelson Mandela Bay metro published the full agenda as well as all documents.

On the issue of oversight, a key finding was that metros performed strongest during the audit phase, when council and Section 79 committees of the council,²⁷¹ the principal oversight structures in the metro, were assessing the annual report and audited financial statements. All five metropolitan councils did not take more than two months to consider the Annual Report after its tabling. It also took most of the metros the same amount of time to adopt the Oversight Report on the Annual Report. An examination of the oversight reports reveals that the councils do not simply endorse the report. The same cannot be said of the oversight during the budget formulation, approval and implementation, which was weak. In particular, the findings underscore that oversight structures are not really visible during budget formulation phase, which is evidently dominated by the executive and the administration. It is pertinent to note that the City of Cape Town is a leader when it comes to the budget formulation, approval and implementation stage. It out-performs Johannesburg, Ekurhuleni, eThekweni and Nelson Mandela Bay metros. The poor performance of the metros is attributed to the fact that there was no indication that the council or the council committee(s) 'considered certain documents'²⁷² or, if they had, the deliberations on the same were not made publicly available.

On the issue of participation, a major finding is that generally the metros perform better when the budget is approved and audited. They complied with the duty of facilitating public participation during those phases. The same cannot be said with respect to the level of public participation during the formulation and implementation phases of the budget process. Of the five metros, Nelson Mandela Bay and Ekurhuleni performed better in facilitating public participation during the budget formulation phase. The former used a combination of the traditional method of engaging the public through public meetings and innovative mechanisms that include an Integrated Development Plan (IDP) App and an IDP Input Form that can be

²⁷⁰ 'Measuring Transparency, Public Participation and Oversight in the Budget Process of South Africa's Metropolitan Municipalities: Findings from the 2019 Metro Open Budget Survey' (IBP South Africa and Dullah Omar Institute 2019) 9 <<https://dullahomarinstitute.org.za/multilevel-govt/local-government-bulletin/volume-14-issue-2-december-2019/metro-obs-report-digital-version.pdf/view>>.

²⁷¹ According to section 79 of the Municipal Structures Act, 'a municipal council may establish one or more committees necessary for the effective and efficient performance of its functions or the exercise of any of its powers'.

²⁷² — 'Findings from the 2019 Metro Open Budget Survey', above, 11.



completed online. The latter engages directly with communities through its ward councillors. The City of Cape Town outperformed the others during the implementation of the budget by announcing in advance all council meetings that deliberate on budget implementation ‘as well publishing relevant reports and minutes’.²⁷³

Assessment of the Practice

The Metro OBS 2019 is a good initiative that appears to facilitate greater budget accountability in metropolitan municipalities in South Africa. Arguably, it inspires improvements by highlighting both the challenges and opportunities for achieving greater budget accountability, transparency, oversight, and public participation in the budgeting process of metropolitan municipalities. It has the potential to nudge metro governments to become more responsive and accountable.

As the findings of the 2019 Metro OBS reveals, however, metro governments appear to be grappling with the challenges of facilitating greater budget accountability. Seemingly this is indicated by the fact that there is mixed performance on budget transparency, oversight, and participation in the five metros that were assessed. Each of the five metros assessed appears to be placing more emphasis on various aspects of the budget process, making compliance somewhat erratic. Nevertheless, all hope is not lost as these are early days in implementing the tenets of the budget process fully. If anything, there is a lot of room for improvement. Better performance is possible.

Although the 2019 Metros OBS focused on metropolitan areas, one can confidently predict that rural municipalities face a much harder challenge of facilitating budget accountability. This is particularly true with regard to the aspect of the budgeting process that requires prudent financial management. There is, however no reason why rural municipalities should not be expected to adhere to an open and visible municipal budgetary process. Perhaps, it might be a good idea to build on the success achieved by the metro governments by implementing the reforms that are recommended by the team of independent researchers and reviewers. For the purposes of promoting transparency, the survey encourages the publication of a pre-budget statement as well as producing and publishing more disaggregated monthly budget statements timely. The inclusion of rather detailed and specific capital project information in the Medium Term Revenue and Expenditure Framework (MTREF) and a timely publication of information on award of contracts and on procurement deviations and extensions of contracts might also go a long way in improving transparency. Municipalities, both rural and urban, can also do a better job of facilitating public participation in the budgeting process. They can do so by ensuring that Section 79 council committees examine the draft MTREF and submit their recommendations to council. They should also encourage the public to attend not only council meetings but also Section 79 committee meetings where budget implementation is discussed.

²⁷³ — — ‘Findings from the 2019 Metro Open Budget Survey’, above, 15.



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<https://dullahomarinate.org.za/multilevel-govt/local-government-bulletin/volume-14-issue-2-december-2019/metro-obs-report-digital-version.pdf/view>



11.5 The Formalisation of Development Charges in South African Municipalities

Thabile Chonco, *Dullah Omar Institute, University of the Western Cape*

Relevance of the Practice

Municipalities are obliged to ‘ensure the provision of services to communities in a sustainable manner’, to ‘promote social and economic development’ and to carry out developmental duties in terms of Section 153 of the Constitution.²⁷⁴ There is a huge demand for municipalities to prioritise economic infrastructure so as to promote economic growth, create employment and reduce poverty. With new growth and plunging traditional municipal revenue sources, there is an increased need for new infrastructure and municipalities are required to find other means to finance the demands for bigger and better infrastructure.²⁷⁵ One such measure is for municipalities to require contributions towards infrastructure costs as a precondition for the approval of a proposed development, known commonly as development charges.

Description of the Practice

Development charges are not a new revenue source for municipalities.²⁷⁶ They are existing charges some municipalities have been levying to recover costs incurred when providing infrastructure services, albeit inconsistently, while some municipalities have avoided doing so because of uncertainties and risks.²⁷⁷ Development charges are also not a municipal tax, unlike

²⁷⁴ See Secs 152(1)(b) and 153(a) of the Constitution.

²⁷⁵ See Colin Crawford and Julian Juergensmeyer, ‘A Comparative Consideration of Development Charges in Cape Town’ (2017) 1 *Journal of Comparative Urban Law and Policy*, 10; South African Cities Network, ‘Assessing the Fiscal Impacts of Development: Study Report’ (National Treasury 2015) <<http://sacitiesnetwork.co.za/wp-content/uploads/2015/05/Fiscal-Impact-of-Development-Report-Final.pdf>> accessed 14 February 2021. See also Business Insider SA, ‘Municipalities Advised to Consider New Taxes, Including on Parking Lots and Fires’ (*Business Insider*, 29 July 2020) <<https://www.businessinsider.co.za/municipalities-advised-to-consider-new-taxes-including-for-fires-and-entertainment-2020-7/>> accessed 14 February 2021.

²⁷⁶ See Nick Graham and Stephen Berrisford, ‘Development Charges in South Africa: Current Thinking and Areas of Contestation’ (undated) <<http://www.imesa.org.za/wp-content/uploads/2015/11/Paper-1-Development-charges-in-South-Africa-Current-thinking-and-areas-of-contestation-Nick-Graham.pdf>> accessed 14 February 2021; David Savage, ‘Evaluating the Performance of Development Charges in Financing Municipal Infrastructure Investment’ (discussion paper, second draft, 23 March 2009).

²⁷⁷ Barbara Cole, ‘Anger Over New Metro Charges’ (*IOL News*, 15 November 2011) <<https://www.iol.co.za/dailynews/news/anger-over-new-metro-charges-1178498>> accessed 15 February 2021; Ayanda Mthethwa, ‘Developers Protest Mogale City’s New Bulk Services Plan’ (*Daily Maverick*, 2 November 2020) <<https://www.dailymaverick.co.za/article/2020-11-02-developers-protest-mogale-citys-new-bulk-services-plan/>> accessed 16 February 2021; SA Commercial Prop News - SAPOA, ‘Fictitious Tax on Property Developers’ (*SA Commercial Prop News*, 30 November 2011) <<http://www.sacommercialpropnews.co.za/south-africa-provincial-news/kwazulu-natal/3954-fictitious-tax-on-property-developers.html>> accessed 15 February 2021.



property rates and taxes levied under Section 229(1)(b) of the Constitution, but do form part of municipal infrastructure finance instruments.

A development charge is a once-off charge that is levied to recover the actual cost of external infrastructure needed to accommodate the additional impact of new development on a municipality's existing engineering services. It is meant to cover the costs incurred by a municipality when installing new infrastructure or upgrading existing infrastructure that is needed to service a proposed new development. This charge is levied against the developer as a condition for approving a land development application.

The Municipal Systems Act offers a legal basis for a municipality to recover costs associated with municipal services or functions from third-parties such as developers.²⁷⁸ On the backdrop of the abovementioned, the National Treasury published, for comment, the Municipal Fiscal Powers and Functions Amendment Bill.²⁷⁹ The proposed law seeks to address the uncertainties concerning the levying of development charges by municipalities. The bill provides for the uniform regulation of development charges, thus catering for a transparent, consistent and equitable basis on which municipalities may calculate and levy development charges from landowners. Charging development charges, in a standardised, consistent and transparent manner, will enhance the revenue streams for financing strategic municipal infrastructure and give municipalities the opportunity to use development charges to guide municipal planning so as to support urban spatial transformation.

A municipality may levy development charges on the engineering services covered in the definition of engineering services provided in the Spatial Planning and Land Use Management Act (SPLUMA),²⁸⁰ as well as bulk external engineering services, the provision and operation of which lies with the municipality. These are engineering services that provide water, sewerage, electricity, municipal roads, storm water drainage, gas, and solid waste collection and removal, required for the purpose of land development. The bill permits a municipality to apply to the Minister of Finance for an extension of engineering services to be included in the calculation of development charges. This provides some flexibility for municipalities to levy development charges on other engineering services not set out in SPLUMA. The bBill will have implications for various actors including municipalities, developers/landowners, as well as national and provincial departments, state agencies and state-owned enterprises as described below:

The Municipality

Municipalities will have the power to levy development charges in terms of the bill. Upon receipt of a land development application, a municipality has a choice of whether or not to levy a development charge against the proposed land development.²⁸¹ Should a municipality decide to levy a development charge, its decision will now be followed by an adoption of a resolution, by its municipal council, to that effect. Once this resolution is adopted, the municipality will have to comply with the Municipal Fiscal Powers and Functions Act. Where a municipality

²⁷⁸ Sec 75A of the Municipal Systems Act 32 of 2000.

²⁷⁹ The Municipal Fiscal Powers and Functions Amendment Bill was published, for comment, on 8 January 2020 <http://www.treasury.gov.za/legislation/draft_bills/Draft%20Municipal%20Fiscal%20Powers%20and%20Functions%20Amendment%20Bill%20-%20published%20for%20comment.pdf> accessed 14 February 2021.

²⁸⁰ Spatial Planning and Land Use Management Act 16 of 2013.

²⁸¹ Sec 9A(1) of the Municipal Fiscal Powers and Functions Amendment Bill.



supports the levying of development charges, it will have to adopt a policy that addresses the methodology for the calculation of various costs; ensures the non-duplication of costs when development charges are calculated; sets out the criteria to be used when development charges are based on municipal engineering service zones; and determines the criteria applicable when a subsidy, reduction or exemption is granted to a developer or certain land developments.²⁸² The policy must also provide for the methods of payment that may be employed, taking into account the principles of equity, transparency and fairness. Whatever shape or form the policy takes, it must be consistent with the Municipal Fiscal Powers and Functions Act on the levying of development charges.

Once the policy on development charges is adopted, a municipality must adopt and publish by-laws for the implementation of this policy. A differentiated approach of the development charges payable may be used for categories of landowners, land developments and municipal engineering services.²⁸³

The Developer/Landowner

The developer will be liable to pay development charges as a condition of getting their land development application approved. A national, standardised legislation and policy framework on development charges will ensure that the variables used to calculate development charges are the same across all municipalities, irrespective of whether the municipality is a metropolitan, local or district municipality. The legislation and policy framework will also minimise the confusion experienced by landowners, as landowners will be able to estimate their liabilities and hold municipalities to account for the delivery of required infrastructure. The payment can be made either as a payment in-kind or as a monetary contribution. For the purpose of this practice note, the latter is applicable: As a monetary contribution that must be paid in full prior to the developer exercising the rights approved by the Municipal Planning Tribunal (residential, commercial, industrial, agricultural and various other land-use rights exist for certain properties and areas. For example, if a developer is granted commercial land use rights, they may only use the land for commercial purposes by installing infrastructure and constructing commercial properties according to the land specifications given by the municipality). The developer will not only pay for the infrastructure which they benefit from, but will also be informed on how the costs are determined, as well as the quality and quantity of the infrastructure installed.

National and Provincial Departments, State Agencies and State-Owned Enterprises

In 2007, Eskom began the construction of Medupi power station in Lephalala Local Municipality, Limpopo, in order to meet the growing demand for electricity in South Africa.²⁸⁴ In the following year, Eskom began the construction of Kusile power station in Witbank, Mpumalanga (eMalahleni Local Municipality), also intended to meet the growing demand for

²⁸² Sec 9B of the Municipal Fiscal Powers and Functions Amendment Bill.

²⁸³ Secs 9B and 9D of the Municipal Fiscal Powers and Functions Amendment Bill.

²⁸⁴ 'Medupi Power Station Project' (*Eskom*)

<https://www.eskom.co.za/Whatweredoing/NewBuild/MedupiPowerStation/Pages/Medupi_Power_Station_Project.aspx> accessed 17 February 2021.



electricity in the country.²⁸⁵ In 2018, President Cyril Ramaphosa launched a multi-billion rand train manufacturing factory in the City of Ekurhuleni ‘as an essential part of government’s rolling stock fleet renewal programme’ to transform passenger rail services and public transport.²⁸⁶ These projects are tied to the national sphere of government, as well as a state-owned entity and they require land – municipal land to be specific. These projects also require infrastructure – municipal infrastructure to be specific. The involvement of the national government does not excuse it from abiding by municipal planning laws when building the said infrastructure in the various municipalities mentioned. In light of the above examples, national and provincial departments, state agencies and state-owned enterprises that may not have paid any form of development charges previously will now have to do so. This is to ensure that municipalities are not left sitting with infrastructure costs stemming from projects such as those mentioned above. Also, the fact that the bill has not provided for the subsidisation or exemption of land use applications for government purposes (land use by the national government, provincial government or a municipality to give effect to its governance role),²⁸⁷ supports the view that national and provincial departments instituting land use applications are not eligible for subsidisation and must cough up development charges.

What Can a Municipality Use the Income from Development Charges for?

Development charges must be spent for the infrastructure for which they are collected. The money received must be used to cover the actual costs associated with the provision of essential engineering service(s) to a proposed land development.²⁸⁸ National Treasury has advised that development charges should not be used for operating costs or costs associated with repairs, maintenance or rehabilitation of infrastructure, as development charges are limited to capital costs for new infrastructure.²⁸⁹ As such, development charges must be recorded as a liability in a municipality’s financial statements. Only when the municipality uses the development charges for the provision of external engineering infrastructure, it is then recognised as revenue. Development charges should also not be used to address historical backlogs in service delivery created by the neglect of service provision and apartheid-era inequity.

However, National Treasury has also advised that where a municipality has borrowed to provide infrastructure in advance of a development, development charges can be used to

²⁸⁵ ‘Kusile Power Station Project’ (*Eskom*)
<https://www.eskom.co.za/Whatweredoing/NewBuild/Pages/Kusile_Power_Station.aspx> accessed 17 February 2021.

²⁸⁶ Address by President Cyril Ramaphosa at the inauguration of the Dunnottar Train Factory (Ekurhuleni, 25 October 2018) <<http://www.thepresidency.gov.za/speeches/address-president-cyril-ramaphosa-inauguration-dunnottar-train-factory%2C-dunnottar%2C>> accessed 16 February 2021.

²⁸⁷ Proposed Sec 9E read together with Schedule 2 of SPLUMA.

²⁸⁸ Sec 9A(3) of the Municipal Fiscal Powers and Functions Amendment Bill.

²⁸⁹ ‘Municipal Fiscal Powers and Functions Amendment Bill’ (National Treasury Development Charges Pamphlet)

<http://www.treasury.gov.za/legislation/draft_bills/Development%20Charges%20Pamphlet%20V1.pdf> accessed 16 February 2021.



repay this debt.²⁹⁰ This will reduce the finance charges in rates and tariffs and reduce the cost burden on existing residents.

Assessment of the Practice

As already mentioned above, development charges are not a new municipal revenue source and as such, some municipalities currently have development charges policies in existence. This is because the levying of development charges is a power that is incidental to the municipal planning power already exercised by municipalities. The national government may, therefore, regulate minimum standards, norms and guidelines on the levying of development charges. Due to the fact that the Municipal Fiscal Powers and Functions Amendment Bill is yet to sit in Parliament, it is difficult to assess the practice as the bill has not been passed. This also means the bill cannot override any pre-existing policies or by-laws currently used by municipalities to levy development charges. Once the bill becomes law, municipalities relying on pre-existing policies or by-laws will have to ensure that they comply with the new Act. This section will, therefore, rely on two examples of current municipal development charges policies, one policy being from an urban municipality and the other from a semi-rural municipality, to assess how municipalities presently deal with the levying of development charges.

City of Johannesburg Metropolitan Municipality Draft Development Contributions Policy 2020

City of Johannesburg is a metropolitan municipality situated in Gauteng province. It is the economic hub of South Africa and as such, would naturally attract development, particularly through economic infrastructure. The municipality is also equipped to take on mega developments and has the capacity, skills and knowledge to work with multi-billion rand developments. In June 2020, the City completed its Draft Development Contributions Policy, which aligns in many respects with the Municipal Fiscal Powers and Functions Amendment Bill. The Draft Policy requires ‘the payment of development contributions to cover the costs of municipal external engineering services needed to accommodate increased demand for such infrastructure that arises from intensified land use’. The Draft Policy also permits the use of development charges to pay off loans taken to fund existing infrastructure for a service. Where adequate external engineering services already exist to service a development, the Draft Policy states that the development charges collected may be used to provide infrastructure to support development elsewhere in the municipal area and that the revenue may not be used for other purposes.²⁹¹ These ‘other purposes’ are not specified but one would imagine that it refers to the exclusions provided in National Treasury’s Development Charges pamphlet.²⁹²

²⁹⁰ National Treasury, ‘Media Statement on the Municipal Fiscal Powers and Functions Amendment Bill’ (National Treasury, 8 January 2020)

[http://www.treasury.gov.za/comm_media/press/2020/2020010801%20Media%20Statement-%20%20Municipal%20Fiscal%20Powers%20and%20Functions%20Amendment%20\(MFPFA\)%20Bill.pdf](http://www.treasury.gov.za/comm_media/press/2020/2020010801%20Media%20Statement-%20%20Municipal%20Fiscal%20Powers%20and%20Functions%20Amendment%20(MFPFA)%20Bill.pdf)
accessed 16 February 2021.

²⁹¹ City of Johannesburg, ‘Draft Development Contributions Policy’ (2020) para 4.2.

²⁹² See National Treasury, ‘Municipal Fiscal Powers and Functions Amendment Bill’.



With regards to the scope of development contributions, the Draft Policy provides that the City's development contributions calculations will not include the costs of engineering services provided by other spheres of government or by state-owned entities. For example, the costs of a designated provincial road cannot be included in the calculation but where a development is next to a provincial road, that development will be required to pay a development contribution for use of the municipal road network. Another interesting provision in the Draft Policy states that 'where a new development straddles the boundary with another municipality, the City may agree with that municipality that a portion of the development charge revenue [be] transferred to that municipality'.²⁹³ Such a provision is great for instances where the neighbouring municipality is not as financially strong as the City and also has less development happening in its area, this way both the primary and neighbouring municipalities would benefit from the development. This, of course, is subject to municipalities working together harmoniously.

Calculating Development Contributions: the charge for each service is calculated as the total impact of the service, multiplied by the unit cost for that service applicable in the current financial year. The calculation is done for each engineering service covered by the Draft Policy and is done through the following formula:

$$\text{Development charge} = \sum_{i=1}^N \text{total impact on service}_i \times \text{unit cost of service}_i$$

Where: N is the total number of services covered by this policy.

Figure 9: Equation for the City of Johannesburg's Development Charge calculation.²⁹⁴

The total impact that a development will have on demand for municipal bulk services is calculated as follows:

$$\text{Total impact on service} = \sum_{i=1}^N \text{unit impact for land use}_i \times (\text{proposed units} - \text{existing units})$$

Where: N is the total number of land uses in the proposed development.

Figure 10: Equation for the calculation of the Total Impact on Service.²⁹⁵

The municipality relies on the proposed land use changes, the unit impact and the unit cost as data inputs to calculate development charges. The policy states that the calculation of development charges is premised on the principles of reasonableness, equity, fairness, predictability, certainty, administrative efficiency and justification, which more or less mimic the principles set out in the bill. So long as the principles can be quantified and justified, then one cannot fault the City for adopting its said formula, absent a standardised formula from the bill and supporting Implementation Guide.

Mogalakwena Local Municipality Draft Development Charges Policy 2020

²⁹³ City of Johannesburg, 'Draft Development Contributions Policy' (2020) para 7.

²⁹⁴ *ibid* para 10(1)(3).

²⁹⁵ *ibid* para 10(1)(4).



Mogalakwena Local Municipality is a semi-rural municipality situated in the Waterberg District Municipality in Limpopo province. In December 2020, the City published its Draft Development Charges Policy, which also aligns in many respects with the Municipal Fiscal Powers and Functions Amendment Bill. The Draft Policy states that money collected as development charges must be used for purposes of funding or acquiring capital infrastructure assets in a timely and sufficient manner to support current and projected future land development in the municipal area, and where calculated with reference to a particular impact zone, must be used for capital infrastructure assets in that impact zone. The Draft Policy prohibits the use of development charges as a general revenue source and provides that money collected in respect of development charges may not be used to fund the operating or maintenance costs incurred by the municipality in respect of municipal infrastructure services.²⁹⁶

The policy also caters to the semi-rural make-up of the municipality with a provision that addresses the levying of development charges in rural areas/farms.²⁹⁷ The provision states that development charges will be determined in terms of paragraph 9(1) for buildings or development related to the primary farming activities and can be classified as agricultural industry. This means that the municipality may, of its own accord or if requested by a developer, reduce or increase the amount of bulk services component for a development on a farm or rural area to reflect the actual costs of installation, if exceptional circumstances permit the reduction or increase. Assuming that there will not be significant additional demand on the bulk services on a farm because the workers already working on the farm will continue working in the new buildings, the municipality will levy development charges for any other development on the farm, for example function venues, tourist accommodation facilities, conference facilities or other commercial activities such as wine tasting as these land-uses attract outsiders who place additional demand on the bulk infrastructure.

Calculating Development Charges: the municipality relied on available service master plans and future development/town-planning scenarios to develop their formula. The municipality first calculated the cost per unit-consumption of water, sewer, storm water, solid waste, roads and community facilities. The calculation is meant to be an assessment of what to multiply the developer's required consumption by. Outstanding loans, as well as grants and subsidies given to the municipality were also taken into account to develop the formula.²⁹⁸

²⁹⁶ Mogalakwena Local Municipality, 'Draft Development Charges Policy' (2020) para 7.

²⁹⁷ *ibid* para 14(2) read with para 9(1).

