Summary

Despite a general trend toward further decentralisation, there are almost as many approaches to fiscal decentralisation within the European Union as there are member states and there is no ideal scheme or blueprint for reform. However, decentralisation poses the same issues in each country, related to the degree of decentralisation sought and the appropriate mix of expenditure assignments and revenue sources (including sources of taxation) that will produce an equitable and workable result. The model employed in any individual country will reflect the local economic and political context but in each case the elements of the system must be consistent with one another.

Countries with a low degree of decentralisation tend to rely more on property and other taxes and/or on extensive grant systems. When the level of decentralisation increases beyond a certain level, other revenue sources have to be found and countries rely increasingly on the Personal Income Tax (PIT). However, the PIT—especially progressive systems—can accentuate disparities in fiscal capacity. Equalisation grants are a crucial component of decentralised systems, since they impact positively on equity and efficiency and compensate for disparities. Equalisation is crucial but can be very expensive, depending on the degree of fragmentation of local government, existing disparities among local government units, the structure of their own revenues and the degree of equalisation sought.

Local government systems, especially in Europe, have to face another set of problems related to excessive fragmentation, which impacts negatively on costs and the quality of local service provision. Attempts to amalgamate local units are increasingly giving way to the promotion of contracting and cooperation and the creation pluri- and mono-functional governments at the supra-municipal level.
Medium-Term Trends in the European Union

In fiscal terms, there has been a significant trend toward increased decentralisation in the EU over the past 15-20 years, with the exception of the federal countries of Austria, Belgium (where federation is a recent creation) and Germany (which underwent unification at the same time). Non-federal countries have witnessed an average increase in sub-national government expenditure, as a proportion of general government expenditure, of four percentage points over this period. The Scandinavian countries have maintained (and even extended) their reliance on sub-national government expenditure (at an average of 44 percentage points).

Outside of Scandinavia, countries display a wide range of degrees of decentralisation around an average of 23 percentage points. At the same time, there has been a shift toward regionalisation in some countries, with a new layer of regional government being created between national government and more traditional local government units. In particular, this applies to France, Spain, Italy and the UK.

The Degree and Configuration of Decentralisation

The federal states have unique structures and political relationships that make comparisons with other decentralised systems sometimes problematic, and this statement applies despite the regionalisation of other states. Moreover, the non-federal states vary as much in the configuration of decentralisation as they do in the degree of decentralisation. Local government revenues (excluding transfers but including shared taxes) make up only 30 percent of expenditures in the Netherlands and the UK while comprising some 60-75 percent of expenditures in other states. Croatia can be loosely assigned to this latter group but there is still no dominant structure or model.

Instead, each state has developed its own decentralisation system over time and with different structures in terms of (1) expenditure, (2) revenue sources and (3) taxes. Some commonalities can be observed in these three areas, but the crucial element is the consistency between them, as discussed later on.
1. Expenditure Structure

The sub-national government units of the unitary and regional states of the EU spend an average of 18-19 percent of total expenditures on general services (including administration), on education, on health and on an array of other functions including transportation, culture and economic promotion. They spend some 22 percent on social security and welfare and about 7 percent on housing (and other community amenities). There is indeed a commonality of the types of expenditure that sub-national units undertake and, while their relative importance varies widely, those countries with larger degrees of decentralisation tend to spend those increased resources on education, health and social security.

The Croatian system of local and regional government provides an array of services that is typical of unitary states, but housing and economic promotion are unusually important.

2. Revenue Structure

The sub-national government units of the unitary and regional states of the EU vary substantially in their reliance on revenue sources. As the degree of decentralisation increases (as in the Scandinavian countries), the reliance on non-tax revenues diminishes. Otherwise countries either rely substantially on tax revenues (as with Sweden) or on tax revenues (as with the Netherlands and UK) or on a mix of both (as with Denmark).

In Croatia, shared taxes are the most important source of revenue and the level of grants is relatively low by international standards. This means that Croatia has a low level of vertical imbalance and will have limited equalisation capacity, especially for municipalities and cities. Italy, for example, has a higher level of grants and would probably have higher vertical imbalance (as will be investigated below). Equalisation requires grants—especially if countries are characterised by large regional disparities.
3. Tax Structure

Regarding the structure of taxes that accrue to sub-national government units of the unitary and regional states of the EU, there appear to be two distinct groups. The Scandinavian countries rely heavily on personal income taxes (PIT) while most other countries rely on property taxes or other taxes (such as local sales taxes). Spanish sub-national government has a broad mix of tax sources, including the corporate income taxes (CIT). Generally, it might be noted that those countries with a high degree of decentralisation (such as in Scandinavia) rely comparatively more heavily on the PIT while those countries with a lower degree of decentralisation rely more heavily on property and other taxes.