²⁹⁸ *ibid* Annexure A at paras 5(2)-(3).



$$W = \frac{K_{tot}}{E_{tot}} - \frac{L_{ex}}{E_{ex}}$$

Where:

W = cost per unit consumption factor

$$K_{tot} = K_{ex} + E_{fut}$$

= Cost of existing infrastructure + Cost of Future Infrastructure

$$E_{tot} = E_{ex} + E_{fut}$$

= existing consumption + future consumption

L_{ex} = Outstanding existing loans

Figure 11: Formula to calculate the cost per unit consumption factor.²⁹⁹

Similar to City of Johannesburg's policy, Mogalakwena Local Municipality's policy states that the calculation of development charges is based on the principles of fairness and equity, predictability, spatial and economic neutrality, and administrative ease and uniformity. Interestingly, annexed to its draft development charges policy is a document titled 'Development Charge Calculation Report' where the municipality states the following:

'[p]reviously DCs were not applicable in Mogalakwena Local Municipality. However, master planning and DC calculations are based on new infrastructure being required for increased usage or consumption of services. Even though a certain area has always had certain zoning rights, it could be that historically the services were designed for an average lesser take-up of those rights, as it was the norm at that time and as such, the original developers did not pay for the new infrastructure required.'

The above paragraph highlights the disparities between semi-rural and urban municipalities. Mogalakwena Local Municipality, unlike City of Johannesburg, previously did not levy development charges but now has a development charges policy because of new infrastructure demands. This means this municipality has much more ground to cover with regards to learning how to levy development charges and also pressuring developers to actually pay as they previously did not and also the municipality was probably one of the 'friendlier' municipalities that developers moved to in order to avert paying development charges in the bigger cities.

The following observations can thus be made with regards to the current practice. First, at present, most municipalities' development charges policies seem to mirror each other, as well as to mirror the Policy Framework for Municipal Development Charges issued by the National Treasury in 2011. This Policy Framework encompassed a broad understanding of the role, purpose and legal nature of development charges across South African municipalities but municipal policies will have to be amended once the act is passed (something the City of Johannesburg has already proactively done) and the guidelines for the implementation of municipal charges become final.

²⁹⁹ ibid Annexure A at para 4.



Secondly, until the bill becomes law and National Treasury develops and implements guidelines for the calculation of development charges, municipalities will continue to levy development charges on the basis that they currently do, be it as part of Development Charges policies adopted under Section 75A of the Municipal Systems Act, through municipal planning by-laws or through policies adopted by the council of the municipality concerned. This means a municipality will have wide discretion as to the levying of development charges and, more specifically, the calculation of said development charges, provided that the arrangement is set out in a duly sanctioned policy as shown in the two examples above.

With regards to the bill, the following observations can be made. First, the bill is not too concerned with the type of applicant or the proposed land use, as the principle is that development charges should be calculated for all land use applications so that the infrastructure costs of the development are known irrespective of the municipality levying the development charges or not. Instead, the bill focuses on the impact of the proposed development on infrastructure, and the cost incurred by the municipality in addressing that impact and not on whether the developer should pay for the particular type of land use. If the municipality opts not to levy a development charge, then an alternative source of funding should be identified.

Secondly, although the systematised regulation of development charges should be welcomed, this does not remove the fact that the levying of development charges will remain a complex process. Whereas metros and big cities may be better placed to implement the act, other municipalities may experience challenges in implementing the act. Thus, once the act is enacted, there may be a need for regulations and implementation guidelines that will give more explanation and guidance on the purpose and implementation of development charges. On the other hand, despite all municipalities being asked to implement development charges (with some municipalities doing so and others not doing so), the standardisation of development charges and the calculation therefore raises two issues: the first is the issue of developers who may have decided to move to smaller municipalities to avoid paying development charges and the second issue is that of potentially keeping developers away from smaller, rural municipalities due to a lack of incentives. The first issue is addressed through uniformity presented by the bill, which has the potential to curb the abuse of rural/semi-rural and smaller municipalities, to whom developers would flock in order to escape development charges imposed by bigger municipalities, and provide these municipalities with much needed revenue to provide the necessary infrastructure to support the development. This uniformity, however, lends itself to the second issue pertaining to standardisation across municipalities. Matsie avers that standardisation/uniformity brings to bear the missed ‘opportunity to incentivise developers to develop in smaller or rural municipalities. So even though the revenue is needed in the smaller or rural municipalities, the standardised approach does not attract development and developers, who are already more inclined to develop in urban areas.’ According to Matsie, ‘it would be helpful for the bill to include an approach that regulates development charges in a scale or proportional approach just to give more incentives to developments in rural municipalities’.³⁰⁰

³⁰⁰ Statement by Rebekah Matsie, Senior Researcher, SALGA (LoGov Country Workshop, Local Financial Arrangements, 2 July 2021).



Thirdly, in a bid to revive the local economy post the Covid-19 pandemic, and fulfil the obligation to promote social and economic development as required by Section 152(1)(b) of the Constitution, municipalities may be eager to increase economic infrastructure and, thus, approve land development projects subject to levying development charges. Once the bill is enacted, supporting regulations and implementation guidelines may also be helpful in providing certainty on the calculation of development charges. This is necessary to eliminate the negative financial impact municipalities may face when they approve land use applications that do not take sufficient account of the impact of the proposed land developments on the municipal fiscus.

In ending, development charges and the levying thereof is a complex space to navigate. The introduction of a legal framework for the levying of development charges is thus a good starting point as it can be used widely across all municipalities. While the bill goes a long way in providing consistency and uniformity in the levying of development charges, it is clear that metropolitan municipalities, as well as cities will have an upper hand as they have long been levying development charges and are also magnets for development, unlike their rural counterparts.

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12. Local Financial Arrangements in Ethiopia

12.1 The System of Local Government in Ethiopia

Yilkal Ayalew Workneh, *Centre for Federalism and Governance Studies, Addis Ababa University*

Types of Local Governments

The Federal Democratic Republic of Ethiopia (FDRE) Constitution has established a federal state structure composed of nine ethnic based constituent units namely: Tigray, Afar, Amhara, Oromia, Somali, Benishangul/Gumuz, Gmbella, Southern Nations, Nationalities and Peoples (SNNP) and Harari. Ethiopia is a dual federal state since Article 50(1) of the Constitution stipulates as The Federal democratic Republic of Ethiopia comprises the federal government and the state members. Local government is not explicitly stipulated by the Federal Constitution which remains almost silent. This paves the way to the constituent units to enjoy unlimited constitutional space in the area. Article 50(4) of the federal Constitution merely states that 'State government shall be established at the state and other administrative levels that they (i.e. the regional states) find necessary'. In fact, the second sentence of the article gives a specific federal mandate to the region and reads 'Adequate power shall be granted to the lowest units of government to enable the people to participate directly in the administration of such units'. This implies the Constitution has implicitly provided for the establishment of non-ethnic local governments.

In addition, Article 39(3) states that Every Nation, Nationality and People in Ethiopia has the right to a full measure of self-government which includes the right to establish institutions of government in the territory that it inhabits'. According to this article, local governments are established along ethnic lines for ethnic groups which are basically 'ethnic local government'.³⁰¹ Here, the Federal Constitution poses a duty on the regional states to realize genuine self-government and ample amount of decentralization of power to the local levels. Accordingly, all regional state constitutions have provisions related to local government with a relative uniformity.

As mentioned above, the constitutional recognition of local government in Ethiopia has remained debatable. Despite this debate, local governments are constitutionally recognized at least implicitly. If one gets a closer look to the provisions of the Federal Constitution, it envisaged the establishment of two kinds of local governments: ethnic and regular.³⁰² These two categories of local governments have two distinct objectives.³⁰³ Ethnic local governments

³⁰¹ Zemelak A Ayele and Yonatan T Fessha, 'The Constitutional Status of Local Government in Federal Systems: The Case of Ethiopia' (2012) 58 *Africa Today* 89, 93.

³⁰² Zemelak A Ayele, 'The Existence of Local Government and its Institutional Security within Ethiopia's Federal System' in Asnake Kefale and Assefa Fiseha (eds), *Federalism and Local Government in Ethiopia* (UNDP and Center for Federal Studies 2015) 203.

³⁰³ *ibid.*



aim at realizing the self-determination rights stipulated under Article 39(3) of the Federal Constitution. Practically these local governments are established in the name of 'nationality zones' or 'special *woreda*' in all regional states except Oromia, Harari and Somali. On the other hand, the regular local governments are established by the regional states as per the Federal Constitution's provision of Article 50(4) in the name of *zone*, *woreda* (city/town administration) and *kebele*.

Regarding administrative structure, all regional states, except Harari³⁰⁴, are composed of three levels of local governments: nationality (*zone*), special (*woreda*) and *kebele*. Nationality *zones*, *woredas*, special *woredas* and *kebeles* have three tiers of institutional structure composed of a council; administrative council and judicial body.³⁰⁵ Zones are administrative levels just below the regional state comprising a number of districts (*woredas*) or urban centers. Unlike nationality *zones*, regular *zones* are founded by ordinary legislation with no council in Amhara, Oromia, Somali, Afar and Tigray regional states. It is a deconcentrated administrative body of the regional state. The *woreda* is the local government level standing next to the zone, encompassing *kebeles* and administratively subordinate and accountable to both the zone and regional state. *Kebele* is the lowest local government level included in all regional state constitutions. There are two categories of urban local governments: cities and towns. 'Cities' signifies the two cities under the federal jurisdiction (Addis Ababa and Dire Dawa). There are urban centers named by the legislations of their respective regional state councils. Towns are urban centers located beneath the zonal administrative structure and ranges from small to large based on their population size. Unlike others, small and medium towns may have a *woreda* status and in each *woreda*, there is a town from which the *woreda* is administered.³⁰⁶

Legal Status of Local Governments

Institutional security of local government is a crucial element of political autonomy of local government.³⁰⁷ In order to protect the existence of local government as a sphere or level of government from the encroachment of the central government, constitutional recognition is recommended as an effective formal mechanism.³⁰⁸ Political autonomy also entails uninterrupted existence of local government. The constitutional recognition of local government as an autonomous level of government does not only resist the intrusions from other levels but it also enhances the political and economic role that local government ought to play. Accordingly, local government administrations are supposed to be autonomous units. However, no constitutionally entrenched functions meet the above standards in the Ethiopian

³⁰⁴ Harary regional state is composed of only two levels of governments: regional state and *kebele*.

³⁰⁵ Christophe Van der Beken, *Completing the Constitutional Architecture: A Comparative Analysis of Subnational Constitutions in Ethiopia* (Addis Ababa University Press 2017) 141.

³⁰⁶ WSUP Advisory, 'Developing an Integrated Urban Sanitation and Hygiene Strategy and Strategic Action Plan for Ethiopia' (Draft Situational Analysis for Ethiopia's IUSHS) 20.

³⁰⁷ Ayele, 'The Existence of Local Government and its Institutional Security within Ethiopia's Federal System', above, 202.

³⁰⁸ *ibid.*



federal tradition. The Federal Constitution leaves this to the regional states to determine tiers, powers and functions.

As an element of political autonomy, local government functional competencies should be original, clearly defined, and development-related.³⁰⁹ This is usually achieved through providing constitutional guarantees and full power to local governments on those functions. Considering the dual nature of the Ethiopian Constitution, local government units do not have original functions.³¹⁰ Rather their functions are determined by regional states.

(A) Symmetry of the Local Government System

Despite the fact that both typologies of local governments lack original autonomy, there is some kind of asymmetry between urban local governments and other regular (*woreda*) and ethnic (nationality zone and special *woreda*) local governments. The state constitutions constrained the councils of the latter in law-making powers. On the other hand, urban councils are empowered to issue policy and regulations of their own.³¹¹ Accordingly, medium and large towns have enjoyed special status as compared to *woreda* governments having larger population. Moreover, a kind of paradox has arisen as the city councils which are under the supervision of the nationality *zone* council have a law-making power while the latter is restricted to its specific implementation guidelines.

Political and Social Context in Ethiopia

Ethiopia had entered in to the process of decentralization before a formal federal arrangement was endorsed in 1995. The Ethiopian People's Revolutionary Democratic Front (EPRDF), the incumbent political party since 1991, encouraged the establishment of local government units along ethnic lines. This was deemed to be a necessary response to accommodate diversity which was considered to be the most pressing challenge of the country.³¹² Proclamation number 7/1992 was instrumental for the beginning of the first phase of decentralization (1991-2001). The Proclamation also laid down the foundation for the Federal Constitution. It had listed 64 ethnic groups to establish their own ethnic self-administration.³¹³ After ten years, the party realized that emphasizing only ethnicity leads to inefficiency in ensuring development and equitable service delivery and engaged in the further creation of new local governments and at some degree amalgamates certain of the existing ones.³¹⁴ Indeed, in 2001, the District Level Decentralization Program (DLDP) launched by the federal government, administrative

³⁰⁹ Zemelak A Ayele, 'Decentralization, Development and Accommodation of Ethnic Minorities: The Case of Ethiopia' (Doctoral dissertation, University of Western Cape 2012) 55.

³¹⁰ *ibid* 488.

³¹¹ Van der Beken, *Completing the Constitutional Architecture*, above, 187.

³¹² Zemelak A Ayele, 'The Politics of Sub-National Constitution and Local Government in Ethiopia' (2014) 6 Perspectives on Federalism 89, 109.

³¹³ National/Regional Self Governments Establishment Proclamation no 7/1992, Art 3, Federal Negarit Gazeta, No 2.

³¹⁴ Ayele, 'The Politics of Sub-National Constitution and Local Government in Ethiopia', above, 109.



convenience, good governance and development issues began to be the salient justifications for strengthening the decentralization process.

Currently, there are no less than 60 political parties registered in Ethiopia. Based on their constituency, political parties often classified in to three: national, regional and local parties. They also could be categorized in to three based on their political programs: EPRDF, incumbent party and composed of four ethnic based parties representing regional states of, Amhara, Tigray, Oromiya and Southern Nations Nationalities and Peoples.³¹⁵ EPRDF's affiliates are five in number which comprise Afar, Somali, Benishangul-Gumuz, Gmbella and Harari regional states.³¹⁶ These parties are ethnic based and not opposition parties following EPRDF's ideological orientation. Except a few, most of the opposition parties are ethnic based; their constituencies are regional and local governments. Ethnic based local parties are mostly oppositions mainly seeking either regional statehood or new ethnic local government status. Member parties of EPRDF are represented by an equal number of people both in its executive committees and despite the obvious difference in population size each party is supposed to represent. Moreover, many agree that the TPLF was the most influential member of EPRDF.³¹⁷ The party structure which controls all levels of government and its decision-making procedures on the principle of 'democratic centralism' affected local government creation and undermines the role of regional states in creating local government systems based on their circumstances.³¹⁸ Following the 2016 protests in the country an increasing party fragmentation within EPRDF has been seen. This political dynamic changed the previous centralized nature of the party and TPLF has been relegated from its core position in the party.³¹⁹ Enjoying this political liberalization opposition ethnic based local parties are getting more assertive in their claim of new territorial autonomy.

A City/Town administration, as the term implies, is established in urban areas. Based on classification, urban centers of Ethiopia are classified in five categories ranging from small towns to metropolitan City of Addis Ababa based on demographic size. According to Situational Analysis of IUSHS, the population size of small towns ranges from 2,000 to 20,000 people and constitute 80 per cent of total number of towns and only 33 per cent of urban population. The medium-sized towns range between 20,000 and 50,000, and hold 25 per cent of the urban population. Large-sized towns range between 50,000 and 100,000 people. There are 13 mega

³¹⁵ Amhara National Democratic Movement (ANDM) currently called Amhara Democratic Party/ADP/. Tigray People Liberation Front (TPLF), the Oromo Peoples' Democratic Organization (OPDO) currently called Oromo Democratic Party/ODP/, and the Southern Ethiopian Peoples' Democratic Movement (SEPDM).

³¹⁶ Afar National Democratic Party (ANDP), Somali People's Democratic Party (SPDP), Benishangul-Gumuz Peoples Democratic Party (BGPDP), Gambela people's Unity Democratic Movement (GPUDM), and Harari National League (HNL).

³¹⁷ Following party fragmentations, this has been confirmed by the leaders of the remaining member parties as there was no equal power balance within and TPLF took the upper hand in decision-making and even interfering in the internal affairs of each member parties.

³¹⁸ Ayele, 'The Politics of Sub-National Constitution and Local Government in Ethiopia', above, 90.

³¹⁹ Currently, the regional parties except TPLF and all affiliate parties have been merged in to one monolithic national party in the name of Prosperity Party.



towns with a population between 100,000 and 500,000 people each. Addis Ababa is the only city in the country that hosts over 500,000 with about 3.5 million residents.³²⁰

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— — 'The Politics of Sub-National Constitution and Local Government in Ethiopia' (2014) 6 *Perspectives on Federalism* 89

— — 'Decentralisation, Development and Accommodation of Ethnic Minorities: The Case of Ethiopia' (doctoral dissertation, University of Western Cape 2012)

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— — and Fessha YT, 'The Constitutional Status of Local Government in Federal Systems: The Case of Ethiopia' (2012) 58 *Africa Today* 89

WSUP Advisory, 'Developing an Integrated Urban Sanitation and Hygiene Strategy and Strategic Action Plan for Ethiopia' (Draft Situational Analysis for Ethiopia's IUSHS, 2015)

³²⁰ WSUP, 'Developing an Integrated Urban Sanitation and Hygiene Strategy and Strategic Action Plan for Ethiopia'.



12.2 Local Financial Arrangements in Ethiopia: An Introduction

Mohammed Dejen, *Centre for Federalism and Governance Studies, Addis Ababa University*

Local financial autonomy is a critical component of the overall local government autonomy. Local government without financial autonomy cannot enjoy other forms of autonomy. As McLure and Martinez-Vazquez argue, '[s]ubnational governments that lack independent sources of revenue can never truly enjoy fiscal autonomy; they may be – and probably are – under the financial thumb of the central government'.³²¹

Local financial autonomy has two elements: revenue raising and expenditure autonomy. The first is linked to local government's ability to raise revenue from internal sources by imposing taxes and charging fees for services it provides. The existence of internal sources of revenue does not count out the possibility of local government receiving revenue from senior levels of government. However, it is often suggested that local government should cover the majority of its expenditures by using revenue collected from internal sources. Moreover, at least the majority of revenue transferred to local government by the senior levels of government should be unconditional allowing local government to decide on how to spend it.³²² Expenditure autonomy has to do with local government's power to autonomously decide on how to spend the revenue it raises.

The Federal Constitution does not assign any revenue raising powers to local government as it does not also assign functional competences to the latter. The state constitutions are also vague on the revenue raising powers of local government. Indeed, under the state constitutions, *woredas* are *mandated to assess and collect* – without the power to determine the rate of – certain state taxes, such as rural land-use fees and agricultural income tax. They do so on the regional states' behalf. Thus, in principle, *woredas* are required to transfer to the regional government a certain portion of the revenue they collect from these taxes, even though in practice the latter allow *them* to retain the revenue.

In any case, *woredas* in different states raise revenue from different sources including:³²³

- income taxes from *woreda* employees and from employees of enterprises that are licensed by the *woreda*;
- taxes from small traders and traditional minors;
- user fees from libraries, clinics and community halls;
- license fees from irrigation schemes and water wells;
- fees for the registration of births, deaths, marriages and divorces.

³²¹ Charles McLure and Jorge Martinez-Vazquez, *The Assignment of Revenues and Expenditures in Intergovernmental Fiscal Relations* (World Bank 2000) <<http://www1.worldbank.org/publicsector/decentralization/March2004Course/AssignmentRevenues.pdf>> accessed 30 December 2019.

³²² World Bank, *World Development Report 1999/2000: Entering the 21st Century* (Oxford University Press 1999) 117.

³²³ Zemelak Ayele, *Local Government in Ethiopia: Advancing Development and Accommodating Ethnic Minorities* (Nomos 2014).



Likewise, cities collect revenue from the following sources:

- urban land lease fees;
- land-use fees;
- municipal service fees including market fees, sanitary service, slaughterhouses, fire brigade services, mortuary and burial services, registration of birth and marriage, building plan approval, property registration and surveying, and use of municipal equipment, transport or employees;
- sale of own properties (other than land).

Addis Ababa and Dire Dawa, the two federal cities, are authorized to collect from revenue sources that normally fall within the competence of the states, these two cities do not fall within the jurisdiction of any state. They thus collect revenue by imposing income tax on their employees and on income earned from urban agricultural activities, as well as by collecting profit, excise and turnover taxes on individual traders working in the cities. They also collect revenue in the form of urban land-lease and -use fees, property rates, capital gains tax on properties in the city, stamp duties, user charges from vehicles in the city, and services charges on municipal services. Addis Ababa covers close to 97 per cent of its expenditure from internal revenue, and receives no block grant from the federal government.

As a rule, local government cannot borrow money from any source. In fact, even the states need federal approval before they can borrow revenue from domestic market and they are barred from the international market. It is not thus surprising that *woreda* and cities are barred from borrowing. Perhaps the exception in this regard are Addis Ababa and Dire Dawa which are statutorily authorized to take short- and long-term loans from domestic sources with the authorization of the federal government.³²⁴ They may directly borrow or sell bonds, provided it does not endanger delivery of basic services.³²⁵ Furthermore, the Addis Ababa city government may request that the federal government borrows money from international sources on its behalf.³²⁶

As far as financial transfers are concerned, *woredas* receive conditional and unconditional grants from the states. Unconditional grants or which are also known as block grants are *woredas'* main source of revenue, covering up to 80 per cent of their budgets. The states set aside approximately 50 per cent of their annual budget for transferring to all *woredas* within their jurisdiction. The amount of money that a single *woreda* receives in state transfer is determined based on a preset formula.

Woredas also receive what is called special-purpose grants (SPG) which are conditional grants that the state transfer to *woredas*. State and federal governments provide financial assistance to *woredas* with respect to specific projects including projects relating to a food-security program, productive safety-net program, public service capacity-building program (PSCAB), road fund, and HIV/AIDS program. For the purpose of executing these programs, the federal

³²⁴ Art 46(1), Dire Dawa Government Charter Proclamation no 416/2004; Art 55(1), Addis Ababa City Government Revised Charter Proclamation no 361/2003.

³²⁵ Art 46(1), FDRE Proclamation no 416/2004; Art 55(1), FDRE Proclamation no 321/2003.

³²⁶ Art 54(3), FDRE Proclamation no 361/2003.



government transfers SPGs to regional governments which, in turn, transfer them to local government.

Cities do not receive financial transfers from the states. They receive transfers that are meant to finance their recurrent costs relating to their state functions. The cities are required to cover the costs of providing municipal services from internal sources. The cities are thus required to administer and record municipal revenue separately from their revenue for state functions.³²⁷ The federal government also finances specific nationally relevant projects undertaken in Addis Ababa and Dire Dawa.³²⁸ It may assist these two federal cities financially to enable them to discharge their responsibilities.³²⁹

Before the DLDP (District Level Decentralisation Program) was launched in the early 2000s, *woredas* and cities had no expenditure autonomy. Indeed, local council could make plan and attach budget to their plans. Their plans however needed to be approved by the state executive organ. In the early 2000s, as part of the DLDP, the states revised their constitutions among other things to allow *woredas* to adopt their budget and decide on their expenditure. It should be noted however that *woredas* cover over 75 per cent of their expenditure using state transfers. As indicated above the transfers, except the SPGs, are as rule unconditional and *woredas* can decide how to spend the money they receive from the states. However, the amount that they receive is so small that it barely covers their recurrent budget. Studies show that they spend over 90 per cent of state transfers for paying salaries for their employees.³³⁰ This leaves them with limited expenditure autonomy.

References to Scientific and Non-Scientific Publications

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Dire Dawa Government Charter Proclamation no 416/2004

Addis Ababa City Government Revised Charter Proclamation no 361/2003

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<<http://www1.worldbank.org/publicsector/decentralization/March2004Course/AssignmentRevenues.pdf>> last accessed 30 December 2019

³²⁷ Jan Werner and David Nguyen-Thanh, 'Municipal infrastructure Delivery in Ethiopia: A Bottomless Pit or an Option to Reach the Millennium Development Goals?' (working paper 01-2007, Institute of Local Public Finance 2007) <<http://www.ilpf.de/en/download/wp-01-2007.pdf>> accessed 30 December 2019.

³²⁸ Art 46(1), FDRE Proclamation no 416/2004 ; Art 55(1), FDRE Proclamation no 321/2003.

³²⁹ Art 46(1), FDRE Proclamation no 416/2004 ; Art 55(1), FDRE Proclamation no 321/2003.

³³⁰ Ayele, *Local Government in Ethiopia*, above.



Werner J and Nguyen-Thanh D, 'Municipal infrastructure Delivery in Ethiopia: A Bottomless Pit or an Option to Reach the Millennium Development Goals?' (Working Paper 01-2007, Institute of Local Public Finance 2007) <<http://www.ilpf.de/en/download/wp-01-2007.pdf>> accessed 30 December 2019

World Bank, *World Development Report 1999/2000: Entering the 21st Century* (Oxford University Press 1999)



12.3 The Fiscal Equalization Scheme for *Woredas*

Mohammed Dejen, *Centre for Federalism and Governance Studies, Addis Ababa University*

Relevance of the Practice

The most common rationales for intergovernmental fiscal transfers cited by scholars³³¹ are addressing vertical and horizontal fiscal imbalances and mitigating inter-jurisdictional externalities (spillover) effects. Equity and fairness issues among constituent units of a federation, local tax efforts and expenditures control, revenue adequacy, and transparency and stability are also used as basic criteria for implementing effective fiscal transfer. In the words of Anwar Shah, equalization fiscal transfers are often seen as ‘the glue that holds a federation together’.³³² The fiscal transfer could take one of these forms: conditional or unconditional grants.

The success of any political devolution of power is very much dependent on the availability of financial resources at the hands of local officials to fulfil their powers and responsibilities. To state differently, political decentralization will not be meaningful unless financial powers are equally dispersed at the lowest levels of governments. Financial autonomy is essential element of political decentralization. And yet, the availability of financial resources at the disposal of local governments by itself is not enough. There must be financial autonomy for these governments to expend according to their priorities and needs.

Ethiopia uses the block grant approach for financial transfer to regional states and the same applies to local level equalization transfers. Block grants account for about 70 per cent of the total share of the *woreda* budget.³³³ *Woredas*, in principle, are free to spend the block grant on the basis of their priority areas. In theory, the unconditional grant for local governments help maintain their autonomy and to be free from the undue influence of the zonal and regional administrations.

Description of the Practice

In Ethiopia, local governments are not entitled to clearly defined tax sources. Of course, *woredas* have the power to set tax rates and collect thereof. Their main sources are from levying on agricultural income tax, sales tax and user fees. They have also the power to collect rural land tax use.³³⁴ However, the tax rate is to be determined by the regional

³³¹ Jun Ma, ‘Intergovernmental Fiscal Transfers in Nine Countries: Lessons for Developing Countries’ (WPS1822, World Bank 1997) (Cases of the United States, Canada, the United Kingdom, Australia, Germany, Japan, Korea, India and Indonesia).

³³² Anwar Shah, ‘Horizontal Fiscal Equalization in Australia: Peering Inside the Black Box’ (WPS 3785, World Bank 2017).

³³³ Tilahun Meshesha Fenta, ‘Local Government in Ethiopia: Practices and Challenges’ (2014) 2 *Journal of Management Science and Practice* 71.

³³⁴ *ibid.*



governments.³³⁵ Overall, adequate taxing power is not transferred to local governments that matches their functions and responsibilities. Although local governments are entitled to block grants transferred from the regional government and are free to spend based on their priorities in principle, in practice they are not free. For example, regional states will set guidelines how and on which areas to spend. Practically, almost more than 70 per cent of the source of income for local governments comes from unconditional block grants from the regional state.³³⁶

One of the principles of fiscal equalization is to provide financial means for local governments to provide equal or comparable public services such as health, education, clean water etc. for their population with other relatively rich local governments. Taking this into account, Ethiopia applied a horizontal fiscal equalization scheme for all states. Vertical fiscal imbalances are very wide in Ethiopia as the federal government controls the very lucrative sources of income. The federal government controls more than 80 per cent of the total income where regional states are left with meagre resources which account for less than 20 per cent on average. The horizontal imbalances are also very much visible arising from resource endowment disparities and the differential costs of public service provisions. For the regional states to provide at least the minimum standards of public service provision for their residents, the equalization fiscal transfer from the federal government is necessary. The fiscal transfer from the federal government indeed is one of their major sources of revenue. It takes either the conditional or unconditional grants, in most cases focusing on the second option.

In line with this general principle, all regional states also introduced a mechanism of fiscal equalization among all local governments.

Assessment of the Practice

However, an assessment done by Ghebrehwet³³⁷ for the 2007 and 2009 fiscal year on fiscal equalization indicates that the scheme has created disincentives for those better performing local governments in their efforts of generating more revenues. Those local governments which are high contributors to the equalization pool have less incentives to better perform in collecting more revenues in the future. Ethiopia is also ethnically the most diverse state and applying horizontal equalization among the ethnically different local governments became politically sensitive as those well-off *woredas* think that they are subsidizing poor *woredas* which are ethnically different. Political entrepreneurs also mobilize their ethnic groups as their resources are being taken by other ethnic groups. The practice is also not encouraging as many of the *woreda* and other local governments are not in a position to cover their own expenditure let alone to contribute for fiscal equalization.

³³⁵ *ibid.*

³³⁶ Zemelak Ayele, 'Local Government in Ethiopia: Still an Apparatus of Control?' (2011) 15 *Law, Democracy and Development* 133.

³³⁷ Ghebrehwet Tesfai Baraki, 'The Practice of Fiscal Federalism in Ethiopia: A Critical Assessment 1991-2012. An Institutional Approach' (doctoral thesis, University of Fribourg 2015).



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12.4 Financing Municipal Services

Zemelak A Ayele, *CFGS – Centre for Federalism and Governance Studies, Addis Ababa University*

Relevance of the Practice

Local government functions in Ethiopia are in general categorized into state functions and municipal functions. State functions are those that are linked with provision of basic services such as education and health care. These are identified in the various poverty reduction policies as areas of policy intervention. Rural *woredas* are expected to be the center of state service delivery.³³⁸ Cities are also expected to provide state services to their residents. Besides, they are expected to provide municipal services which are typically services that are available or are expected to be available in urban areas. Such services include cultural centers; recreational centers; youth centers; museums; sewerage; streets; street lighting; land administration; solid wastes; fire-fighting, nurseries, care centers (for the aged, disabled, orphaned or homeless children); pollution control; abattoirs; parks; markets; sanitation; liquor licenses; and ambulance services.³³⁹ Cities are expected to deliver these services. The schemes through which municipal functions or services are financed differ from the way state functions are financed. This report entry examines how and why municipal functions are treated differently in terms of finance.

Description of the Practice

The 1995 Federal Constitution is completely silent on how local government would be financed. This is not surprising given that local government is within the exclusive competence of the states, with barely any constitutional mention. What is rather surprising is the silence of the state constitutions on sources of revenue of local government. None of the ten state constitutions allocate financial sources to local government. Indeed, there is a provision in each state constitution which provides that *woredas* could utilize sources of revenue that the state has not begun utilizing. This not only is unclear but also meaningless. Thus, until about 2000, local government did not have any clear source of revenue. Moreover, it could not adopt its own budget but needed the approval of the relevant state. In 2000, the federal government adopted a poverty reduction policy which aligned with the Millennium Development Goals. In the policy paper it was stated that local government would play a central role in poverty reduction. To this effect, states were required to transfer, as unconditional grants, about half of what they receive from the federal government in the form of federal transfers. Since then,

³³⁸ See, for example, Ministry of Finance and Economic Development (MoFED), *'Ethiopia: Sustainable Development and Poverty Reduction Program (SDPRP)'* (2002).

³³⁹ See, for instance, Art 8(2)(y and z) and (i-iii) of Amhara Regional State Proclamation no 91/2003; Art 16(7-10) of the Afar Regional State Proclamation no 33/2006; Art 13(6) of the SNNPR Proclamation no 103/2006; Art 2(8), Oromia Regional State Proclamation no 65/2003.



states transfer unconditional and conditional grants to *woredas*. The states have also legislatively authorized *woredas* to collect certain revenues in the form of land use fees, agricultural income tax and the like. In any case, *woredas* depend for over 75 per cent of their income on state transfers, over 90 per cent of which they use to cover their recurrent budgets.

As for the financing of their services, the two federal cities, Addis Ababa and Dire Dawa, are authorized by federal laws to raise revenue from various sources, as they do not fall within the jurisdiction of a state.³⁴⁰ For instance, they collect a tax on their employees' income and on income earned from agricultural activities, as well as profit, excise and turnover taxes from individual traders working in the cities. They also collect revenue related to properties in the city and user charges, for example, on vehicles. As a result, Addis Ababa covers almost 97 per cent of its total expenditure from its own revenue. The two cities in general rely on revenue they generate from the sources listed above. In general, they do not receive unconditional grants from the federal government. Hence, Addis Ababa reportedly covers over 97 per cent of its expenditure from own revenue. The so-called regional cities – those which are within the jurisdiction of one of the states and which are over 100 in number – are treated differently from the rural *woredas* in as far as they do not receive unconditional grants. Instead, they are given earmarked grants for discharging their state functions. Even the grants for the state services are not formula-based block grants.³⁴¹ Rather, 'they are determined on an "ad hoc" basis with a view to financing the recurrent costs of the state functions of the cities'.³⁴² They are thus left to cover the costs of providing municipal services from their internal sources of revenue by collecting user fees from those who make use of the services.³⁴³

Assessment of the Practice

Why the different treatment of state services and municipal services? One explanation is that the federal government, in its policy on poverty reduction, considered the so-called state services as important intervention areas for poverty reduction. It did so because over 90 per cent of those who live in absolute poverty are found in rural areas. This might have been the reason why there was a focus on rural areas and state functions in terms of finance. The other explanation might be ideological. The former ruling party, the Ethiopian People's Revolutionary Democratic Front (EPRDF), considered itself a vanguard of the marginalized rural population and rural areas as it saw the rural areas, where over 80 per cent the Ethiopian people live, as its support base. After losing elections in many urban centers in the 2005

³⁴⁰ See Federal Democratic Republic of Ethiopia (FDRE) Proclamation no 361/2003 Art 52 and FDRE Proclamation no 416/2004 Art 43.

³⁴¹ Marito Garcia and Andrew S Rajkumar, *Achieving Better Service Delivery through Decentralization in Ethiopia* (World Bank 2008) 24.

³⁴² *ibid.*

³⁴³ Jan Werner and David Nguyen-Thanh, 'Municipal Infrastructure Delivery in Ethiopia: A Bottomless Pit or an Option to Reach the Millennium Development Goals?' (working paper 01-2007, Institute of Local Public Finance 2007) <<http://www.ilpf.de/en/download/wp-01-2007.pdf>>.



election, the EPRDF had attempted to give attention to urban areas. It was after this election that the first policy on urban local government was formulated in 2007.³⁴⁴

References to Scientific and Non-Scientific Publications

Legal Documents:

Oromia Regional State Proclamation no 65/2003

Amhara Regional State Proclamation no 91/2003

FDRE Proclamation no 361/2003, Article 52

FDRE Proclamation no 416/2004, Article 43

Afar Regional State Proclamation no 33/2006

SNNPR Proclamation no 103/2006

Ministry of Finance and Economic Development (MoFED), 'Ethiopia: Sustainable Development and Poverty Reduction Program (SDPRP)' (2002)

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Garcia M and Rajkumar AS, *Achieving Better Service Delivery through Decentralization in Ethiopia* (World Bank 2008)

³⁴⁴ Ministry of Works and Urban Development, 'Plan for Accelerated and Sustained Development to End Poverty (2005/06-2009/10): Plan for Urban Development and Urban Good Governance' (2007).



12.5 Financing Healthcare: The Example of the Raya-Kobo District

Sisay Mengistie, *Centre for Federalism and Governance Studies, Addis Ababa University*

Relevance of the Practice

Raya-Kobo Woreda is one of the districts/*woredas* found in North Wollo Administrative Zone of the Amhara region. It is located in north-eastern part of the country and Amhara region respectively. The *woreda* is located 570 km from Addis Ababa and 410 km from Bahir Dar, capital city of Amhara region. Raya-Kobo Woreda borders with Raya-Alamata District in the north, Gubalafto and Habru districts in the south, Gidan District in the west and Afar region in the east. Based on the 2007 national census conducted by the Central Statistical Agency of Ethiopia (CSA), the recent projection shows that the *woreda* has a total population of 245,149, an increase of 26.43 per cent over the 1994 census, 33,142 or 14.93 per cent are urban inhabitants. With an area of 2,001.57 square kilometers, Raya-Kobo has a population density of 110.89.

Provision of primary health care services is within the functional competences of *woredas* in the Amhara state even though not clearly provided in the state constitution. However, in practice *woredas* are engaged in primary health service provision.

Description of the Practice

The Raya-Kobo district has nine health centers and 47 health posts; therefore, 80 per cent of the population has access to health services. However, the shortage of medicine and other necessary health materials is very critical. As we will see in the following paragraphs, government is primarily responsible to build health organizations and to provide essential equipment including medicine.³⁴⁵

It is indeed true that the health management system highly centralized prior to the formulation of first national health policy during the transitional period of 1993. At that time, it was the central government that determined issues related to policy, budget, and construction of health institutions, even recruitment of health workers, and provisions of logistic supply like drugs and other materials. However, things were changing subsequent to the formulation of a health policy which gives priority to decentralization and democratization of the health system. Consequently, the health system of the country was restructured along a decentralized setting with nine regional states and two city administrations.³⁴⁶

³⁴⁵ Interview with Haimanot Moges, Head of Raya-Kobo Woreda Health Office (Kobo, 10 May 2020).

³⁴⁶ Ministry of Health, 'Health Sector Development Programme (HSDP- IV)' (2010); Richard Wamai, 'Reforming Health Systems: The Role of NGOs in Decentralization Lessons from Kenya and Ethiopia' (Harvard School of Public Health 2004).



Following this general direction, the federal government under proclamation no 475/1995 defined the powers and duties of government institutions at each level. Hence, several responsibilities were devolved to the district-level health units. Accordingly, the District Health Offices are empowered to manage and coordinate the function of primary health care services at district level. Moreover, they are in charge of planning, financing, monitoring and evaluating all health programs and service deliveries in the district.³⁴⁷ Following the second phase of decentralization, responsibilities of health care service delivery were decentralized from the regional health bureau to the district health office.

According to the revised Constitution of Amhara Region (Articles 83 and 86), local governments have the powers and responsibilities to prepare and decide an annual economic development and social service plan within its jurisdiction. Thus, the tasks of administering primary health care institutions are the responsibilities of District Health Offices such as that of Raya-Kobo.

In particular, to collect user fees is one of the responsibilities of the district according to proclamation no 117/2006 of Amhara National Regional State, the Health Service Provision and Administration Proclamation. The proclamation unequivocally declared that health institutions, besides the government budget allocated to them, can collect and use internal revenue as an additional budget aimed at improving the quality and quantity of health services provided in that locality, and to improve their economic capacity for additional service provision. Therefore, according to this proclamation, improving the quality of health services is the central and the ultimate objective of health centers when utilizing their internal revenue. The proclamation, under Article 4, further lists the following sources of internal revenue of district health institutions:

- fees from the provision of varieties of health treatment services, and bed services to in-patients;
- revenues from the provision of services that have a direct relation with medical services such as laboratory fees;
- revenues from drugs sale and laboratory examination, sales of finite – terminated medical equipment;
- revenue generated from free service and from sale of non-clinical equipment, for example, house rent, and from contract income;
- money or material directly donated by partner organizations in the form of cash or in-kind.

Once the money and materials are collected from the above sources, they must be kept in a special bank account opened in the name of health institution in collaboration with the District Finance Office and stored in the District Health Office. Health Offices can use all revenue that they generate from service provision. The procedure of opening an account requires three members of staff whose names are announced to the bank and deposited by the joint name of the two representatives. Accordingly, the medical director of the health center, the purchasing and finance administration officer, and a case team leader who is appointed by the medical director of the health center are the three persons responsible to sign and open a health center bank account by their name on behalf of health center.

³⁴⁷ Ministry of Health, 'Health Sector Development Programme (HSDP- IV)'.



The purpose of using internal revenue is to realize several aims: first, to provide standardized, quality, prompt and sustainable health services; second, to enhance the culture of people to use health institutions and to develop a sense of ownership by improving the quality of health service provision; third, to organize health institutions purchase necessary drug and medical equipment; and lastly, to enhance work motivation and to develop a sense of ownership through building the capacity of a health institution's manpower.³⁴⁸ Health center administrations, in collaboration with the District Health Office, prioritize their interests and actual demands, evaluate their financial capacity and determine how to act accordingly. Based on this principle they purchase drugs and reagents; cover transport costs; purchase medical equipment; construct infrastructural facility such as water pipes, lines for electric light, sewerage and fence building; invest in a clean and safe environment of the health institutions; cover the costs of nonmedical services (such as food, security and hygiene), transfers to third parties; improve health system information or evidence; and build additional rooms.

According to the federal health policy, health centers can also use such internal revenue for training purposes (for laboratory, pharmacy and counseling); to computerize the finance and drug storage systems of the health institutions; to purchase necessary office materials (pen, paper, etc.); to pay for transport costs; to build additional rooms; for rehabilitation purposes; to cover the salary of contractual workers who will be employed not more than 3 months; to cover other recurrent administrative costs related to improving the quality of health institutions; for non-medical training (computer and other office administration and management activities).

There are, however, certain tasks which are not covered by internal sources of health institutions. For instance, scholarship training and its transport cost; domestic training that is longer than a month; payment in the form of gifts for a third party; the employment and salary of advisors (including research work); and any activities which are not explicitly mentioned in the previous paragraphs.

As far as financial matters are concerned, the District Health Office has no direct contact with the nearby Zonal Health Department but has a direct relation with the Regional Health Bureau which directly finances its subsidy to the District Health Office without the need for an intermediary body (zone administration). The only relation the district has with the Zonal Health Department is in the sphere of reporting (prior to the submission of reports to the Regional Health Bureau, whatever the matter, it shall report first to the zone) and training to upgrade the capacity of district institutions, organized either by the zone or by the region. In addition to health treatment fees, district health institutions are financed through district block grants transferred by the regional government, and external loans as well as in-kind or cash assistances from donor organizations and other sources.

Assessment of the Practice

As we have seen from the above discussion, the local governments in general and health sector district level institutions in particular have been granted important powers and functions. The

³⁴⁸ Proclamation no 117/2006.



tasks of constructing health centers and health posts, recruiting health workers, providing professional as well as in-service training, generating internal revenue from user fees and to finance health institutions etc. are some of the competences of district-level local governments in general and district health offices in particular. The result of the study also highlights the problem of inadequate budget which hampers the quality and quantity of health care service provision in general and the quantity of buildings and other related infrastructures in the district in particular. Even though District Health Offices have the power to generate internal revenue from user fees, they cannot spend it in performing tasks they want, like, for example, to pay for worker's salary and per-diem fees. Instead, they are bound to invest internal revenue in pre-determined tasks. Therefore, on the bases of the above analysis and discussion, the following recommendations are deemed necessary to enhance the quality health services and to reinforce the ability of local government health institutions. Although responsibilities of expenditure given to local government is highly decentralized, assignments of revenue collection power still remain centralized. As a result, the major share of district budgets is granted either by the regional state or federal government in the form of conditional grants and rarely in the form of unconditional ones.

Hence, it seems plausible to balance the assignment of expenditure responsibilities with the power of revenue collection. The regional state government has to give discretionary power to the *woreda* administration and District Health Office to use their internal revenue at least to cover the per-diem and monthly salary of the workers employed through contract. It indeed enhances the motivation of the health workers' activities as well as reduces the existing budget gap and thereby improves the quality and quantity of health care services at the local government level. Capacity building of local government should keep being implemented with increased capital budget and hence more funding to lower tiers of government institutions is necessary.

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13. Local Financial Arrangements in Argentina

13.1 The System of Local Government in Argentina

Lucas González and Juan Javier Negri Malbrán, *Universidad Nacional de San Martín*

Types of Local Governments

Argentina is a federal country consisting of 23 provinces and the Capital City of Buenos Aires as a federal district. Their autonomy is enshrined in the Constitution of 1853, which was last time reformed in 1994. According to the Federal Constitution, provinces can vote their own constitutions and laws. They have the power to elect their authorities and organize their own administrations, even in areas of justice and security. In addition, provinces have broad constitutional autonomy in fiscal and spending functions. A delineation of powers between central government and the provincial states is based on the general principle that all provinces have the power of those competences not expressly delegated in the Constitution to the federal state.

The third tier is composed of local governments. As the provinces have a political, administrative, judicial, and financial autonomy, the scope of municipal autonomy is determined by the province in which they are located. That translates into a wide range of definitions and configurations for local governments. Several municipal governments, depending on the provinces, have the authority to draft municipal charters (usually depending on the size of their populations). In some provinces, municipalities include only urban areas around cities, leaving rural areas under the jurisdiction of provincial governments. This translates into serious challenges for the delivery of social services. In others, municipal governments may include several cities and rural areas too.

Departments are an administrative division between provinces and municipalities, which do not have policy functions nor fiscal responsibilities. They mainly have a cadastral and statistical role, but in some provinces, they are also electoral districts to elect provincial representatives.

The adoption of federalism and a decentralized system of government that recognized autonomy to subnational units was the result of civil wars in the 1820s, after independence, and the only possible way to solve the political and economic conflicts in a country of enormous territorial extension.

Legal Status of Local Governments

Both the national Constitution, as amended in 1994, and most of the provincial constitutions explicitly recognize the autonomy of municipalities. According to Article 123 of the Argentine Constitution, '[e]ach province dictates its own Constitution, in accordance with the provisions of Article 5 ensuring municipal autonomy and regulating its scope and content in the



institutional, political, administrative, economic and financial order.’ The sanction of several municipal charters (*cartas orgánicas municipales*) marks a progressive increase in the decision-making capacity of the municipalities. But this contrasts with limited administrative capacities to provide services (many of them decentralized at the provincial level) and scarce public resources and tax powers to finance their expenses (mostly concentrated at the national level).³⁴⁹

(A) Symmetry of the Local Government System

Although the Argentinian Constitution establishes a substantial autonomy for subnational tax powers, in practice the provinces have delegated large amounts of responsibility to the national government for the collection of revenue (income taxes, sales, special taxes and taxes on fuel). The resulting revenue concentration contrasts with a process of decentralization of expenditure whereby the responsibility for key social functions is in the provincial hands. The only activities that are the exclusive competence of the national authorities are those related to defense and foreign affairs. In the areas of economic affairs, public security, and social infrastructure, the national government shares responsibility with the provinces, while the latter have exclusive competence in primary and secondary education and local (municipal) organization and services. The Constitution defines a wide area of public services for which national and provincial authorities can participate in the legislation and provision of public services, although the tendency in the last two decades has been for the national government to decentralize direct administration of those functions to the provinces. Therefore, the provinces are currently in charge of most social expenditures (including basic education, health services, poverty programs, housing) and economic infrastructure. Despite this, the national government maintains a significant regulatory power in many of these areas and manages some programs within these sectors, such as social security, social programs for poorer households, and complementary educational programs that subsidize poorer schools.

Given this decentralization of spending and fiscal centralization, there is a high degree of vertical fiscal imbalance. Argentina addresses this large vertical fiscal imbalance through a complex system of intergovernmental transfers. The most important component of this system is the revenue sharing agreement (called *coparticipación*), which is the process by which part of the revenues collected by the central government are transferred to the provinces. Over time, the system has redistributed revenue from the richest central region to the most backward provinces in the northwest and northeast. It has also favored richer and low-density Patagonian provinces. Despite this, the system has corrected part of the large regional income asymmetries among provinces in Argentina. We have to bear in mind that regional inequalities in Argentina are enormous. Formosa, for instance, has a GDP per capita more than 10 times lower than the City of Buenos Aires (2,256 versus USD 23,439). Although it has corrected regional income inequalities, the revenue transfer system has not had a substantial impact on

³⁴⁹ Monica Iturburu, ‘Municipios Argentinos: Potestades y restricciones constitucionales para un nuevo modelo de gestión local’ (2nd ed, Instituto Nacional de la Administración Pública 2000) 33.



provincial and local welfare indicators, as most social functions depend on the provinces (and are strongly correlated with provincial spending, particularly in social areas).

Political and Social Context in Argentina

The main parties that govern the provinces are the Justicialist Party (PJ), *Cambiamos*, which is the alliance governing the national government (formed by the Radical Civic Union, or UCR, Republican Proposal, or PRO, and other minor parties), and a constellation of minor parties, including the Socialist Party and provincial parties. *Cambiamos* governs four provinces (Buenos Aires, Corrientes, Jujuy and Mendoza) and the City of Buenos Aires. The PJ (in one of its several factions) governs 14 provinces (Catamarca, Chaco, Córdoba, Entre Ríos, Formosa, La Rioja, La Pampa, Salta, San Juan, San Luis, Santa Cruz, Tierra del Fuego, Tucumán, and Santiago del Estero). The socialists govern one province (Santa Fe) and provincial parties govern the other four provinces (Chubut, Misiones, Neuquén and Río Negro). Argentina has 1922 municipalities³⁵⁰ governed by these and other national, provincial or local parties.

According to the last census, Argentina has 40,117,096 inhabitants, out of which more than 91 per cent (36,517,332) live in urban areas and the rest (3,599,764) in rural areas. More than 19 million live in 10 cities of more than 500,000 inhabitants, the largest being the metropolitan area of Buenos Aires (with 12,806,866 inhabitants and 31.9 per cent of the population).

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³⁵⁰ Iturburu, 'Municipios Argentinos', above, 80.



13.2 Local Financial Arrangements in Argentina: An Introduction

Lucas González, *Universidad Nacional de San Martín*

Addressing socioeconomic problems is mostly a subnational task in Argentina, as in many other decentralized countries. In the midst of adjustment reforms and deep economic crisis in the 1990s, the national government initiated a process of retrenchment and reduced significantly the social services it delivered. Associated to it, policy responsibilities of subnational units dramatically increased after the 1990s decentralization policies. Several key social services, such as primary health and education, are policy responsibilities of subnational units in Argentina (as well as in the most decentralized federal systems, such as Brazil and Mexico, and even in some decentralized unitary countries, such as Colombia). These decentralized social services are crucial to improve socioeconomic indicators at the subnational level.

Municipal governments in Argentina have 6 per cent of the total revenues and 9 per cent of the total spending. These shares are 16 and 33 for provinces and 80 and 58 for the federal government.³⁵¹ This imbalance means that subnational units have to rely on two main sources of revenue to face dire socioeconomic conditions: their own revenue (that is, the revenue they collect autonomously) and federal transfers they receive from the central government. Local governments collect very few taxes (such as garbage and lightning service fees), which represent about 40 per cent of municipal total revenue, and depend on provincial as well as federal transfers, which are about 50 per cent of their total revenue.³⁵² Some of them are automatic transfers (such as those from the revenue sharing system) and other discretionary. Without federal transfers, more disadvantaged provinces and municipalities depend on their own revenue to deliver vital social services. This severely diminishes their capacity to deal with the social problems they face, especially because their own revenue is lower than the national average and they usually have to deal with worse social indicators (and in most cases, they have poorly trained professionals with low salaries to deliver them).

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³⁵¹ Alejandro López Acotto and Mariano Maccioli, 'La estructura de la recaudación municipal en la Argentina: alcances, limitaciones y desafíos' (Ministerio del Interior 2015) 24.

³⁵² *ibid* 26.



13.3 Financing School Canteens to Fight Child Malnutrition in Urban and Rural Chaco

Lucas González, *Universidad Nacional de San Martín*

Relevance of the Practice

How do local governments cope with demanding social needs? Do their own finances help them targeting increasing social needs in their districts? Or, do central government transfers help subnational governments provide useful services?

This section explores initiatives developed at the local level in the Province of Chaco, in northern Argentina, to cope with child malnutrition in the context of limited federal and provincial transfers as well as insufficient revenues collected locally.

As part of an ongoing research project,³⁵³ we carried out a survey in June-July 2019 to 183 school principals in Barranqueras, Charata, Fontana, General José de San Martín, Las Breñas, Machagai, Quitilipi, and Resistencia. The interviews were conducted during the months of May and July 2019 by teams of pollsters from the Government School of the Province of Chaco. We also conducted fieldwork research to schools across the province.

Chaco is one of the poorest provinces in Argentina, with a GDP per capita less than half the national average and performance far below the national average on a whole host of social and economic indicators. According to the 2010 census, approximately 23 per cent of provincial residents live in households with unsatisfied basic needs, the third highest rate in the country.³⁵⁴ The province has the highest illiteracy rates among children of 10 years of age (5.5 per cent)³⁵⁵ and the lowest life expectancy at birth in the country, both among men and women (69.5 and 76.4 years, respectively).³⁵⁶

These social conditions are also reflected in available data on nutrition in the province. Research on childhood nutrition in Argentina shows that both undernutrition and overweight/obesity are present in the country, with the latter being more common, affecting about one-third of Argentine children.³⁵⁷ Chaco is one of the few provinces with over 5 per

³⁵³ Ana de la O, Lucas Gonzalez and Rebecca Weitz-Shapiro, 'Voluntary Audits: Experimental Evidence on a New Approach to Monitoring Front-Line Bureaucrats' (APSA Annual Meeting, Washington DC, August/September 2019).

³⁵⁴ Instituto Nacional de Estadística y Censos (INDEC), 'Censo nacional de población, hogares y viviendas 2010: censo del Bicentenario: resultados definitivos' (INDEC 2012).

³⁵⁵ *ibid* 116.

³⁵⁶ Instituto Nacional de Estadística y Censos (INDEC), 'Tablas abreviadas de mortalidad por sexo y edad 2008-2010. Total del país y provincias' (INDEC, Serie Análisis Demográfico N° 37, 2013).

³⁵⁷ Sergio Britos, Gala Díaz Langou, Cecilia Veleda, José Florito, Nuria Chichizola, and Malena Acuña, 'Lineamientos Para Una Política Federal de Alimentación Escolar' (CIPPEC 2016).



cent of children aged 6-72 months who were found to be underweight in a study conducted by the Ministry of Health.³⁵⁸

One major federal program designed to address nutritional deficits is the school free meal program, known colloquially as *comedores escolares* (school canteens). The school meal program forms part of a larger national anti-hunger program, the *Plan Nacional de Seguridad Alimentaria* (Food Security National Program) which was established in 2003 in the wake of the 2001 national economic crisis. School canteens that provide a free meal or snack during the school day have a long tradition in Argentina³⁵⁹ and have had varied structures and funding sources. The current program is funded jointly by the national government and the provinces.³⁶⁰

In our field research, we found that federal and provincial funds in Chaco are insufficient to cope with increasing demands for meals for children due to rising unemployment, increasing food prices due to high inflation, and soaring poverty. As a consequence, school canteens in the province have to rely on local governments and their communities to cope with the increasing demands they face.

Description of the Practice

Given levels of poverty and social exclusion in Chaco, it is not surprising that many local observers attach great importance to the province's school free meal program. A previous provincial Minister of Education expressed the view that, given Argentina's ongoing economic crises, the food served in schools 'is not a complement like in other years, but instead one of the children's principle meals or even their only meal of the day.' One school principal pointed to the importance of the program as a source of higher quality nutrition than students would otherwise receive; in her words, there are 'parents with few resources who don't know how to feed their children; they buy or give them money for candies, so the milk that we give them in school becomes their most important food.'

School principals are the key actor in the implementation of the meal program. They are responsible for preparing menus, managing foodstuffs, coordinating and overseeing food preparation on site, and ensuring that food is distributed to students during each school day at snack and/or lunch time, depending on the meal regime the school is assigned by the program.

School canteens suffer from a lack of resources, both for the federal and provincial program administration and to fund sufficient food to meet student needs.³⁶¹ The lack of resources has

³⁵⁸ Dirección Nacional de Maternidad e Infancia (2006) 52.

³⁵⁹ Sergio Britos, Alejandro O'Donnell, Vanina Ugalde, and Rodrigo Clacheo, 'Programas Alimentarios En Argentina' (Centro de Estudios sobre Nutrición Infantil 2003).

³⁶⁰ Britos and others, 'Lineamientos Para Una Política Federal de Alimentación Escolar'. Also see Gala Díaz Langou, Pablo Bezem, Carolina Aulicino, Estefanía Cano, and Belén Sánchez, 'Los Modelos de Gestión de Los Servicios de Comedores Escolares En Argentina' (CIPPEC 2014).

³⁶¹ Gala Díaz Langou and others, 'Los Modelos de Gestión de Los Servicios de Comedores Escolares En Argentina', above.



to do with increasing prices due to inflation and more number of children attending school canteens due to the lack of food in their homes.

As a consequence of these restrictions in federal and provincial funds, local governments began to play an important role. Larger cities allocate part of their social programs to fund personnel to run canteens, especially cooks and cleaning personnel. In other cases, particularly in smaller towns and rural areas, mayors get personally involved in contacting local supermarkets and getting donations for school canteens.

Local community organizations and parents' associations also help school canteens providing the main meals to kids in school in urban localities and rural areas in Chaco. According to our survey, in 94 per cent of the schools there is a parents' association, and in 31 per cent of the cases, principals report that the parents' associations are very active in helping them running the canteens.

A usual view of community participation is related to improving accountability. We found this dynamic mostly in urban areas, especially in larger cities, where parents' associations exert pressures on school principals and members of the school board to control school finances and improve services (such as the quality of the classrooms' infrastructure, the cleanliness of toilets, and the quality of food in canteens).

When it comes to accountability for overall performance in school, the opinion that most worries the school principals is that of the parents. In total, 167 directors reported to parents among the three most relevant actors at the time of accountability (equivalent to 92 per cent of principals), followed by students (52 per cent) and supervisors (51 per cent). Only 20 per cent believe they are concerned about the opinion of the ministry and 4 per cent, the opinion of the Court of Auditors.

In schools of these districts, the majority of students are middle class, children of professionals, who usually work as employees in the public sector.

If relation to the provision of food services, if funds from the province and the federal government do not reach in time, school directors usually ask parents to collaborate with products, such as yerba mate (a local version of tea) and sugar, or to collaborate in parents' associations to help getting access to the products.

In schools located in the most humble neighborhoods of the City of Resistencia (capital of the province), it was possible to identify, based on observation and during interviews with the directors, their strong commitment in the administration of the school canteen and in providing quality meals to students.

But in schools far away from the main urban areas of larger cities and especially in rural areas we saw a different dynamic.

To begin with, the socioeconomic background of families is different. In smaller towns, students are usually divided in two groups: mostly middle-class students, who attend during the morning, and students from more humble families, who come to school during the afternoon.

In the smallest cities in the interior of the province and in rural areas, most of the students come from poor families, children of coastal workers, farmers, and day laborers, who do not



have a fixed daily job. Many students are in a situation of social vulnerability. In some cases, school directors asserted that ‘food in the school is the only one of the day they get.’

One important feature of school canteens in these district is the level of involvement of the school directors in the provision of meals, which is usually very high. They help preparing special menus, taking into account the eating habits of students in those regions, usually very different from those in larger cities. These students really need better nutrition at schools, because many of them do not get it at home.

Another important feature is that parents’ associations are very active. They get funds through other activities, such as running a kiosk in schools. In one school, parents organized a pie sale as an activity to raise funds for repairing classrooms and help the school canteen with food, and got great results out of the participation of families. With those funds, they can cover gas expenses, and compensate for the lack of products that are not supplied by the Ministry of Social Development.

In these schools, directors highlighted the sacrifice that is carried out day by day to be able to offer meal services. In some cases, canteens have one or two people who cook. They are paid around ARP 50 per month for a 6-hour work day. This ‘salary’ is provided by the municipality, in the form of a social assistance plan.

But the most relevant dynamic we found was that instead of encouraging social accountability, community participation was mainly related to guaranteeing the delivery of food in school canteens. Parents participated and got personally involved to secure a decent meal a day for their kids. According to our fieldwork, food preparation is mostly carried out by volunteers, in part due to the lack of funding for staff to carry out this task. Local governments face serious limitations in smaller towns and rural areas to contribute funding personnel. In most of the cases, cooks in canteens are the mothers of students (in a few cases also fathers, who usually work in the fields). Teachers also often help in the kitchen, because the staff is not enough. Very importantly, parents also help school canteens by growing vegetables and taking care of animals in small farms near schools. In some of these cases, working for the school canteen was a source of food not only for students but also for their parents.

Assessment of the Practice

The analyzed case shows how fiscal transfers from the federal government are crucial to deliver critical social services, especially in poorer localities of the interior and rural areas. Local governments also play a key role, mostly through the personal involvement of the mayor. Her main role is mostly to secure food for students and decent infrastructure for schools and their canteens.

But the study also presents a novel dynamic. Community participation has been crucial in innumerable cases around the world. Its most usual role is to improve social services by increasing accountability. This dynamic is present in most larger cities and across urban areas in the province. It also provides networks of social engagement, characteristically in parents’ associations, to help improving services at schools.



But in many school canteens in Chaco, particularly those in remote localities and in rural areas, the direct involvement of the community has been crucial to run canteens. Parents and teachers help cooking meals, growing vegetables and raising animals to provide a reliable source of food for children. Sometimes parents also get their own food in the schools.

Despite the optimistic note related to the role of community participation in the delivery of social services in poorer districts and rural areas, it is important to stress the enormous limitations in the role of federal and provincial transfers in this study. Without them being relevant in the provision of this and other social services, it is very unlikely that very unequal developing countries, such as the one under study here, can reduce the enormous disparities across their territories.

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13.4 Trust Fund UniRSE, Santa Cruz

Romina Del Tredici, *Universidad Nacional de San Martín and Universidad Católica de Córdoba*

Relevance of the Practice

The national government favored the Province of Santa Cruz with the distribution of discretionary public works during the presidencies of Néstor and Cristina Kirchner (2003-2015), but punished it during the government of Mauricio Macri (2016-2019). In this context, the provincial government created the Trust Fund 'United in Corporate Social Responsibility' (UniRSE), which allowed it to sustain public investment at the local level during the latter period. The analysis of this fund is important because it involves different revenue sources, intergovernmental transfers, and integrated investment strategies to strengthen urban-rural linkages. It also allows us to discuss whether there is a deficit in terms of public accountability and local budgets' transparency. Finally, this practice shows how conditional grants can directly affect local life when are aimed to reduce disparities across municipalities by fostering investment at the local level.

Description of the Practice

In most federal countries, central governments transfer large amounts of money among regions. In some cases, these transfers are institutionalized and relatively stable, but in others they are the result of political struggles and coalitions among actors. In Argentina, there is a high degree of discretion in the territorial allocation of public works. During the presidencies of Néstor and Cristina Kirchner, the distribution had a partisan and structural logic: the central government favored allied governors in the countryside and punished governors of the largest central provinces, who were the strongest competitors for the presidency.³⁶² It mostly benefited the least populated and politically allied provinces in Patagonia: Santa Cruz, the home province of the Kirchners, was at the top of the list.³⁶³ On the contrary, the central provinces were the main electoral coalition and the main political allies of Mauricio Macri. As a relatively weak president, in terms of legislative support and in public opinion, Macri was less capable of resisting pressures from the governors of the central provinces. The Patagonian provinces were not among the most affected in terms of the distribution. However, the national government reduced almost half the amounts transferred (on average and per capita) to them. The Province of Santa Cruz, in particular, was the least favored.³⁶⁴

In 2016, the Government of Santa Cruz signed agreements with mining companies for the creation of the UniRSE Fund for four years (Provincial Law no 3476/2016). The objective of the

³⁶² González LI and Del Tredici R, '¿A Qué Provincias Favorece el Gobierno de Mauricio Macri? La Distribución de Fondos Federales de Infraestructura (2016-2018)' (2019) 1 *Tramas. Revista de Política, Sociedad y Economía* 25.

³⁶³ *ibid* 8.

³⁶⁴ *ibid*.



program was to collect mining revenues and redistribute them across the provincial territory. It helped to finance infrastructure and housing projects, health facilities, and even sports scholarships.³⁶⁵ The government created an administrative committee of the fund, chaired by a representative of the Ministry of Economy, Finance, and Infrastructure and included representatives of the Ministry of Production, Trade, and Industry, the Ministry of Social Development, Health and Environment, and the Secretariat of State of Labor and Social Security and the Mining Chamber of Santa Cruz. The legislation establishes that mining companies should contribute a monthly percentage of up to 2 per cent of the value of their exports.

Alicia Kirchner, the Governor of the province, defined the program as a combination of ‘public works with Corporate Social Responsibility’ which, through an alliance with mining companies, allowed the provincial government to carry out important public works to connect cities across the territory of the state.³⁶⁶ The Minister of Production claimed that the UniRSE fund was what allowed them to sustain provincial government’s investments during Macri’s government.³⁶⁷ We have to bear in mind that federal and provincial public works are usually the major sources of public works at the local level in Argentina.

Assessment of the Practice

The creation of this fund was possible because the national government granted large tax cuts to mining companies in 2016.³⁶⁸ In 2020, as an indication of the relevance of the UniRSE fund, the Governor decided to extend it until 2024. Mining companies, on the other hand, expressed their commitment to continue financing it, as a form of corporate social responsibility.³⁶⁹

During the first two years, the fund contributed to overcome the financial costs the national government imposed and, when the fiscal situation improved, ‘it began to turn towards the encouragement and promotion of productive investments’.³⁷⁰ The government reoriented mining revenue with ‘the objective of improving the development of the whole province and not only of the localities that have large mining projects’ in their territories. In three years, ‘2,386 million pesos were executed, of which 44 per cent was distributed directly among 21 municipalities and (smaller units of government, called) development commissions. Of the

³⁶⁵ Sebastián Premici, ‘El desarrollo como horizonte’ (*Cadena del Sur*, 2 December 2019) <<https://cadenadelsur.com/el-desarrollo-como-horizonte/>> accessed 22 May 2021.

³⁶⁶ Romina Del Tredici and Lucas I González, Interview with Alicia Kirchner, Governor of Santa Cruz (Rio Gallegos, 5 February 2021).

³⁶⁷ Romina Del Tredici and Lucas I González, Interview with Silvina Córdoba, Minister of Production of Santa Cruz (Rio Gallegos, 4 February 2021).

³⁶⁸ La Opinión Austral, ‘Provincia renovó hasta 2024 acuerdos con mineras por el UniRSE’ (*La Opinión Austral*, 10 October 2020) <<https://laopinionaustral.com.ar/edicion-impres/provincia-renovo-hasta-2024-acuerdos-con-mineras-por-el-unirse-253798.html>> accessed 22 May 2021.

³⁶⁹ *ibid.*

³⁷⁰ Premici, ‘El desarrollo como horizonte’, above.



total resources collected, 1,080 million pesos were specifically allocated to finance infrastructure projects.³⁷¹

For the Governor, the funds were essential for the ‘connection among cities.’³⁷² The works carried out have the objective of strengthening, diversifying productive activities, and providing autonomy to the areas of the province that are located furthest from the capital.³⁷³ The provincial investments indirectly act as conditional grants to the municipalities and, because some of them are investments in services infrastructure (e.g. gas), they may affect municipal financing generating more economic activity and improving municipal tax collection.³⁷⁴

The opposition to the government questioned the lack of transparency in the use of these funds.³⁷⁵ The program can be questioned, in the first place, due to the lack of autonomy of local governments in the decision-making process over the allocation of infrastructure funds and, once they are finished, the property of public works (being a hospital or a school) belongs to the province. Second, it can also be criticized because of the absence of citizen participation in the process: the agreements take place between companies and the provincial state, and social organizations rarely participate or receive funds. Finally, although there is an inter-ministerial committee that administers the funds, there are no other types of spending supervision.

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³⁷² Del Tredici and González, Interview with Alicia Kirchner, above.

³⁷³ La Opinión Zona Norte, ‘Inauguraron la última etapa de la planta de gas en Los Antiguos que beneficiará a miles de familias’ (*La Opinión Austral*, 13 April 2021) <<https://laopinionaustral.com.ar/edicion-impres/queda-inaugurada-la-ultima-etapa-de-la-planta-de-gas-en-los-antiguos-337094.html>> accessed 22 May 2021; Grupo La Provincia, ‘Bauer encabezó apertura de un Centro Cultural en Santa Cruz y destacó el trabajo con las regiones’ (*Grupo La Provincia*, 12 May 2021) <<https://www.grupolaprovincia.com/cultura/bauer-encabezo-apertura-de-un-centro-cultural-en-santa-cruz-y-destaco-el-trabajo-con-las-regiones-714807>> accessed 22 May 2021.

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³⁷⁵ El Divergente, ‘Radicalismo de Puerto San Julián pide transparencia a gobierno provincial en manejo de fondo UNIRSE’ (*El Divergente*, 16 December 2020) <<https://www.eldivergente.com.ar/radicalismo-de-puerto-san-julian-pide-transparencia-a-gobierno-provincial-en-manejo-de-fondo-unirse/>> accessed 22 May 2021; Mediática Digital, ‘Siguen malgastando el futuro de Santa Cruz’ (*Mediática Digital*, 10 June 2019) <<https://www.mediaticadigital.com.ar/nota/24094-siguen-malgastando-el-futuro-de-santa-cruz/>> accessed 22 May 2021.



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13.5 Local Government's Taxing Power

Mónica Iturburu, *Universidad Nacional del Centro de la Provincia de Buenos Aires*

Relevance of the Practice

The National Constitution (NC) recognizes three levels of government – nation, provinces and municipalities – and assigns to the provinces the majority of taxing powers. The federal government (FG) has exclusive and permanent authority over import and export duties and is authorized to collect direct taxes on an exceptional basis and indirect taxes together with the provinces. Provinces also have permanent jurisdiction over direct taxes. Regarding local governments, Article 123 of the NC states that each province dictates its own constitution, ensuring municipal autonomy and regulating its scope and content in the institutional, political, administrative, economic, and financial order. Some authors say that this article implies the express recognition of the local government's original taxing power.

Despite the constitutional provisions, the FG holds the most significant taxing power in practice. At the beginning of the national organization, due to the separation of tax sources and the concurrent power to collect internal taxes, the provinces held a high degree of autonomy. This autonomy remained until 1934; since then, successive laws have been restricting it. The most outstanding is the Federal Tax Revenue Share Law no 23.548, enacted in 1988, which has been modified several times and is still in force. This law limits what can be taxable or not for the two most critical provincial taxes. Since 1993, provincial autonomy has been reduced to its minimum expression by signing the Fiscal Agreement that added more restrictions for all provincial taxes, establishing restrictions on average rates, and forced the elimination of taxes. The Fiscal Consensus I (signed in 2017) reinforced this strategy,³⁷⁶ later partially made more flexible by the Fiscal Consensus II in 2018. All these legal instruments were ratified by the provincial authorities.

The taxing power concentration in the FG reduces the scope to which provinces can exercise their power since they are prevented from creating similar taxes to the ones collected by the FG. Municipalities also face this prohibition, created by the law no 23.548, except for all charges and administrative fees for services (Article 9(b)). Furthermore, the fact that the legal provision comes from a commitment assumed by the provincial level, without local government's participation, reinforces the subjugation of municipal autonomy.

According to law no 23.548 (Article 9(g)), provinces must establish a system for distributing revenues received from the FG among the municipalities in their territory. This system must determine the indices for the distribution of funds. In compliance with this commitment, twenty-two out of the twenty-three provinces have established a revenue share system, in some cases, with several years of delay and due to court orders. The instituted systems are

³⁷⁶ Alberto Porto, 'Autonomía Fiscal Provincial en la Argentina. ¿Federalismo o Centralismo?' in Alberto Porto (ed), *Temas de políticas públicas* (Universidad Nacional de La Plata 2019) <<https://www.mfp.econo.unlp.edu.ar/wp/wp-content/uploads/2019/08/POLIticas-PUBLIcas-Porto-DIGITAL-web.pdf>>.



very varied. Each province distributes among the municipalities the federal revenues they receive, in percentages that go from 8 per cent to 26 per cent. Provinces also redistribute the taxes they collect, such as the gross income tax. Some jurisdictions transferred the collection of some taxes to the municipalities (for example, one province did so with the gross income tax and seven with the real land tax). Only a third of municipal revenues come, on average, from their own sources, and in recent years the level of self-financing has decreased.³⁷⁷

The criteria for assigning resources to municipalities (secondary distribution) are also very heterogeneous, but the compensatory criterion (69 per cent) dominates widely, distributing resources based on variables that allow a certain approximation to the level of expenditures. Although the most used is the population, a third of the regimes establish formulas that favor the less populated municipalities by distributing additional funds based on the 'distance from the capital', 'rural population that receives services from the municipality', 'inverse to population', 'inverse to population density', or distributions in which a portion of the shared mass is allocated excluding the capital city. However, the percentages that are distributed according to these criteria are always marginal (between 1 per cent and 10 per cent).

Description of the Practice

The tasks carried out by the municipalities have increased since the 1990's, when the federal and provincial governments transferred functions to them. In some cases, it resulted from formal processes (such as health or drinking water). In many others it resulted from transfers made only in practice due to the lack of sufficient services from the competent jurisdiction and the public expectation deposited at the closest level of government. The most recent example corresponds to internal security, a provincial competence progressively carried out by municipalities – sometimes encouraged by the provincial orbit. It includes the provision of resources for the provincial police's operation, the installation of monitoring centers, and the creation of armed patrols. Depending on its size and location, municipalities carry out different responsibilities that do not correspond to them. This progressive appropriation of greater functions was not compensated with the provision of equivalent resources, generating financial shortcomings that led those municipalities most affected to seek alternative sources of income.

The contrast between the increase in functions municipalities have to deliver and the restriction established by law no 23.548, limiting the taxing power to the remuneration rates for services, generated a process of manifest deformation of the concept of 'charges and administrative fees'.³⁷⁸ Municipalities have begun collecting fees for services delivered that, due to their taxable events, absence of territorial contact, calculation bases, and taxable categories, looked a lot like provincial and federal taxes. Different judicial bodies created

³⁷⁷ Directorate for Analysis of Provincial Debt and Municipal Finances, 'Regímenes provinciales de coparticipación de recursos a los gobiernos locales en Argentina' (Ministry of Economy and Public Finance – National Directorate for Fiscal Coordination with the Provinces 2014)
<https://www.economia.gob.ar/dnap/municipios/documentos/regienes_provinciales_de_coparticipacion_de_recursos.pdf>.

³⁷⁸ The concept of 'tasa' was translated as 'charges and administrative fees'.



resolutions that acknowledged exceptions that allowed municipalities to charge fees for potential services or had a very generic tax base.³⁷⁹ Nevertheless, the judicial power has also stopped the municipal tax collection aspirations. For example, a road fee was applied to the sale of fuels in several municipalities, which was considered unconstitutional by some courts and resisted by gas station's owners and users, generating a wave of interruption of the application and inhibition of those who planned to enforce it. However, these policies are rarely initiated in small municipalities, which themselves do not have sufficient capacities to increase the tax burden on their residents. Added to this is the lack of autonomy, due to the fact that most provincial constitutions only recognize it in local governments that exceed a population floor. However, if the tax innovation initiated by larger municipalities is little resisted, it tends to be replicated in small local governments.

Assessment of the Practice

In summary, municipalities face a scenario of deregulated functions and regulated income. Since municipalities are the first representation of government that citizens have and mainly act on the field, when is possible they continue to assume new tasks, sometimes reallocating resources from their own and non-delegable functions. To a large extent, the insufficient collection is explained by the weakness of the tax systems that are conditioned, in part, by rules of a lower rank than the constitutional one. The significant positive correlation between the economic development of the jurisdictions and their degree of self-financing has been evident during the Covid-19 pandemic, which accentuated the differences between the municipalities with the greatest capacities and those that lagged behind. Faced with this scenario, many rural municipalities could not provide a satisfactory response to a population that had to face social, preventive and mandatory isolation without digital, banking or basic health infrastructure, generating a negative impact that is still difficult to measure.

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14. Local Financial Arrangements in India

14.1 The System of Local Government in India

Asha Sarangi and Lipika Ravichandran, *Centre for Political Studies, Jawaharlal Nehru University*

Types of Local Governments

In India, institutions of local government exist at two levels, local *panchayats* or councils in the rural areas and municipalities in the urban areas. At the rural level, *Panchayati Raj* Institutions (PRIs) consist of three levels: *gram panchayats*, *panchayat samitis* and *zilla parishads*.

A *gram panchayat* can be translated as village council or jury as it is the only grassroots-level institution of PRIs' formalized local self-governance system in India at the village or small-town level. It consists of an elected *sarpanch* (head) and five to twelve elected members. The *gram panchayats* are responsible for the creation of annual development plans, the budget for construction, repairs and maintenance of community assets, *khadi* and village industries³⁸⁰, adult and non-formal education, public health, poverty alleviation, education, cultural activities, rural housing and electrification, promoting agriculture, social welfare and public distribution scheme.

At the intermediate level, the *panchayat samitis* (block panchayats) operate. They work at the *tehsil* or *taluka* level³⁸¹ known as development block and provide a crucial link of communication between *gram panchayat* and district administration. They are also known as *mandal parishad*, *mandal panchayat* and *taluka panchayat* and are primarily made of four-

³⁸⁰ Village and *khadi* industries are based on the concept of *Swadeshi* wherein the use of labour is central and the use of capital is limited, underlying the concept of self-reliance in the economy. These industries rely on local raw materials and local production at small scale.

³⁸¹ There are two constitutional amendments, 73rd and 74th passed in 1992 which provide a whole scenario of the different levels of local governments at rural and urban level. The 73rd amendment states a three-tier system of *panchayati raj* at the village *panchayat* (*gram*), block (intermediate) level (*panchayat samiti*) and district levels (*zilla parishad*) for a population of more than 20 *lakh* (2 million). *Gram* or village *panchayat* consists of *gram sabha* and members of the village *panchayat* directly elected by the people and headed by the *pradhan* (elected head) village council (*gram sabha*) consist of all the members of the village. Each *gram panchayat* is assisted by four committees that is *samata samiti* (committee for welfare of women and children, scheduled caste and tribes and other backward classes) *vikas samiti* (committee for development in agriculture), *shiksha samiti* (education) and *lokhit* committee (public health and public works). In between *gram panchayat* and *zilla panchayat* is *panchayat samiti* (committee) which forms the main chain of communication between the two. The next level of local government is *zilla parishad*, consisting of all the elected representatives of *gram panchayat* and elected representatives from territorial constituencies in the panchayat, members of legislative assembly and legislative council

The 74th Amendment consists of three bodies of urban governments – *nagar panchayat* which is primarily constituted when the village transitions from rural to urban, municipal council for smaller urban areas, municipal corporations for larger urban areas. Municipal committees are also assisted by ward committees which makes a two-tier system.



member ex officio bodies bringing together all *sarpanchas* of the development block, the members of parliament (MPs) and MLAs (members of legislative assembly) of the area, and sub-divisional officer (SDOs).³⁸² The functions of the *panchayat samitis* are agricultural and land improvement, establishment of primary health centers and primary schools, water and sanitation, village infrastructure (construction of roads etc.), establishment of cooperative societies, water and irrigation management, promotion of animal husbandry, dairy and poultry, social welfare, social activities, technical training, poverty alleviation, promotion and development of cottage and skill industries.

The third level is the *zilla parishad* (district council). *Zilla parishad* or the district council is an elected body consisting of members from state legislatures and the Parliament as explained later. The ex officio chief executive officer of the *zilla parishad* is the additional deputy commissioner who is either from the Indian Administrative Services (IAS) or Provincial Civil Services (PCS) appointed in the state. The *zilla parishad* consists of mainly elected members from demarcated constituencies, the chairpersons of *panchayat samitis*, MPs and MLAs. The member of the *zilla parishad* also acts as chairperson of the *parishads* (councils) that fall in their constituencies from which they are elected for a term of five years. The functions of the *zilla parishad* are planning and administration of development projects for the district, delivery of services and facilities to the village, promotion of agricultural projects such as training new techniques of farming, horticulture, rural housing, electrification, animal husbandry and dairy, promotion of small-scale industries, health and hygiene, education and social welfare. In all the levels of local governments, there are reserved seats for women, scheduled caste, scheduled tribes and other backward classes.

All the institutions of local self-government operate under the principle of democratic decentralization. The rationale of democratic decentralization was to create PRIs in a multi-level framework of governance which are autonomous, democratic and financially strong. It was a step away from a top-down approach to local governance in order to provide self-administration to people in the rural areas. The twenty-nine functions and responsibilities of the PRIs which have been stated above are all enshrined in the Indian Constitution in the Article 243G. The functions are listed in the eleventh Schedule of the Constitution.

At the urban level, there are three types of local bodies, the *nagar nigam* (municipal corporation), *nagar palika* (municipality) and *nagar panchayat* (town *panchayat*). The status of an area decides the provision and implementation of urban local bodies. For an area transitioning from rural to urban, a city council is required. In small urban areas a municipality is required and in large urban areas a municipal corporation.³⁸³ The functions and powers of urban local bodies vary from state to state. Municipal corporations work and directly interact

³⁸² The districts in a state are divided into sub-divisions and the sub-divisional officer (SDOs) oversees these divisions. The SDO is responsible for the administration of these divisions in the districts. There can be two kinds of roles. One in which they are in charge of office work and another, in which they are not bound in an office but are overseeing a range of works such as communicating with people, overlooking implementation of government schemes.

³⁸³ Transitioning areas are defined based on how fast a town is developing due to industrialization or agricultural growth or secondary services. The criteria of population and the level of administrative functions is considered too, as big cities such as Delhi, Mumbai and others will have a municipal corporation and smaller towns will have municipalities.



with the state governments. The head of the corporation is the mayor and the principal executive officer is the municipal commissioner. Municipalities interact with the respective state government through the district collector. The head of the municipality is the president elected by the members of the *palika*. The state government appoints officers such as health or sanitation Inspectors to provide assistance to the president. City councils have a chairman and ward members. The functions assigned to urban local bodies are urban planning and management, provision of health services, education, water management, waste disposal and sanitation, public infrastructure, birth and death registrations, poverty alleviation and delivery of social services.

Legal Status of Local Governments

To realize the goals of democratic decentralization, the government amended the Constitution and passed the 73rd and 74th Amendment Act in 1992. The important aspects of the act were the three-tier system of *panchayati raj* for all states exceeding the population of two millions, the holding every five years of *Panchayat* elections, the reservation of seats for women, scheduled castes and scheduled tribes, the appointment of a state finance commission to make recommendations in cognizance with the financial powers of the panchayat and the establishment of district planning committees (DPCs) to prepare development plans for the district as a whole. It also foresaw the establishment of a state election commission to help state governments conducting periodic elections to the PRIs. Similarly, for urban local governments, the 74th Amendment provides a three-tier structure of governance with the municipal wards as the territorial constituencies forming the basic unit of urban local governance.

The scope of powers and functions enshrined in the Constitution envision PRIs to function as institutions of local self-government and to operationalize the devolution of powers which is central to the principle of democratic decentralization. The scope and powers entrusted to PRIs base themselves in the ideals of economic development and social justice. In accordance with the constitutional amendment, the state governments repealed the then existing acts. The 73rd Amendment Act was further extended to the scheduled areas and areas predominantly occupied with tribal population. It was extended through the provisions of *Panchayat Extension to Scheduled Areas Act, 1996*.

For the urban local bodies, 74th Amendment Act was adopted in 1992 enjoining the government of the day to ensure continuity of the municipalities through a periodic five-year election. Similar to the *Panchayati Raj System*, the urban local bodies have a three-tier system, including the above-mentioned municipal corporations, municipalities and town *panchayats*. The composition of these councils is decided by state governments respectively. There are reservations of seats for women, scheduled castes, scheduled tribes and other backward classes.

(A) Symmetry of the Local Government System



The rural and urban government bodies do not have exactly similar scopes of responsibilities. The former are more entrusted with tasks of being regulators, administrators and providers of various services at the local level. The latter have two sets of parts to play. One, the municipal corporation must deliberate on matters related to budget, taxation, pricing of services and others, and two, the municipal commissioner is the executive head and exercises control on various departments such as finance, health etc. For example, the urban local bodies have to look at the jurisdictional domain of various urban areas, their judicial powers, implementation of policies and plans as per the 74th Constitutional Amendment. Despite their differences regarding modes of functioning and the devolution of the powers and authority, both rural and urban local bodies aim at enabling people's participation as a sign of democratic citizenship.

Political and Social Context in India

India has a multiparty parliamentary system of democracy with representatives at the local, state and national levels contesting elections and participating in democratic decision-making process. Both national and state level political parties are involved in the local level governance through their elected representatives in both rural and urban forms of local government. Local government in India is a state subject, however, the central government holds a supervisory role to guide, encourage, engage and assist the states to promote local government and development. Political participation in *panchayati raj* elections has a long tradition of great leaders like Jawaharlal Nehru, Sardar Vallabhbhai Patel and Subhash Chand Bose who took active leadership in municipal politics. Thus, politics at local government provides a gateway to national level politics and thereby initiates an active involvement of national and regional parties. The presence of national, state and regional parties at the level of local government maintains a strong party presence which has its bearing on national and state level politics. Political parties are the essence of parliamentary democracy and their role in local governments strengthens the roots of democratic decentralization. According to the World Bank report, in India 65.97 per cent live in rural areas³⁸⁴ and 34.03 per cent of the population lives in urban areas.³⁸⁵

Local governments have had a tremendous effect in the realization of democracy at the grassroots and at the level of municipalities in the urban areas. Conducting elections at the lowest tier of government has added to the vibrant political culture of India. The trickling down of democratic decentralization and power has entrenched the roots of democracy, however, its substantive realization has many hurdles to cross.

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14.2 Local Financial Arrangements in India: An Introduction

Asha Sarangi and Lipika Ravichandran, *Centre for Political Studies, Jawaharlal Nehru University*

In India, local financial arrangements at the level of local self-governments are a complicated system as there are institutional differences at urban and rural levels. Local authorities in India are responsible for state owned projects, wherein they use their resources for the operation of these projects. It is an important imperative on the part of the local governments for the development of municipal bodies and districts. In the domain of financial functionality, rural and local governments have a similarity in the pattern of expenditures for civic and social services, however the degree of expenditure varies. The varied expenditure depends on the revenue generation and the needs of the rural and urban population. The urban local bodies have more revenue sources and they collect more taxes as they have a larger population to take into consideration. Whereas the rural local bodies have less revenue due to smaller population. But the services provided by both the bodies are almost similar but different in scale. For example, the urban local body caters till tertiary health care whereas the rural local body provides only primary health care. The estimate for expenditure is included in the five-year plans which show both planned and unplanned expenditures for each state and its local population. For example, during the 2016-17 cycle, in Tamil Nadu, the urban local bodies spent Rs. 13,301 crores (approximately €2 billion), while *Panchayat Raj* Institutions spent Rs. 4,960 crores (approximately €0.7 billion).³⁸⁶

Based on the study by the Indian Council for Research on International Economic Relations (ICRIER) in March 2019, prepared for the Fifteenth Finance Commission, urbanization in India has occurred at a rapid rate. The urban and rural local governments have the weakest financial autonomy which adversely affects their ability to perform core functions and deliver services. Moreover, they lack behind in providing any stimulus to economic growth.

According to the 73rd Constitutional Amendment Act (Rural Local Bodies) and the 74th Constitutional Amendment Act (Urban Local Bodies) the state legislature has the following powers in order to strengthen the finance of the rural and urban local government:

- authorize a *panchayat*/municipality to levy, collect and appropriate taxes, duties, tolls and fees;
- assign to a *panchayat*/municipality taxes, duties, tolls and fees levied and collected by the state government;
- provide for making grants in aid to the *panchayats*/municipality from the consolidated fund of the state.

The act also provides to constitute a finance commission to review the financial position of the local governments.

The resources of the local bodies can be categorized into three categories:

³⁸⁶ Kumarapalayam R Shanmugam, 'Tamil Nadu State Government Finances' (Madras School of Economics 2018) <https://fincomindia.nic.in/writereaddata/html_en_files/fincom15/StudyReports/24.pdf>.



- own resources;
- shared/assigned resources;
- grants and aids.

In rural local bodies, their own resources are generated in the forms of house tax, cattle tax, commercial crop tax, etc., whereas in urban local bodies, their own resources are generated in the forms of property tax, profession tax, etc.

According to the Economic Survey of 2017 - 18, *panchayats* received 95 per cent of its revenue from external sources and only 5 per cent were generated on their own. This is because of tax evasion and at the same time states have not devolved the taxation powers to the local bodies. To conclude, the local bodies are heavily dependent on external sources such as the state and the center for its resources in turn exposing them to high risks.

The ICRIER report states that, 'municipal revenues/expenditures in India have been stagnating at around 1 per cent of the GDP for over a decade.'³⁸⁷ The report further states that finance and expenditure have been a reason of contestation as the constitutional provisions on the devolution of power has been feeble and there are administrative failures in its implementation.

India follows a pattern of decentralization where the central and state governments have the sole discretionary powers to disburse financial arrangements to urban and local governments. Based on rapid urbanization, abysmal poverty conditions, and farmers suicide in present day India, it is important that fiscal autonomy be implemented at the level of local governments. Fiscal autonomy means independence in generation and utilization of fiscal resources. Example-levy and collection of taxes and fees on their own by Urban Local Bodies.

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14.3 Fiscal Autonomy: Restraints and Limits

Asha Sarangi and Lipika Ravichandran, *Centre for Political Studies, Jawaharlal Nehru University*

Relevance of the Practice

It was only with the coming in of the 73rd and the 74th Amendment Act that the fiscal decentralization of local government was strengthened. The urban and the rural bodies have their own revenue raising sources in terms of taxes and non-tax revenues and formulate their expenditures accordingly. In India, the fiscal decentralization itself is a breakthrough. In order to increase their own resource mobilization, the urban local bodies are encouraged to tap the debt instruments like long-term bonds. This has been incentivized by the union government. The union government pays the urban local bodies Rs. 13 crores (approximately €1.3 million) for every Rs. 100 crores (approximately €10 million). In 2018, in the state of Gujarat, the Surat municipal corporation mobilized Rs. 450 crores (approximately €45 million) via bonds to fund a sewage treatment project.

The urban-rural interplay works at various levels in this entire exercise of financial arrangement, particularly when it comes to allocating the funds and their required expenditures. For example, the District Planning Committee is a constitutional body (Article 243ZD) which consolidates the plans prepared by the *panchayats* and the municipalities in the district and prepares a draft development plan for the district as a whole. The legislative member's local area development fund (MPLAD/MLALAD) is effectively utilized for the development of both rural and urban areas within his/her constituency with the aid of the District Planning Committee.

Description of the Practice

The Indian Constitution envisages for the financial autonomy of the local self-governments through Article 243(H) (*Panchayati Raj* Institutions) and 243(X) (Urban Local Bodies), both of which empower them to levy, collect taxes, fees and tolls. But in real terms, this autonomy is not given in practice because it is the state government that decides the amount of taxes, tolls and fees to be levied and collected. However, the local bodies are involved and invited at times by the state and district level bodies to participate and execute these activities.

A number of institutions are involved in carrying out these practices. For example, the state level bureaucracy and its outreach through the district administration is responsible for allocating the funds and their expenditures at various local levels. Most often, the elected bodies and representatives of people are involved in the decision-making exercise of various sorts. Where the government has invited the private sector to be part of public-private partnership (PPP) projects, the private sector works along with the public sector's undertakings and projects.



The urban local governments deliver several public services such as providing safe drinking water, wastewater treatment, solid waste management, public transportation system, investment opportunities, public safety measures, women's safety rules and regulations, and control of infectious diseases and epidemics etc. In these and many other such activities for the public welfare and good, a number of permanent government functionaries, including the lower-level officials, are entrusted with these tasks to achieve the objectives in a certain time frame.

The urban local bodies levy taxes like professional tax, property tax, entertainment tax whereas the rural local bodies levy taxes on agricultural land, local fair, and land use planning etc. Furthermore, the state government makes funds available to local bodies through grants in aid from its consolidated funds.³⁸⁸ These provisions are mentioned in Article 243(H) of the Constitution.

Assessment of the Practice

The devolution of financial powers under the 74th Amendment Act has left the responsibility on the states to devolve expenditures from the list of 18 municipal functions listed in the 12th Schedule of the Indian Constitution. The state also has the ambit to introduce taxes, duties, tolls and fees as stated in Article 243(X). Moreover, it can assign revenues from various taxes to the urban governments. According to Article 243(Y), state finance commissions (SFCs) are responsible for the tasks of revising and endorsing federalization of tax revenues and grants-in-aid to urban local governments. This provision of devolution of financial arrangements has been limited and inadequate.

In the case of rural local governments, the *Panchayati Raj* Institutions (PRIs) similarly have to depend on the state governments for finance and expenditure as well as decentralization of financial powers based on the respective state to raise revenues.

Since the local government is not given much fiscal autonomy, local governing bodies of various sorts have to mobilize sources on their own too.³⁸⁹ This kind of financial constraint results in non-completion of several projects and policies that are otherwise listed in the state governments' vision documents of the five-year plans.

The state government's populist policies at times hamper the developmental goals and objectives seriously. Another factor that intervenes in this is vote bank politics, affecting the welfare-oriented policies of state and its local level governmental bodies. At times the rationale of imposing a particular tax and its collection is arbitrarily decided without involving all the stakeholders.

Local government bodies are often not involved or even made aware of the major resources like land and water and their potential utilization needed in the present context. The neo liberal policies, with the assistance of multinationals and corporate sectors involved, aim at

³⁸⁸ Isher J Ahluwalia and others, 'State of Municipal Finances in India' (Indian Council for Research on International Economic Relations 2019).

³⁸⁹ On these own sources, see the Introduction to Local Financial Arrangements in India, report section 3.1.



excluding a large number of local stakeholders from arriving at decisions and redesigning the policies beneficial to the people at large.

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15. Local Financial Arrangements in Australia

15.1 The System of Local Government in Australia

Carol Mills, *Institute for Public Policy and Governance, University of Technology Sydney*

Types of Local Governments

Australia is a federation with three levels of government: the Commonwealth (federal/national), states and territories; and local government. Local government is established through the separate constitutions of each state and one territory. Therefore, although councils perform similar functions, there are effectively seven different governance systems across the country.

The size of councils in Australia varies dramatically. The largest is Brisbane City Council in Queensland which serves a community of just over one million people, covers an area of 133,809 ha³⁹⁰ and has an operating budget of over AUD 3 billion.³⁹¹ In stark contrast, Sandstone Shire Council, in Western Australia, has a population of 81 residents living in an area covering 3,266,650 ha,³⁹² comparable to the size of Belgium at 3,300,000 ha.³⁹³ Sandstone's expenditure in 2020 was AUD 5.6 million.³⁹⁴

Reflecting the country's British administrative heritage, local governments across Australia are typically referred to as a 'council', 'city' or 'municipality', 'shire' or 'town' depending on factors such as their size, location, or history. 'County councils' also exist as incorporations of, and controlled by, two or more local governments; established to deliver services usually across rural areas.

Currently there 537 local governments in Australia. This has been reduced from its peak of 1,000 due to ongoing structural reform aimed primarily at improving efficiency and effectiveness. Reduction has mostly been obtained through the process of amalgamation.

Despite often being strongly resisted by local communities and councils, amalgamations have been a significant policy in most Australian jurisdictions over the last two decades. Opposition to amalgamations has been based on numerous factors, such as concerns about loss of local identity and scepticism about purported efficiency gains. Both arguments were central to opposition to the most recent round of council large scale mergers that took place in New South Wales in 2016. At that time the state government pushed a highly controversial program that was only partially finished, and ultimately abandoned, after community and council resistance derailed the process in a number of locations.

³⁹⁰ Information retrieved from the Australian Bureau of Statistics (2019).

³⁹¹ Information retrieved from Brisbane City Council (2020).

³⁹² Information retrieved from the Australian Bureau of Statistics (2019).

³⁹³ Information retrieved from World Bank (2015).

³⁹⁴ Information retrieved from Shire of Sandstone (2020).



Local government in Australia has traditionally performed a regulatory role, including planning and building approvals, dog and cat management, and food and health inspections. Whilst they tend to have a narrower remit than in many other comparable countries, they also play an important role in community infrastructure such as the provision of local roads and waste management. In recent decades many councils have also extended their economic and community services to include childcare, youth programs, libraries and sport and recreation facilities, and community health activities.

Legal Status of Local Government

Local government is currently not formally recognised in the Australian Constitution. Whilst there has been attempts to amend this, including two referendums, its legal status remains dependent on state legislation. Many of its powers and responsibilities are subordinate to state and national governments, and there is often significant overlap of policy and programs.

These structural arrangements place limits on local government service delivery responsibilities and earnings. Local governments raise revenue from a range of sources including user charges, fines, developer contributions and income from properties, with utilities, waste and recycling services representing the most significant portion of own-revenue raised. However, the only form of tax they can charge is rates. Larger councils have significant income earning capacity and are able to generate around 80 per cent of their income, including waste and recycling charges. In contrast, much smaller councils are increasingly dependent on state and federal government grants.

Commonwealth grants have played a significant role in funding local government since the mid-1970s. However, the historic interpretation of the Australian Constitution was such that funds can only go *via* the state authorities. In this context, funding from the Commonwealth for local government purposes is 'tied', meaning that the state and territories do not have any discretion in how it is to be used. This arrangement was made more complex by a 2009 High Court of Australia decision (*Pape v Commissioner of Taxation*) regarding the Commonwealth's powers to authorise one-off payments to taxpayers. That decision was seen by many to limit the Commonwealth's ability to directly fund local government and remains contentious.

(A)Symmetry of the Local Government System

Australian local governments (councils) are led by elected officials. Generally, elected members act as formal decision-makers for strategic plans, policies and budgets prepared by the executive leadership staff of a council. The nature of these plans is often set out in state and territory legislation.

One form of elected official is the councillor. In addition to their strategic decision-making duties, councillors are also responsible for appointing and overseeing the performance of the general manager/chief executive officer in accordance with an employment contract. This has become a contentious issue in several locations, with some local governments experiencing a high turnover rate amongst their chief executives. This has created numerous concerns,



ranging from claims of councillors excessively interfering in operations, to perceived tenure uncertainty making it difficult to attract quality staff.

Another form of elected official is the mayor. The mayor is typically a ceremonial figure and in most cases is chosen from within the cohort of councillors to act on a rotational basis. There are, however, some differences across the country. For example, mayors in Queensland (and now increasingly in other jurisdictions) are mostly directly elected and have wide powers to prepare major policies and budgets.

Voting in local government elections is compulsory in all locations, excluding South Australia, Tasmania and Western Australia. Councillors are usually members of a political party and local government elections are party political, with the major political parties being represented and generally holding a majority. This is particularly the case within metropolitan areas. In fact, local government is often seen as a training ground for political aspirants. In rural areas, candidates are more likely to run independently, although they may be a member of a political party on a personal level.

Political and Social Context in Australia

The geography of Australia, and its cultural, social and economic history, present specific challenges to local government. This has led to councils lacking a uniform capacity to deliver services.

Rural and regional Australia is facing wide-ranging challenges including an ageing local population, poor infrastructure, limited education and employment opportunities, the drift of young people to urban centres, and more. In many rural towns, local councils provide a significant role as a major employer and service provider within the community therefore their sustainability is central to community wellbeing. This is less likely to be the case in a metropolitan location. Therefore, the role of local government within the community varies greatly, depending on a number of external factors.

The Australian Local Government Association (ALGA), the peak body for councils, identified 5 priority areas in its 2020-23 Strategic Plan which provide a useful guide to issues of contemporary importance to the sector. These are: financial sustainability; roads and infrastructure funding; waste; community resilience and climate change.

The Commonwealth has supported local government through a series of grants programs, as previously mentioned. Much of that funding is for infrastructure. For example, the current main initiatives focus on roads (AUD 7.3b between 2000 and 2019) and regional and community infrastructure. However, in 2016 the total value of Commonwealth grants equated to just 7 per cent of the amount spent by local government nationally. In its 2019 national election proposals, ALGA called for further funding for these programs in addition to health and wellbeing, digital, and Indigenous community funding.

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15.2 Local Financial Arrangements in Australia: An Introduction

Carol Mills, Institute for Public Policy and Governance, University of Technology Sydney

In Australia, the national government collects the majority of tax revenue (over 70 per cent) through mechanisms such as Income and Goods and Service Taxes (GST), despite being responsible for less than half (about 40 per cent) of all public sector expenditure on service delivery. This is a relatively new proportion of tax collection, as prior to the introduction of GST in July 2000, states also collected a number of taxes and duties. These were largely replaced by the GST and a redistributive process was established to allocate national revenue to the other layers of government and across jurisdictions. There are many critics of this model at the state and local government levels. Nationally, local government collects about 3 per cent of all tax revenues and is responsible for about 6 per cent of total public sector expenditure on service delivery.

The single main source of revenue for local government is property rates. In 2018, they accounted for about 40 per cent of the total AUD 17 billion revenue collected by councils nationally. Other local government revenue sources include fees and charges (such as for water, waste and recycling service, parking, lodging development applications, or use of facilities like swimming pools), and rental income from owned assets.

Local government revenues vary substantially across Australia. This is due to property rates being the main revenue source, and state governments using different methods to value the land on which property rates are based. For example, South Australian local governments collect 60 per cent of their revenue from rates, compared with around 15 per cent for the Northern Territory. Total own-source revenue (such as rates and services charges) can comprise up to 85 per cent of a local government's revenue. This is lower in rural areas where land values tend to be lower and there are more sparsely populated areas. Rural and regional local governments can collect as little as 20 per cent of their expenditure and also face significant diseconomies of scale in terms of the costs of providing services. As a result, many rural councils, are reliant on grants from other levels of government such as through the annual Financial Assistance Grants system.

A range of criteria is used to determine the Financial Assistance Grant amounts and the formula is often the subject of intergovernmental conflict. It is strongly argued that the needs of regional and remote local governments are inadequately reflected in these formulas, and there is limited capacity to lobby for change due to the structure of the local government associations representation arrangements.

The main expenditure items of local governments are housing and community amenities (24 per cent), transport and communication (22.5 per cent) and general public services (17.2 per cent). These figures vary depending on the different responsibilities of local governments in each state and territory and particularly whether they are metropolitan or rural councils.



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15.3 Limiting Rate Increases in New South Wales and Victoria

Carol Mills, *Institute for Public Policy and Governance, University of Technology Sydney*

Relevance of the Practice

Australia provides an interesting case through which to study the impact of restricting a local government's ability to raise property taxes or rates. At a national level only New South Wales (NSW) and Victoria have a rate pegging or capping system in place. In South Australia the rate capping legislation was introduced to state parliament in 2018, however it was voted down. By examining the different practices in the various Australian states, researchers will be able to provide an analysis of the relative merits of rate capping as an approach to ensure taxes remain in line with economic growth.

Description of the Practice

Since 1977, certain council revenues have been regulated in NSW under an arrangement known as 'rate pegging'. Rate pegging limits the amount which councils can increase their general income. General revenue mainly comprises rates revenue, but also includes certain annual charges (excluding stormwater and waste, and water and sewerage). The rate peg refers to the maximum percentage amount that a council may increase its general income for the year. Since 2011-12, this amount has been set by the NSW Independent Pricing and Regulatory Tribunal (IPART) under a delegation by the Minister for Local Government.

In 2016 the Victorian state government also introduced rate capping. The cap placed on rate increases is intended to provide Victorian councils with a clear framework to guide their budget planning and decision-making. The framework is also designed to ensure that essential services continue to be delivered and that councils invest in necessary local infrastructure to meet community needs. Only the general rate and municipal charges section of a rates bill are subject to the rate cap. All other elements, such as waste charges and other user fees and levies, remain uncapped. The rate cap applies to the council's total rate revenue and not individual properties. In many cases, individual rates bill may increase or decrease by more (or less) than the capped rise amount.

In both NSW and Victoria, there are provisions in place should a council wish to increase its rates above the percentage approved by the state governments. In Victoria, councils must demonstrate to the Essential Services Commission that an increase is warranted and that they have engaged and listened to ratepayer and community views. Similarly in NSW councils can apply to IPART for a special rate variation for higher percentage increases.



Assessment of the Practice

The NSW Independent Local Government Review Panel undertook a study in 2013, reviewing revenue and rates over a nine year period, 2001-02 to 2010-11. Growth in total revenue of NSW councils was 5.7 per cent per annum in comparison to an average 8.0 per cent for the other mainland states. Rates revenue increased by 4.4 per cent per annum in New South Wales compared to an average of 8.0 per cent elsewhere. A study by the Productivity Commission on Development Contributions (2020) found that rate capping can act as a disincentive for councils to accommodate growth in response to population growth.

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16. Local Financial Arrangements in Malaysia

16.1 The System of Local Government in Malaysia

Andrew Harding, *Centre for Asian Legal Studies, National University of Singapore*

Types of Local Governments

Under the Federal Constitution of Malaysia 1957, there are three levels of government: federal, state and local. Local government is designated under Schedule 9 as a state matter. Nonetheless, local government is governed by uniform legislation in the form of the Local Government Act 1976 (LGA) and other statutes such as the Street, Drainage and Building Act 1974, and the Town and Country Planning Act 1976 (TCPA). It should be noted that this uniformity only applies to the 11 states of West (otherwise known as ‘Peninsular’) Malaysia, and not to the East Malaysian states of Sabah and Sarawak on the Island of Borneo, which have different legal systems from that of West Malaysia, as well as different legal and administrative history, statute laws generally, and extent of state autonomy compared to the states of West Malaysia.³⁹⁵ Accordingly in this report, to avoid laborious double coverage and potentially confusing, varied responses on each issue, this report is confined to West Malaysia, although federal statistics necessarily apply to Malaysia as a whole, and cannot usually be broken down.

The historical development and the present structure of local government are set out in detail in report section 4. Malaysia has three types of local governments, namely, city councils (18), municipal councils (38), and district councils (94). Apart from these three types of local council, there are six special-purpose local governments designed as ‘development authorities’.³⁹⁶ There is only one level of local government, and local councils are accordingly not placed under higher-level authorities other than the state and federal governments, and there are no intermediate organisations of any kind.

These types of council are somewhat differently structured but perform the same functions. District councils, which cover rural areas, are the most recently created, and it is only since the 1976 reforms that all rural areas in West Malaysia have become areas governed by local authorities.³⁹⁷ District councils will be seen in this report to be under-privileged compared to the two kinds of urban council, being relatively poorly endowed and empowered in practice compared to the other two types of local government. This is in spite of the fact that their functions are exactly the same, albeit applied to smaller populations. Accordingly, it is difficult to differentiate between rural and urban local government in the absence of any clear markers

³⁹⁵ Local government in Sabah is governed by the Local Government Ordinance 1961, and the equivalent legislation in Sarawak is the Local Authority Ordinance 1948, the Kuching Municipal Ordinances 1988, and the City of Kuching North Ordinance 1988.

³⁹⁶ See below, Section 3 on the (A)Symmetry of the Local Government System.

³⁹⁷ For more detail on the 1976 reforms, see the introduction to the Structure of Local Government in Malaysia, report section 4.1.



and a lack of literature encountered in this project that is devoted to district councils as opposed to all councils. To take just one example, the issue of practice regarding public-private partnerships is distinguished³⁹⁸ between states that are part of the federal government's consortia arrangements and states that are not; there is no distinction between urban and rural councils. The urban-rural divide in terms of treatment is a deep and historic one in Malaysian local government, and is of course a very symptomatic of countries like Malaysia that have been in the throes of rapid development and the intense urbanization that goes with it. Despite the fact that, as we shall see, local governments exercise a wide range of powers, a number of factors inhibit the autonomy of local governments. These factors will be examined further in this report, especially in report section 5 on inter-governmental relations (IGR).

First, local government elections are not required by the Constitution, and have been suspended since 1965, so that there is no local *self-government*, and no *right* as such to local self-government.

Secondly, as a consequence of this, local councillors are appointed by the state governments, and appointments are usually, although not always, made on the basis of party allegiance to the party in power at the state level; this does not seem to depend on whether that party is in government or in opposition at the federal level. Accordingly, local government is stitched into the patronage-based, clientelist system that characterizes Malaysian politics, rendering it especially unlikely that local councillors will decide against the desires of the state government.³⁹⁹ This factor is critical.

Thirdly, state governments have powers under the LGA, Section 103, to give directions of a general character to local governments; this power is expanded even further on occasion in practice to directions of a specific character.

Fourthly, policy on local government is coordinated amongst the various states by the National Local Government Council, a federal body set up under Article 95A of the Constitution, which gives much power to the federal government to control the operation of local government despite it being a state matter.

Fifthly, as is that case in most countries, it is universally acknowledged that local government finance faces considerable challenges, except in some wealthier areas such as Penang and Selangor. Local government finance is discussed further in report section 4 on local government structure.

Taken together, these five factors restrict considerably the freedom of operation of local governments. Under report section 5 on IGR the report introduced as an example the 'SPICE' episode, set out in detail in a recent book by a former Penang councillor, Lim Mah Hui. In this episode the state government went beyond its powers, in making decisions regarding a contract to build a new conference centre, that were properly within the jurisdiction of the local government.⁴⁰⁰

³⁹⁸ See report section 3.2. on Urban Cleansing and Privatisation.

³⁹⁹ Lim Mah Hui, *Local Democracy Denied? A Personal Journey into Local Government in Malaysia* (SIRDC 2020).

⁴⁰⁰ *ibid.*



Legal Status of Local Governments

List II of the Federal Constitution's Ninth Schedule recognises local government as function of the state governments, but, acting under a provision in the Constitution (Article 76) for effecting uniformity amongst the states, Parliament passed the LGA in 1976, and this statute governs local government in West Malaysia. Accordingly, the local government system is legally and constitutionally entrenched, even though there are no elections.

Local government authorities are legal persons in the form of bodies corporate and may sue or be sued in their own rights as well as being subject to judicial review under administrative law with respect to their acts and decisions. In a recent example, a district council was held to have exceeded its powers by amending a valuation list and charging rates to a company not included in the original list.⁴⁰¹ Powers not specifically allocated to the federal power under the Constitution lie with the states; however, local government powers have to be specifically granted by statute and they are subject to the overriding principle that local authorities cannot act *ultra vires*, that is, beyond the powers they are given by statute. Local government powers nonetheless include any powers that are *reasonably incidental* to the statutory powers they enjoy. This is specified in the LGA, but is also a well-known principle in common law systems.⁴⁰²

(A) Symmetry of the Local Government System

Local government is the lowest level of Malaysia's multi-layered system of government, employing only 7 per cent of all public employees. Nonetheless, local government functions such as development control, public housing, roads and transport, parks and public places, and public nuisances are extremely important aspects of both urban and rural living and the environment.⁴⁰³ The three types of local authority represent a basically symmetrical system, all local authorities performing the same functions. They are all under state control, except for the Federal Territory of Kuala Lumpur, which is under federal jurisdiction. There are six special-purpose development authorities focused on development in specific areas at the local level, which are under federal, not state, control. These are the Federal Territories of Putrajaya and Labuan, Pengeran and Johor Tenggara Local Authorities in Johor, the Tioman Development Authority in Pahang, and the Kulim Hi-Tech Industrial Park Local Authority in Kedah. The Iskandar Regional Development Authority is also discussed under report section 4 on local government structure, but this authority acts only in a facilitative way and does not exercise statutory powers over specific local government functions in its area.

⁴⁰¹ *Majlis Daerah Hulu Selangor v United Plantations Bhd* [2021] MLJU 1205, Federal Court. For a striking recent example of judicial review, see *Perbadanan Pengurusan Trellises & others v Datuk Bandar Kuala Lumpur & others* [2021] 2 CLJ 808, Court of Appeal. This case is discussed in detail in report section 6 on people's participation in local decision-making. And for the juristic nature of local authorities, see LGA, Sec 13.

⁴⁰² LGA, Sec 101(hh); see Andrew Harding, 'Planning, Environment and Development: A Comparison of Planning Law in Malaysia and England' (2003) 5 *Environmental Law Review* 231.

⁴⁰³ Andrew Harding, *The Constitution of Malaysia: A Contextual Analysis* (2nd edn, Hart/Bloomsbury, forthcoming 2022) Chapter 5.



Political and Social Context in Malaysia

Currently more than two thirds of Malaysians live in urban areas, and these (municipal and city councils) correspond to most of Malaysia's 'local government areas', that is, those areas (now encompassing all of Malaysia's territory) that have local authorities as defined by the LGA, Section 3. Over the last four decades Malaysia's developmental state under the 'Vision 2020' policy has instrumentally recreated the country as an industrialised one, transforming it from a largely agricultural society into an urban and suburban one.⁴⁰⁴

Rural areas are under the authority of district councils, which are still administered with respect to local functions by something resembling the colonial system of district officers.⁴⁰⁵ District officers are appointed by, and are responsible to, either the state government or the federal government, depending on the state in which the authority lies. The district officers are chairs of the district councils, which are advised by various committees of specialists. The districts, that is, rural areas, have never at any point had representative local government. Nonetheless, the district councils perform equivalent functions to those of municipal and city councils. They are also under-funded compared to urban authorities. This is typical facet of uneven development in many countries. As Singaravelloo reports,

'Financial strength is proportional to the size of the local authority. Larger local authorities have a larger population and economic base that provides the revenue needed to finance their activities. Smaller local authorities, however, especially district councils, have smaller populations and economic activities that can only contribute a small amount to their revenue. Examples of local authorities with a critical population size in 2010 were Majlis Daerah Lenggong (13,378), Majlis Daerah Pakan (Sarawak) (15,139), Majlis Daerah Pengkalan Hulu (15,878), Majlis Daerah Kuala Penyu (Sabah) (18,958), Majlis Daerah Jelebu (26,608), Majlis Daerah Labis (32,540), Majlis Daerah Cameron Highlands (34,510). The smaller revenue base is not even sufficient to provide the basic services that local authorities are assigned to deliver.'⁴⁰⁶

The National Physical Plan and the National Urbanisation Plan⁴⁰⁷ emphasize urbanization, which is seen as Malaysia's major priority and problem. This indicates that rural areas are of low political concern. It is suggested that any reintroduction of local government elections and any revisiting of state and local government powers should embrace district as well as urban councils, and address squarely the needs of rural communities.⁴⁰⁸

⁴⁰⁴ Andrew Harding, 'Law and Development in Malaysia: A Vision Beyond 2020?' in Salim Ali Farrar and Paul Subramaniam (eds), *Law and Justice in Malaysia: 2020 and Beyond* (Thomson Reuters 2021).

⁴⁰⁵ Jagdish Sidhu, *Administration in the Federated Malay States* (Oxford University Press 1980).

⁴⁰⁶ Kuppaswamy Singaravelloo, 'Local Government and Intergovernmental Relations' in Noore Alam Siddiquee (ed), *Public Management and Governance in Malaysia: Trends and Transformations* (Routledge 2013) 211.

⁴⁰⁷ *ibid.* 214.

⁴⁰⁸ The most recent proposals in this regard, by the PH government in July 2018, mentioned only reintroducing local elections in some densely-populated urban areas; in any event these were not acted upon. See, further, Danesh Prakash Chacko, *Reintroduction of Local Government Elections in Malaysia* (Bersih & Adil Network Sdn Bhd. 2021).



Local councils consist of between eight and 24 persons who are appointed by the state governments from amongst prominent citizens resident in the locality for terms of three years.⁴⁰⁹ Councillors have therefore tended to reflect the interests of the political party or parties in power at the state level; in West Malaysia at least, political parties operate at the national level and there are no purely local parties, although obviously some parties are perceived as being stronger in some specific areas or originated therefrom (e.g. Parti Gerakan is associated with Penang). With regard to Kuala Lumpur, since it is a federal territory, the *Datuk Bandar* (mayor) is appointed by the federal government for a period of five years, and the *Dewan Bandaraya Kuala Lumpur* (Kuala Lumpur City Council) is placed under the Prime Minister's Department.⁴¹⁰

Reforms to the local government system, especially regarding elections in some urban areas, were promised by the Pakatan Harapan (PH) government, which left office on 1 March 2020. The present Perikatan Nasional (PN) government has not stated any intention in this regard, but meanwhile the country has been under emergency rule (from 12 January to 1 August 2021) due to the Covid-19 pandemic. Under the Emergency (Essential Powers) Act 2021, all elections were suspended; this ordinance has now been revoked.⁴¹¹

Despite the stability enforced by the Malaysian Government's largely successful efforts to improve the economic standing and opportunities of the majority Malay/Muslim population (around 60 per cent of the population of 32 million), there still exists a strong ethnic social division which in recent years has tended increasingly to be expressed via religious affiliation (Muslim and non-Muslim).⁴¹² Under the Constitution, Article 160, a Malay is defined in terms of adhering to Islam as well as using the Malay language and Malay customs. This ethnic factor has had a considerable impact on local government, as successive governments have declined to reintroduce local elections in spite of strong demands, especially in mixed urban areas, for local democracy.⁴¹³ The often-stated reason is that local democracy is likely to inflame inter-ethnic tensions.⁴¹⁴ Nonetheless, the 14th general election in May 2018 was conducted entirely without violent incident anywhere in Malaysia, indicating a level of political maturity that belies the fear of ethnic violence, most evident in the tragic events of 13 May 1969 (see below), reemerging.

Since significant changes in the law and socio-economic policy in 1971, spurred by the 13 May incident, the majority community (styled *bumiputera*) community, comprising Malays and natives of Sabah and Sarawak, have benefited from special quotas in certain areas such as education and employment opportunities.⁴¹⁵ This system has impacted local government in various ways discussed later in this report.

⁴⁰⁹ LGA, Secs 3 and 13.

⁴¹⁰ Federal Capital Act 1960, Secs 4 and 7.

⁴¹¹ Emergency (Essential Powers) Ordinance 2021, Secs 12-13.

⁴¹² Dian AH Shah, *Constitutions, Politics and Religion in Asia: Indonesia, Malaysia and Sri Lanka* (Cambridge University Press 2017) 10.

⁴¹³ Mah Hui, *Local Democracy Denied?*, above.

⁴¹⁴ This issue is discussed in detail in report section 6 on people's participation in local decision-making in Malaysia.

⁴¹⁵ There is vast literature on this issue but see, e.g., Lee Hwok-Aun, *Affirmative Action in Malaysia and South Africa: Preference for Parity* (Routledge 2021); Andrew Harding, *The Constitution of Malaysia: A Contextual Analysis* (2nd edn, Hart/ Bloomsbury, forthcoming 2022) Chapter 3.



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16.2 Local Financial Arrangements in Malaysia: An Introduction

Andrew Harding, *Centre for Asian Legal Studies, National University of Singapore*

Sources of Revenue

In general terms, Malaysian local authorities derive their revenue from three main sources:

- local taxation in the form of property assessments or the equivalent (about 51 per cent);
- rents and fees for services, and licences (about 32 per cent); and
- fiscal transfers from state and federal governments, for example for road maintenance or specific development projects (about 17 per cent).

These sources will be examined in more detail in what follows.

The general provision for the revenue of Malaysia's local government is the Local Government Act 1976 (LGA), Section 39. The Ministry of Housing and Local Government (MHLG) has classified local government's sources of revenue (i.e., those falling under the first two points above) into six categories as follows:

- assessment rates;
- fees for licences and permits;
- rentals;
- government grants;
- car parking charges, planning fees, compounds, fines and interest;
- loans (from higher levels of government/financial institutions).⁴¹⁶

Taxes can only be levied under federal law and so the federal government collects most types of tax receipts, such as income tax, export tax and road tax. Thus, the proportion of total government revenue collected by local governments is relatively small, at 3.4 per cent in 2013.⁴¹⁷ Still, tax revenues still represent the greatest share of income for local authorities. Assessment tax, which is a property tax collected on the basis of the annual assessment of rental value or the value-added (selling price) of the property, is an important source of revenue for local authorities. The LGA sets a ceiling on the tax of 35 per cent of annual value or 5 per cent of value-added of a holding. Taxation rates can be varied according to the use and location of the property. Thus, the amount of revenue that can be collected from the assessment tax depends on the property's level of physical development. Assessment tax revenue, therefore, varies with the taxation rate, annual value (or value-added), and number and type of holdings.⁴¹⁸

⁴¹⁶ Ahmad Yunus, 'United Cities and Local Governments Country Profile: Malaysia' (UCLG 2016) 8-9. And see Nurul Faezah Mohd Talib and others, 'Transparency in Malaysia Local Government Administration. The Overview of Internally Generated Revenue (IGR)' (2017) 1 *International Journal of Business and Management* 22.

⁴¹⁷ Yunus, 'United Cities and Local Governments Country Profile: Malaysia', above, 8-9.

⁴¹⁸ Yunus, 'United Cities and Local Governments Country Profile: Malaysia', above.



However, due to the over-reliance of most councils on these assessment taxes, weaker local authorities, and especially rural ones, are often still strapped for financial resources in carrying out their operations.⁴¹⁹ As a result, these authorities rely heavily on grants from the federal government or the state.⁴²⁰ In this regard, a good relationship between the local government and the federal and state government is necessary to obtain funding on a consistent basis. It is at this point that the political patronage system becomes very important for local government, and there are instances of deliberate political partisanship in funding allocations.

Financial grants from federal and state governments include, but are not limited to:

- annual equalisation grants;
- launching grants;
- development project grants;
- road maintenance grants;
- balancing grants.⁴²¹

Annual equalisation grants, available to all Peninsular Malaysian states, serve to compensate the difference between a local authority's fiscal capacities and fiscal needs. These grants are channelled by the federation to local authorities through the state, in accordance with the State Grant (Maintenance of Local Authorities) Act 1981. The formula used is set by the MHLG. This goes some way towards compensating rural councils whose property assessments will tend to be rather lower than urban ones.⁴²²

Launching grants are provided by the state to local authorities for restructuring purposes: to purchase new equipment for service extensions or to undertake infrastructure development projects. Like the others, these grants have to be approved by the MHLG. The size of the grants to a particular local authority depends on factors such as land area, population and expected revenue.

Development project grants are funds made available to all local authorities for the implementation of socio-economic projects, encompassing infrastructure projects, social facilities, cleanliness, beautification, purchase of equipment and machinery, recreational parks and sanitary projects.

Balancing grants are offered by the state to cover rising operational expenditure costs, such as from the increase of pay levels negotiated by the federal government for the public sector. Smaller local councils can also choose to utilise these grants to aid in minor development projects.

Licence fees are a major source of income for local authorities, and are levied by local authorities to regulate trading activities within their jurisdictional areas. The LGA gives wide powers to local authorities to register, license and regulate trade, commerce and industry. The charges imposed by local governments vary according to the category of licence.⁴²³

⁴¹⁹ *ibid.*

⁴²⁰ *ibid.*; and Talib and others, 'Transparency in Malaysia Local Government Administration', above.

⁴²¹ *ibid.*

⁴²² Talib and others, 'Transparency in Malaysia Local Government Administration', above.

⁴²³ *ibid.*



Fees and service charges are levied when local authorities carry out various activities and provide facilities for the local community. They can also impose charges for services rendered. In general, these sources produce no less than 10 per cent of the total revenue of local authorities. Examples include fees and charges for planning processing under the TCPA, car parking, and use of tools and recreational facilities such as swimming pools.⁴²⁴

Federal funding for local government also targets needy areas, which are invariably rural. For example, in April 2021 the MHLG allocated RM 6.3 million for tourism and economic development in Kuala Langat, a rural area in Southwest Selangor.⁴²⁵

Based on figures from fiscal year 2016/17, subnational governments raised in total approximately USD 676 purchasing power parity (PPP) per capita, of which state and local governments, respectively, accounted for 65 per cent and 35 per cent. The total revenues correspond to about 2.5 per cent of the country's GDP, which is relatively low compared to both federal and unitary countries in Southeast Asia (only Cambodia reports lower figures).

In fiscal year 2016, local government revenues amounted to RM 10.42 billion (about Euro 2.1 billion, or USD 235 PPP per capita), of which 10.5 per cent corresponded to transfers made to local governments and the remaining 89.5 per cent was locally-raised revenue, as discussed above. Details of local revenues are available only at an aggregate level, which does not allow discernment between taxes/tariffs and fees as sources of revenue. In practice states as well as local governments have financial difficulties, and do not have the capacity at any significant level to financially support local governments, which mainly rely on federal funding to supply shortfall and mount special projects.

All subnational governments are allowed to borrow for a period not exceeding five years. In fiscal year 2016, subnational debt corresponded to 0.4 per cent of the country's GDP and 0.6 per cent of the general government outstanding debt. Local government debt remains low, corresponding to 0.2 per cent of total subnational debt in fiscal year 2016. According to Article 111 of the Constitution, state governments, except those of Sabah and Sarawak, are only allowed to borrow from the federal government, with its prior approval. According to the Local Government Act 2006, local governments may, with the approval and under conditions agreed by the state government, contract loans. Within the powers of local governments, such loans may be used for the acquisition of land, the construction of public buildings, for carrying out permanent works, for providing or maintaining plant equipment and vehicles and to pay off existing loans.

Statistics reported by Lim Mah Hui for Penang Council (MPIP) during 2007-17⁴²⁶ indicate that over this period the proportion of tax revenue decreased from 62 per cent to 54 per cent, while non-tax revenue increased from 28 per cent to 41 per cent, and non-tax receipts (federal and state government transfers) decreased from 10 per cent to 5 per cent. Average annual revenue growth over the period was 5.9 per cent and the total revenue for 2017 was RM 359 million

⁴²⁴ *ibid.* See also the case study on SPICE in report section 5 on intergovernmental relations of local governments.

⁴²⁵ 'Housing and local government ministry approves RM6.3m fund to Kuala Langat' (*Malay Mail*, 15 April 2021) <<https://www.malaymail.com/news/malaysia/2021/04/15/housing-and-local-government-ministry-approves-rm6.3m-fund-to-kuala-langat/1966752>>.

⁴²⁶ Lim Mah Hui, *Local Democracy Denied? A Personal Journey into Local Government in Malaysia* (SIRDC 2020) 70-1.



(Euro 72 million). Penang is one of the wealthiest local authorities. There are no equivalent figures available for district councils.

The result of a lack of adequate resourcing has been an understandable emphasis on maintaining services rather than on development and response to changing needs. This affects rural areas more than urban areas. Little has been done, despite much rhetoric, to improve provision of services at similar or lower cost by privatising local government services.⁴²⁷ There is consequently a deficit in effective enforcement of relevant laws, authorities seemingly unable in many ways to fully utilise their powers. This is especially the case with collection of local rates.

One particular problem that seems capable of being easily addressed is that, since local government employees do not form part of the public service as such but are simply employees of the local authority in question, they cannot simply be transferred to other local authorities. Thus, meritorious employees can get stuck at middle levels of promotion for years, there being few opportunities for promotion, and may leave the service for better prospects elsewhere; mediocre employees on the other hand tend to remain where they are.

Problems of enforcement of local government laws are widespread and are attributable to lack of enforcement officers, itself a function of local government finance.

The National Finance Council

In a federal system, mention needs to be made of the National Finance Council (NFC), which impacts on local government in that in large measure it affects state finance and therefore in part determines available funding to be transferred to local authorities. Large development projects are also usually funded by cooperation between the state and local, as well as federal, government.

The role of the NFC is to look into the various aspects of financial management of the states and to coordinate federal-state finance. The Federal Constitution (Article 108(4)) stipulates that it shall be the duty of the federal government to consult the NFC in respect of, inter alia: the making of federal grants to the states; the assignment of the whole or any portion of the proceeds of the federal government to the states; the annual loan requirements of the federation and the states and the exercise by the federation and the states of their borrowing powers; and the making of loans to any of the states.⁴²⁸ This consultation is non-binding.⁴²⁹ The NFC comprises the Prime Minister (PM) as chairman, one other federal minister designated by the PM; and one representative from each of the states, appointed by the Ruler/Governor. The NFC meets at least once a year, or when called by the PM, or requested by at least three states.⁴³⁰

⁴²⁷ Ahmad Atory Hussain and Malike Brahim, 'Administrative Modernisation in the Malaysian Local Government: A Study in Promoting Efficiency, Effectiveness and Productivity' (2006) 14 *Pertanika Journal of Social Sciences and Humanities* 51.

⁴²⁸ Abdul Rahim Anuar, 'Fiscal Decentralization in Malaysia' (2000) 41 *Hitotsubashi Journal of Economics* 85.

⁴²⁹ Gary Marks, 'Country Profile – Malaysia' (*University of North Carolina at Chapel Hill*, 16 May 2021)

<<https://garymarks.web.unc.edu/data/regional-authority-2/>>.

⁴³⁰ Anuar, 'Fiscal Decentralization in Malaysia', above, 92.



As a result of the limited revenue base of state governments, many states are dependent on federal transfers and loans to finance their expenditure.⁴³¹ Thus the NFC plays a crucial role in facilitating negotiations between the federal and state government concerning federal financial and funding issues i.e. federal sponsored development projects, transfer of financial resources (grants and loans) to the states.⁴³²

The NFC will also be consulted in other issues to ensure that both the federal and state governments have influence in these areas. One example is in the establishment of a national development plan⁴³³ provided for under Article 92 of the Federal Constitution, where the NFC will have to be consulted before Parliament can give effect to the development plan.

In the most recent NFC meeting,⁴³⁴ the federal government agreed to implement four enhancements to allocations channelled in various forms of grants and support to the state governments for 2021. During the meeting, the Ministry of Finance said that the federal government was aware that the state governments were experiencing a very drastic reduction in revenue post-Covid-19. This impacts, in turn, local government finance. Hence, one enhancement provided an allocation of RM 260 million (Euro 57.1 million) to the state governments to help them implement small-scale projects at the grassroots, that is, at local government, level.

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⁴³¹ *ibid.* 94.

⁴³² *ibid.* 85.

⁴³³ Plan for the development, improvement or conservation of the natural resources of a development area, the exploitation of such resources, or the increase of means of employment in the area.

⁴³⁴ 'Federal Govt Implements Four Enhancements to Grants, Support for States' (*Official Portal of Ministry of Finance*, 6 May 2021) <<https://www.mof.gov.my/en/news/press-citations/federal-govt-implements-four-enhancements-to-grants-support-for-states>>.



16.3 Urban Cleansing and Privatisation

Andrew Harding, *Centre for Asian Legal Studies, National University of Singapore*

Relevance of the Practice

This case study is based on Singaravelloo's discussion of Malaysian privatisation.⁴³⁵ Privatisation is part of what is known as 'new public management', which in this instance is used in Malaysia to attempt to solve problems of underfunding in local government. Although this function is referred to as 'urban cleansing', it concerns solid waste collection, which is a function of all local councils, not just urban ones, as well as dealing with water pollution, and sewage disposal, and public nuisances.

In the context of Malaysian local government, cleansing services are critical. They are the main reason for the development of local government. Furthermore, in a tropical climate cleansing is especially important. For example, in Malaysia garbage is collected at least twice and sometimes three times a week, whereas as once a week is normal in colder climates. Citizens attach great importance to cleansing services. Complaints are frequent with regard to local government neglect and incompetence in this area of activity. These complaints have often reached Parliament and Cabinet and have been the cause of concerted government action at the national level.

Given what has been said above concerning local government finance, from the 1980s privatization has been a major initiative designed to deal with government, especially local government, problems. The Malaysian Government took its cue from other governments such as the United Kingdom's, which invested heavily in privatization initiatives during the 1980s.⁴³⁶ At the national level, government-linked companies have been important in terms of economic and infrastructural development. At the local level, urban cleansing has featured prominently.

Public-private partnerships, states Singaravelloo

'have evolved over time in Malaysia, from the context of traditional privatization involving both parties, to the outsourcing of public services to the private partners, through the awarding of contracts, to one that expects strong financial capacity from the private sector (during the Ninth Malaysia Plan), and on to one that shares the risks and burdens and better returns (in the Tenth Malaysia Plan).'⁴³⁷

⁴³⁵ Kuppaswamy Singaravelloo, 'Fostering Public-Private Partnership in a Win-Win Situation: The Experience of a Malaysian Local Government' in Luiz Montanheiro and Mirjam Bult-Spiering (eds), *Public and Private Sector Partnerships: The Enterprise Governance* (Sheffield Hallam University Press 2013).

⁴³⁶ Abu Bakar Munir, 'Privatisation in Malaysia: A Case Study of the Telecommunications Department' in William Neilson and Euston Quah (eds), *Law and Economic Development: Cases and Materials from South East Asia* (Longman 1993) 169.

⁴³⁷ *ibid.* 155.



Description of the Practice

Some local authorities decided to privatise urban cleansing services by transferring them to private companies under contract with the local authority. The smaller, especially rural local authorities, facing financial difficulties used their own staff to provide the urban cleansing. During the first Mahathir administration (1981-2003), the federal government intervened, removing this service from local governments in the Peninsular Malaysia, and repackaging them to three major interim consortia, that is, Alam Flora Sdn. Bhd. to cover Kuala Lumpur and the states of Selangor, Pahang, Terengganu and Kelantan; to Northern Waste Management Services Sdn. Bhd. (now Environment Idaman Sdn. Bhd.) to cover Perak, Penang, Kedah and Perlis in the north of the peninsula; and to Southern Waste Management Sdn. Bhd. to cover Johor, Melaka and Negri Sembilan.⁴³⁸

The consortia for solid waste disposal claimed that they would perform more efficiently once the solid waste management service was fully and finally privatised. However, the system was found to be problematical, because payment by local authorities to the consortia was affected by their poor financial standing. Local authorities therefore sought financial help from the federal government. Singaravelloo records that a total of RM 151.84 million (Euro 30.3 million) was given as financial aid to 28 local authorities during 1998-2010. By December 2010, local authorities in Peninsular Malaysia owed RM 357 million to the consortia.⁴³⁹ The interim solid waste management collection agreement did not support the consortia in their search for commercial financing for investments, which are mostly needed to purchase new machineries and equipment. What was initially initiated as an interim measure for five years had by 2010 extended to sixteen years in Johor and about nine years in the neighbouring State of Negeri Sembilan.

With effect from 1 September 2011 the federal government decided to enforce the Solid Waste and Urban Cleansing Management Act 2007, thus taking ultimate control over the delivery of urban cleansing services in eight states and the federal territories which meant enforced privatisation in most of Peninsular Malaysia. Opposition-controlled states declined to participate, so that in those states urban cleansing services reverted to the local authorities as per the previous system for them to appoint their own contractors, while some local authorities in Selangor started to run the services themselves to cut costs.

A similar process was used for sewerage services, where problems of efficiency had been encountered, which were privatized to Indah Water Consortium Bhd., a federal-government-owned entity, 'due to the fact that the majority of the local authorities were unable to operate sewerage services effectively, let alone manage and maintain sewerage infrastructure effectively'.⁴⁴⁰ As a result, the federal government privatised sewerage services in the whole of Peninsular Malaysia as a federal service, enacted a law to empower the company to perform its duties and to recoup its expenses from consumers by means of a separate bill using a tariff

⁴³⁸ *ibid.*

⁴³⁹ *ibid.*

⁴⁴⁰ *ibid.*



structure. However, bill collection proved unable to meet Indah's expenses, and it was repeatedly bailed out by the federal government.

Assessment of the Practice

Privatisation in the sphere of local government services has not succeeded in solving the problems with these services, while spawning other problems. The story of urban cleansing does not show that there is a genuine alternative to providing a secure financial basis for local services. As a microcosm of decentralisation, local initiative and commitment seem more likely to improve services than mega-fixes at the federal or even state level. Clean and consistent water supply and waste collection continue to be problems in many parts of the country.

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17. Local Financial Arrangements in Canada

17.1 The System of Local Government in Canada: An Introduction

Martin Horak and Brittany VanDenBrink, *Department of Political Science, Western University*⁴⁴¹

Types of Local Governments

Canadian federalism divides governing responsibilities among three levels of government: federal, provincial, and local. However, the Canadian Constitution gives the provinces sole jurisdiction over municipalities, which results in significant inter-provincial variation among local government systems. While the federal government in recent years began to provide money through joint federal-provincial programs for services that are ultimately delivered by municipalities (primarily hard infrastructure), there is typically no direct federal policy or regulatory involvement with the municipal level of government.⁴⁴² One side effect of this lack of federal involvement is that it is difficult to determine how many local governments there actually are in Canada. A comprehensive survey of available data from numerous sources, conducted in June 2021 by researchers at Western University,⁴⁴³ indicates that there were 3,533 local governments in Canada as of 2020. This is a significant decrease from the total of 4,432 in 1995, which reflects the results of a large-scale wave of provincial imposed consolidations in several provinces around the turn of the millennium. Despite this consolidation, most municipalities in Canada are small and rural. A report based on the 2016 census finds that only 723 had a population of 5,000 or greater. By contrast, 24 municipalities had over 200,000 residents, while three municipalities (Toronto, Montreal and Calgary) had over 1 million inhabitants. Toronto is Canada's largest municipality, with a population of 2.9

⁴⁴¹ Acknowledgements: Data regarding number of municipalities in Canada, as well as the analysis of rural-urban demographic and economic differences in Ontario, were compiled and produced by Amanda Gutzke at Western University. Our sincere thanks for her excellent work.

⁴⁴² Erin Tolley and William R Young, 'Municipalities, the Constitution, and the Canadian Federal System' (Government of Canada 2001) <<http://publications.gc.ca/Collection-R/LoPBdP/BP/bp276-e.htm#Municipalities>> accessed 25 July 2019.

⁴⁴³ These data were collected and analyzed as part of another research project, led by Zack Taylor and Martin Horak.



million as of July 2018.⁴⁴⁴ Just as the country’s 10 provinces and three territories⁴⁴⁵ vary in population size, so too do their municipal populations. Ontario tends to have larger municipalities as a result of its history of amalgamations imposed by the province, many of which took place in the 1990s.⁴⁴⁶ Ontario currently has 444 municipalities.

In some cases, urban municipalities have distinct status under provincial law. For example, Vancouver, Winnipeg, Montreal, and Saint John are Charter Cities, which means that they are governed by their own piece of legislation – or ‘Charter’ – rather than being subject to the broad, province-wide legislation that governs the activity of other municipalities.⁴⁴⁷ The City of Toronto is likewise governed by stand-alone provincial legislation. However, in general the degree to which these charters grant powers and resources over and above those of other municipalities is limited.

Table 1: Types of municipalities in Canada’s four most populous provinces.⁴⁴⁸

Province	Types of Municipality
Ontario	Village
	Township
	Town
	Municipality
	City
	County
	Regional Municipality
Quebec	Village
	Township
	United Township
	Town

⁴⁴⁴ ‘Municipalities in Canada with the Largest and Fastest Growing Populations between 2011 and 2016’ (*Statistics Canada*, 8 February 2017) <<https://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016001/98-200-x2016001-eng.cfm>> accessed 1 August 2019; ‘Municipalities in Canada with Population Decreases between 2011 and 2016’ (*Statistics Canada*, 8 February 2017) <<https://www12.statcan.gc.ca/census-recensement/2016/as-sa/98-200-x/2016002/98-200-x2016002-eng.cfm>> accessed 1 August 2019; ‘Toronto at a Glance’ (*City of Toronto*, undated) <<https://www.toronto.ca/city-government/data-research-maps/toronto-at-a-glance/>> accessed 1 August 2019.

⁴⁴⁵ Canada’s three territories (Nunavut, the Northwest Territories, and Yukon) are located in the far north. Despite their large geographical size, they have very small populations, totaling only about 110,000 in all three territories, which is less than the population of the smallest province (Prince Edward Island, 150,000 inhabitants).

⁴⁴⁶ Andrew Sancton, *Canadian Local Government: An Urban Perspective* (2nd edn, OUP 2015) 150, 152.

⁴⁴⁷ ‘Power of Canadian Cities- The Legal Framework’ (*City of Toronto*) <https://www.toronto.ca/ext/digital_comm/inquiry/inquiry_site/cd/gg/add_pdf/77/Governance/Electronic_Documents/Other_CDN_Jurisdictions/Powers_of_Canadian_Cities.pdf> accessed 25 July 2019; John Stefaniuk, ‘Municipal Powers and their Limits’ (TDS Law) <<https://www.tdslaw.com/site-content/uploads/municipal-powers-and-their-limits-2.pdf>> accessed 25 July 2019.

⁴⁴⁸ Sancton, *Canadian Local Government*, above, 7-8; ‘Types of Municipalities in Alberta’ (*Government of Alberta*, undated) <<https://www.alberta.ca/types-of-municipalities-in-alberta.aspx>> accessed 25 July 2019.



	Municipality City Parish Regional Government Metropolitan Community Regional County Municipality
British Columbia	Village Town District Municipality City
Alberta	Summer Village Village Town City Specialized Municipality Municipal District Improvement District Metis Settlement Special Areas

Generally, Canadian municipalities are responsible for providing physical services including water supply, waste management, local infrastructure management, sewage treatment, planning and development services, libraries, parks and recreation, local police, and parking.⁴⁴⁹ These local government tasks are administered through general purpose municipalities (variously called cities, towns, villages, etc., depending on size), sometimes in conjunction with special purpose bodies. The table above compares the largest four provinces by population to illustrate variation in the legal types of municipalities. In addition to these, there are numerous local government bodies that do not have municipal status – such as British Columbia’s regional districts, which are multi-purpose service federations of municipal governments.

In some provinces, including Ontario, Quebec and Alberta, there is a single tier of local government in some areas, and two tiers of local government in other areas. Upper-tier governments in Ontario, for example, are either called counties or regional municipalities, with the latter typically found in large urban areas. Upper-tier municipalities are comprised of the lower-tier governments within their boundaries. They provide region-wide services like arterial

⁴⁴⁹ ‘The Three Levels of Government’ (*Parliament of Canada*, undated)
 <https://lop.parl.ca/about/parliament/education/ourcountryourparliament/html_booklet/three-levels-government-e.html> accessed 25 July 2019.



roads; transit; policing; sewer and water systems; waste disposal; region-wide land use planning and development; and health and social services.⁴⁵⁰

Legal Status of Local Governments

Canada's Constitution specifies the terms of Canadian federalism. It assigns responsibility for local governments to the provinces. This means that the provincial governments have full jurisdiction over the local governments in their territory. Section 92 of the Constitution Act of 1867 specifies the powers of the provinces and Section 92(8) gives each provincial legislature the power to make laws for the municipal institutions under its jurisdiction. Municipalities are often referred to as 'creatures of the province' because they rely on the provinces for their legal existence.⁴⁵¹

There is significant variation among the provinces in terms of the structure of municipal legislation. Historically, provincial legislation has tended to lay out every power granted to its municipalities; if a specific power is not listed, municipalities do not possess that power. However, in recent years this has shifted, and most provinces now have legislation, such as that implemented in Alberta in 1995 and Ontario in 2001, which grants municipalities the same powers as a 'natural person' unless specifically excluded by the legislation. This gives municipalities the same rights as businesses to enter into contracts, own property, and make investments. Moreover, British Columbia's provincial government sets only broad legislation within which municipalities have the authority and flexibility to respond to each community's unique and changing needs. The Government of British Columbia views municipalities as autonomous and accountable to their democratically elected municipal councils.⁴⁵²

Both urban and rural municipalities in all Canadian provinces have some legal authority to act in the following functions: fire protection; animal control; roads; traffic control; solid waste collection and disposal (except in Prince Edward Island); land use planning and regulation; building regulation; economic development; tourism promotion; public libraries parks and recreation; cultural facilities; licensing of businesses; emergency planning and preparedness; rural fences and drainage; regulation and/or provision of cemeteries; airports (excluding major airports formerly operated by the federal government); and weed control and regulation of cosmetic pesticides.

Additionally, the following functions are typically delivered by urban municipalities: public transit; regulation of taxis; water purification and distribution; sewage collection and treatment; downtown revitalization; and regulation of noise. Generally, urban municipalities

⁴⁵⁰ 'Ontario Municipalities' (AMO, undated) <<https://www.amo.on.ca/AMO-Content/Municipal-101/Ontario-Municipalities.aspx>> accessed 25 July 2019.

⁴⁵¹ Tolley and Young, 'Municipalities and the Constitution', above; Sancton, *Canadian Local Government*, above, 27.

⁴⁵² For a comprehensive overview of Canadian municipal legislation, see Zack Taylor and Alec Dobson, 'Power and Purpose: Canadian Municipal Law in Transition' (2020) 47 IMFG Papers on Municipal Finance and Governance; 'Municipalities in British Columbia' (*British Columbia*, 2019) <<https://www2.gov.bc.ca/gov/content/governments/local-governments/facts-framework/systems/municipalities>> accessed 25 July 2019.



are also responsible for policing, although in some provinces special purpose bodies take care of this function. The exception is Newfoundland and Labrador, where policing is taken care of by the Royal Newfoundland Constabulary. Moreover, the Royal Canadian Mounted Police (RCMP) (or a provincial police force, as in the case in Quebec and Ontario) enters into contracts with some urban municipalities to provide policing, and it is typical for the RCMP or provincial police to provide policing in rural areas.

Ontario is unique in that the province mandates that its municipalities deliver certain social services. This includes income and employment assistance through the Ontario Works program and subsidized childcare with provincial oversight and financial assistance. Additionally, Ontario municipalities are required to provide subsidized social housing, with limited financial assistance from the province. Municipalities in other parts of the country do not have the same statutory responsibility to provide these social services.⁴⁵³

(A) Symmetry of the Local Government System

The fact that the provinces have under the Canadian Constitution sole jurisdiction over municipalities gives rise to considerable inter-provincial variation. Although municipal powers and responsibilities thus vary by province, common core functions include planning, regulating, protecting, and providing infrastructure services for the built environment.⁴⁵⁴

In some cases, there is also asymmetry within provinces in terms of how local government is structured, as different laws may exist for urban and rural municipalities. As noted above, several of Canada's largest urban municipalities are governed by charters that outline specific institutional arrangements for that municipality, and/or grant it additional powers and revenue sources. Toronto, for example, was granted charter status in 2007, giving it additional revenue raising tools beyond the property taxes and provincial transfers that most municipalities rely on. However, it should be noted that Charter Cities do not have additional constitutional protections. A municipal charter can be changed by the province at any time. Indeed, there is much disagreement surrounding the utility of granting cities such additional powers, as such powers have typically been limited and are often not fully used.⁴⁵⁵

General municipal statutes and special charters are not the only laws that apply to municipalities. Indeed, since provincial governments set parameters for municipal action in a multitude of policy fields, ranging from planning and environmental services to policing and housing, the cope of municipal action is shaped by dozens, if not hundreds of different statutes in each province.⁴⁵⁶ In addition, in some provinces, provincial governments may enact laws that apply only to particular municipalities or groups of municipalities – that is, single

⁴⁵³ Sancton, *Canadian Local Government*, above, 22-23.

⁴⁵⁴ Taylor and Dobson, 'Power and Purpose: Canadian Municipal Law in Transition', above.

⁴⁵⁵ Harry Kitchen, 'Is Charter City Status a Solution for Financing City Services in Canada – Or is that a Myth?' (University of Calgary School of Public Policy SPP Research Paper 9-2, 2016) <https://www.policyschool.ca/wp-content/uploads/2016/03/charter-city-status-kitchen_0.pdf> accessed 26 July 2019.

⁴⁵⁶ *ibid* 8.



municipalities can apply to their provincial government to request private statutes as a remedy for a particular local problem for there is no other legal recourse.⁴⁵⁷

Political and Social Context in Canada

All Canadian municipalities are governed by a democratically elected council.⁴⁵⁸ Ward systems are commonly used, especially in large municipalities; Vancouver is Canada's only large city where councillors are elected at-large. With the exception of the City of Vancouver and larger municipalities in the Province of Quebec, local government is non-partisan. The provinces of British Columbia and Quebec are the only two provinces that have legislation that allows for the existence of political parties at the local level.⁴⁵⁹ The fact that local government tends to be non-partisan, and that provincial party systems also tend to be quite distinct from the federal party system, means that the broader political context within which municipalities operate is marked by only weak political links among levels of government. This lack of vertical political integration, together with the weak legal status of local governments, made them the target of politically expedient decentralization in the fiscally lean 1990s. At that time, structural fiscal pressure on the welfare state produced a cascading decentralization of policy and fiscal responsibility through the Canadian federation, and municipalities had to cope with the imposition of unfunded or partly funded policy mandates from the provincial level. The result was intergovernmentally induced fiscal stress at the local level, which has only in recent years begun to be mitigated by increasing fiscal transfers.

Many scholars suggest that local governments, with their weak legal status, are primarily 'policy takers', rather than 'policy-makers', in the Canadian context.⁴⁶⁰ There are certainly cases where Canadian municipalities do make policy independently of the provinces. To a significant extent, their ability to do so depends on their population size and their local property tax base. Since rural municipalities have both a small population and a weak property tax base, their autonomous policy-making capacity tends to be very limited. For both reasons, there is thus a policy capacity divide among Canadian municipalities that closely mirrors the rural/urban divide.

Like many post-industrial countries, Canada is highly urbanized. Almost 72 per cent of the population lives in urban areas with over 100,000 people, and more than a third of all Canadians live in the three largest urban areas (Toronto, Montreal and Vancouver).⁴⁶¹ The Canadian population is thus concentrated primarily in a handful of large urban areas, whose

⁴⁵⁷ Sancton, *Canadian Local Government*, above, 31.

⁴⁵⁸ However, upper-tier governments in two-tier systems (e.g., Greater Vancouver and Ontario's regional municipalities) sometimes have indirectly elected councils composed of representatives of lower-tier municipalities.

⁴⁵⁹ Sancton, *Canadian Local Government*, above, 173, 180, 186, 188.

⁴⁶⁰ *ibid* 251.

⁴⁶¹ Calculated from Statistics Canada Census 2016 data reports.



population is growing quickly. By contrast, the population of rural Canada is (in most regions) growing much more slowly,⁴⁶² and rural areas are on average older, whiter and poorer.

Table 2: Selected Demographic and Economic Indicators in Ontario, by Type of Census Division.⁴⁶³

	Metropolitan	Mixed	Non-Metropolitan
Population change (2011-2016)	+ 5.57%	+ 4.54%	+ 0.92%
Visible minority population (2016)	43.5%	13.5%	2.6%
Average household income (2016)	\$78,477	\$73,258	\$65,748

An analysis of 2016 census data conducted for this report paints a picture of the demographic and economic contrasts between rural and urban areas in Ontario, Canada’s largest province by population (table above). The data are divided into three kinds of census divisions (CDs) – metropolitan CDs, which are located in urban areas with more than 100,000 people; non-metropolitan CDs, which are fully outside settlements with more than 100,000 people; and mixed CDs, which include a combination metro and non-metro areas. As is clear from the table, non-metropolitan – that is, rural and smaller-town – CDs grew much more slowly in population than others between 2011 and 2016; they were also much whiter, with only 2.6 per cent of the population identifying as visible minority, as opposed to 43.5 per cent in metropolitan CDs; and they were poorer, with an average household income that was only 83.7 per cent of the metropolitan average. These demographic differences, which reflect an economic base that has increasingly transitioned towards post-industrial urban productive sectors, set the context for the distinct governance challenges faced by rural and urban local governments in Canada in recent years.

For some time now, rural areas in the urban periphery of large cities in Canada have experienced some out-migration of urban residents facing high housing prices in the city. It appears that the Covid-19 pandemic has rapidly intensified this trend, to the extent that may fundamentally change the rural-urban dynamic in the longer run. Of course, it is too early to tell if the trend will be sustained. There is not even reliable data on the scale of the out-migration over the course of the pandemic yet. However, it was notable that *all* the experts and practitioners interviewed for this research noted this out-migration as a major development and a source of significant challenge, as well as potential opportunity, for rural areas. Interviewees all agreed that the structural driver of the out-migration is the very high cost of housing in large urban centers, most notably Toronto and Vancouver. With the Covid-19 pandemic entrenching work-at-home possibilities for white collar professionals, and simultaneously enhancing the appeal of low-density rural living, this structural trend has rapidly acquired more force.

⁴⁶² Between 2001 and 2016, the rural Canadian population grew by 5.5%, while the overall national population grew by 16.9%. Even this modest rural growth, however, is largely concentrated near urban areas. See Federation of Canadian Municipalities, ‘Rural Challenges, National Opportunity: Shaping the Future of Rural Canada’ (2019).

⁴⁶³ All data are calculated from Statistics Canada 2016 census of the population data tables.



Speaking about dynamics in the Toronto area, one policy analyst said: ‘Especially with the last year, housing has just moved out of the [Toronto area] and it's encroaching on a lot of these different communities. People who would have loved to have lived in downtown Toronto, but simply can't afford to are buying homes in Oxford County’ – about 150km from Toronto.⁴⁶⁴ While the experts interviewed for this project all focused on the Ontario context, media reports suggest similar dynamics surrounding other large urban centres.

This influx of new residents and money brings some benefits to rural areas, such as more budget money for municipalities that rely heavily on property taxes and development fees. As one interviewee noted, ‘from a property tax perspective, from a development perspective, it's pretty significant, (...) you go to some of these places, there's a lot of nice new playgrounds and parks and stuff like that. If you go to Innisfil [a rural community one hour north of Toronto], they built one of the nicest libraries I've ever seen. It's like a monument, incredible. And they're like, “yeah, that's development dollars”’.⁴⁶⁵

The other side of that same coin, of course, is that housing affordability is quickly becoming a major problem in rural communities that are relatively near to urban centres. ‘This notion that affordability is only an urban issue, it really needs to dissipate’, said one respondent. Those households that cash out of hot urban property markets have been driving up housing prices in rural areas at an unprecedented rate, especially since the beginning the Covid-19 pandemic. One interviewee noted that median house prices went up 40 per cent or more during 2020 in many rural communities that are within a two-hour drive of the Toronto area.⁴⁶⁶ Another challenge that comes with the influx of what one interviewee called ‘rural gentrifiers’⁴⁶⁷ is that they tend to want more municipal services in communities that have long provided just the basics, putting upward pressure on property taxes.⁴⁶⁸

Most respondents also noted that the new urban out-migration is leading to cultural and lifestyle tensions in rural areas that are experiencing high rates of influx. ‘It's gonna be a little bit like it was after the Second World War, when a lot of European immigrants showed up in these communities,’ said one interviewee. ‘They haven't seen that kind of change in a generation in two generations really, and they may have a lot of people coming to town that don't look like them, don't engage in the same economic activities that they're used to, that have different expectations. And they may want to set up cricket pitches, not baseball diamonds’.⁴⁶⁹ Another respondent noted of the new arrivals from urban areas: ‘You know, they need to have a big box store, they want some things from you know from the supermarket and stuff, and [long-time residents] are complaining that all these weird products are showing up in the supermarket right like avocados and (...) gluten-free food’.⁴⁷⁰

It is far too early to tell how extensive this out-migration to rural areas will ultimately be, and whether it will continue after the Covid-19 pandemic. However, it appears that a significant

⁴⁶⁴ Interview with local government expert, Rural Ontario Institute (20 July 2021)..

⁴⁶⁵ Interview with local government expert, York University (10 July 2021)..

⁴⁶⁶ Interview with local government expert, Guelph University (28 July 2021).

⁴⁶⁷ *ibid.*

⁴⁶⁸ Interview with local government expert and consultant, Toronto (13 June 2021).

⁴⁶⁹ *ibid.*

⁴⁷⁰ Interview with local government expert, York University (10 July 2021).



shift in rural-urban dynamics is underway in the parts of rural Canada that are relatively close to major metropolitan centres, with possibly far-reaching knock-on effects on rural governance issues.

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17.2 Local Financial Arrangements in Canada: An Introduction

Martin Horak and Brittany VanDenBrink, *Department of Political Science, Western University*

Local Government Revenues

The structure of local financial arrangements in Canada falls largely under provincial control. Provincial governments pass laws that authorize specific ways that municipalities can generate what are called ‘own-source’ revenues. The permissible range of own-source revenues is rather restricted in comparison with many other countries. Own-source revenues are generally limited to local property taxes, user fees charged for services (such as parking, recreation facilities, and tags for garbage collection), and fees charged to property developers. Municipalities are generally not allowed to collect income or sales taxes. At the same time, the fiscal system is highly decentralized – own-source revenues account for more than 75 per cent of all local government revenues in all provinces, and more than 90 per cent of all local government revenues in some provinces, such as British Columbia.⁴⁷¹

Intergovernmental transfers, which range from about 8 per cent to about 25 per cent of local government revenues depending on the province, fall into one of two categories: unconditional, meaning that the funding can be used at the discretion of the municipality, and conditional, which requires the municipality to use the funding for a specific purpose. The vast majority of intergovernmental transfers come from provincial governments. In Ontario, they are used primarily to help pay for the cost of social services and public health; elsewhere in the country, the provinces are responsible for providing these services. From the federal government, the gas tax is the only significant source of revenue that is transferred to municipalities. The gas tax has been a guaranteed source of municipal revenue since 2013 that is used for subsidizing capital infrastructure projects (thus it is a form of conditional funding). Transfer amounts are determined based on each province’s population, and subsequent distribution is administered by the provinces.⁴⁷²

The limited range of local revenue sources, combined with high local fiscal autonomy, means that Canadian local governments are extraordinarily dependent on local property taxes – more so than local governments in any other industrialized country, including the United States. Property taxes account for a majority of own-source local revenues across Canada and constitute a majority of *all* local revenues in several provinces.

In theory, the provinces could grant municipalities the same taxing authority as the provinces have themselves. This means that local income taxes and sales taxes could be levied (as has been done in some American states). While municipal governments have pushed for greater taxing authority at times, and/or for a guaranteed share of federal and provincial taxes, provincial governments have tended to resist calls for a diversification of local revenue sources.

⁴⁷¹ Andrew Sancton, *Canadian Local Government: An Urban Perspective* (2nd edn, OUP 2015) 296.

⁴⁷² *ibid* 35-37, 40, 294-295, 301.



The high local reliance on property taxes has a profound effect on local politics and governance, since it pushes municipal authorities to aggressively pursue growth in the local property tax base, on which the fiscal health of the municipality depends. It likewise follows that the local fiscal capacity of municipalities is significantly influenced by the strength and health of their tax base. This situation tends to disadvantage rural municipalities, which (like their counterparts in other countries) experience lower rates of economic growth on average than large urban municipalities.⁴⁷³

Local Government Spending

Municipalities have two budgets: operating budgets and capital budgets. Operating budgets cover the day-to-day expenses that are needed to deliver goods and services to residents and to ensure the internal municipal organization is running smoothly. Thus, the operating budget covers recurring costs, like salaries, office supplies, utilities, fuel, and contracted services. The capital budget covers large investments and infrastructure repairs, such as road renewal, sewer work, new buses, and new facilities. The most significant categories of public spending at the local level are roads and (in urban municipalities) public transit, water supply and sewage, and police and fire services. In Ontario, due to the provincial mandate that municipalities provide social services, there are significant municipal expenditures for health, social services, and housing.⁴⁷⁴

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⁴⁷³ For the implications of this rural/urban fiscal capacity divide in Ontario, see the First Entry to Report Section 2 (Local Finances) on Property Tax Reliance and the Re-Emergence of Provincial Funding Transfers to Local Government in Ontario.

⁴⁷⁴ Sancton, *Canadian Local Government*, above, 293.



17.3 Property Tax Reliance and the Re-Emergence of Provincial Funding Transfers to Local Government in Ontario

Martin Horak, *Department of Political Science, Western University*

Relevance of the Practice

As noted earlier, Canadian municipalities are extraordinarily dependent on property taxes. The level of property tax dependence in Ontario is slightly lower than the Canadian average (about 40 per cent of all local government revenues, including transfers). This is mainly a function of the fact that Ontario local governments (unlike those in other provinces) are provincially mandated to deliver a range of social services, which are partly paid for by the provincial government. In the 1960s and 70s, the Ontario provincial government also provided transfer support for a variety of non-mandated local government activities (such as transportation infrastructure and social housing construction), but in the face of budget pressures, provincial support for local services not mandated by provincial law declined to virtually zero by the late 1990s. This made Ontario municipalities extraordinarily dependent on property taxes, intensifying fiscal capacity problems for both rural and urban municipalities. However, these capacity problems are different in nature in rural and urban contexts. We will examine the character of fiscal capacity problems generated by the high reliance of property taxes in these two contexts, as well as the re-emergence of provincial fiscal transfers over the past 20 years in response to these problems. Doing so can give LoGov researchers insight into the promise and the limits of supra-local support for local fiscal capacity in a context of high dependence on a single local revenue source.

Description of the Practice

In Ontario, as in much of Canada, many rural areas have been economically and demographically stagnating for some time. This is reflected in much lower – and often stagnant or decreasing – rural property values as compared to urban property values, although urban out-migration associated with the Covid-19 pandemic is now leading to rapid housing value increases in rural areas close to urban centres.⁴⁷⁵ Despite a major round of amalgamation in the late 1990s,⁴⁷⁶ rural Ontario municipalities are relatively small in population, and the combination of small size and limited tax base tightly constrains fiscal capacity. As a result, rural municipalities often lag behind in terms of many of the services that their urban counterparts provide (parks, libraries, social service facilities, etc.).

⁴⁷⁵ Interviews with local government experts, Toronto (13 June 2021), York University (10 July 2021), Guelph University (28 July 2021).

⁴⁷⁶ See report section 4.1. Beyond Municipal Amalgamations in Ontario.



In 1998, the Ontario government set up a modest unconditional transfer program – the Community Reinvestment Fund – aimed specifically at fiscal equalization for small and assessment-poor municipalities. In 2005, this program was re-named the Ontario Municipal Partnership Fund (OMPF). The amounts distributed through the program grew in the initial years, and OMPF now distributes about CAD 500 million per year to selected municipalities – mainly small rural ones – based on a formula that takes into account population, economic variables, and property values. While the program constitutes a minority of overall provincial transfer funding to municipalities, it is the primary provincial unconditional transfer program, and makes a significant difference to the fiscal capacity of many small rural municipalities.

In Ontario's large urban centres, dependence on property taxes creates problems for other reasons. First, while the assessment bases of most large cities are healthy and growing, the property tax is a highly visible tax, and so is subject to tight political limits. As assessment bases increase and taxes grow, politicians face intense public pressure to limit tax increases, ensuring that the property tax windfall from economic growth is incremental at best. At the same time, growth brings major new costs in urban areas – such as the capital costs of major infrastructure works, and the need to provide affordable housing solutions in expensive real estate markets.

Since the late 1990s, which marked the low point of provincial fiscal support for municipalities in Ontario, the provincial government has become increasingly fiscally involved in supporting major urban capital infrastructure projects – especially transportation projects – through conditional transfers. It has done so partly as a result of lobbying by local officials, and partly because the federal government began to roll out a variety of capital infrastructure funding programs based on matching funding in the early 2000s. As a result, Ontario cities have experienced significant capital investment – especially, but not only, in public transit infrastructure – over the past decade.

By contrast, the Ontario provincial government has, in general, resisted calls to increase the range of permissible local revenue sources. The exception to this general reluctance serves as an instructive case. In 2008, after intense lobbying by the City of Toronto (the largest municipality in Ontario, with almost 3 million people), the provincial government passed stand-alone legislation that granted the city the power to levy a number of new taxes, including a vehicle registration tax and a land transfer tax. The city soon instituted both taxes, but they faced intense local political resistance. The land transfer tax has weathered the resistance and generates significant revenue for the city, but the vehicle registration tax was scrapped by a new mayor in 2011 and has not been reinstated.

Assessment of the Practice

By adopting differential responses to local fiscal stress in rural and urban areas, the provincial government has acknowledged and attempted to address the different character of fiscal stress in these two contexts. However, in both cases the responses have been limited and subject to various problems and limitations. According to one former public servant interviewed for this research, the OMPF essentially compensates for the increased financial burden placed on municipalities by the provincial downloading of certain services in the 1990s. In addition, it is spread thinly across many rural municipalities, and – since it is subject to a



yearly provincial budget allocation and is not guaranteed into the future – it has declined in the last few years as provincial fiscal priorities have shifted. Meanwhile, intergovernmental capital funding for major urban infrastructure, while it has spurred useful new construction, has also been subject to high transaction costs, since the projects thus funded require concurrent political approval at multiple levels of government. In Toronto, Ottawa, London, and other major cities, transit infrastructure projects have in recent years repeatedly been delayed and altered as political priorities have shifted at one or another level of government.

Many commentators continue to argue that the longer-term solution to the limits of the property tax base in both rural and urban contexts is diversification of permissible local-source revenues to include items such as local sales and income taxes.⁴⁷⁷ However, the provincial government remains reluctant to go down this road, preferring conditional and/or unconditional transfers to new local revenue sources. Furthermore, as we saw in the case of Toronto, granting access to new revenues would not in and of itself mean that municipalities would choose to use them.

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Canada



Website

www.logov-rise.eu

Twitter

@LoGov_RISE

Email address

logov@eurac.edu

Contacts

**Local Government and the
Changing Urban-Rural Interplay**
Eurac Research
Institute for Comparative
Federalism Viale Druso/
Drususallee 1
39100 Bolzano/Bozen
Italy



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