The PIT, and especially local surcharges on the PIT, has become increasingly popular in the financing of local government. However, those countries which rely on the PIT tend to apply a flat tax rate in order to reduce the impact of progressivity on collections among local government units.

Croatia is unusual in having a low degree of decentralisation but a heavy reliance on the PIT (and CIT) to finance local government. Of course, an increased degree of decentralisation in Croatia would require further taxes, and the tax mix should be considered. The property tax is still missing.

Summary of Systems and Experience

In summary, there is no ideal or even dominant model for decentralisation within the EU, but some stylised facts can be observed. Countries with a low degree of decentralisation tend to rely on property and other taxes and/or on extensive grant systems. When the level of decentralisation increases beyond a certain level, other revenue sources have to be found and countries rely increasingly on the PIT. Scandinavian countries have traditionally relied on it and Italy, Spain and the UK (for Scotland) are expanding their reliance on it. Croatia does not fit easily into this description because it has a low degree of decentralisation but a heavy reliance on a progressive PIT. This could cause difficulties for equalisation between regions of different income levels.
The next stage in the investigation is to examine the issue of equalisation. In particular, the Italian experience will be examined because Italy is commonly regarded as having an unequal regional dispersal of income.

**Why have equalisation?**

There are distinct reasons for having equalisation across regional government expenditure, that can be briefly stated as follows:

- Equalisation fosters national unity. All areas of a country must perceive that they are not disadvantaged in their relations with the centre.
- In Europe, residence is no longer accepted as a factor that should cause or justify disparities in the level of provision of services.
- It is important for efficiency because the migration of firms and individuals will not be caused by disparities in the levels of public services (net of their costs).

**Achieving Equalisation: The Potential Costs**

Countries with a high degree of regional income disparity (as measured by a Lorenz curve) will have a larger disparity of local government revenue across its regions and, in the absence of an equalisation system, will have more disparity in service provision. Therefore, countries that strive for equalisation will have more costs to incur if regional disparities are large. In order to create equality of levels of service provision and/or to implement minimum standards, a decentralised system will have to implement a non-progressive tax system combined with an effective grant system.

Within the EU, there are large variations in the degree of regional disparity (see OECD 3). Italy has a high level of regional disparity of GDP, along with the UK, Hungary, Belgium and France. Austria has the lowest level, followed by Greece, the Netherlands and Sweden. In this context, it is worth noting that Croatia exhibits an even greater degree of regional disparity in income than Italy. Therefore, the costs of equalisation in Croatia could be expected to be large in relative terms.
Achieving Equalisation

Equalization is a common goal, even though the degree of equalisation differs across countries and may have gone too far in some countries, generating reactions from the richest areas. Another common trend in the evolution of grant systems is the replacement of specific/conditional grants with general non-conditional grants. This is to eliminate the contradiction between devolution to local governments of more responsibilities, on the one hand, and retaining control and influence on the same local governments through conditional grants on the other. Conflicts between national and local priorities in crucial sectors can be resolved through the imposition of minimum standards, but they must be minimum and only for crucial sectors.

Some Examples in Practice

Sub-national government systems across the EU all try to considerably reduce levels of inequalities in local service provision with the use of non-conditional equalisation grants based on fiscal capacity and/or expenditure needs. Germany has one of the best known systems of equalization, based on three distinct instruments: the allocation of a share of VAT; a fiscal equalization mechanism and supplementary grants to the poorest Laender.

Italy has a particular challenge with equalisation of expenditures because of its inequalities in regional income and large health expenditure. It tries to overcome this problem with a mix of grants to poorer regions and local governments. The property tax was recently introduced and has become the single most important source of revenue for municipal and city governments.

Equalization is particularly evident for the regions in Italy and operating expenditures across regional governments are largely equalised as a result of the system employed. In fact, even some of the wealthier regions have lower per capita operating expenditures than some of their poorer neighbours.
In Croatia, inequalities for county administrations have been partially equalised because of the importance of the 2001 decentralised functions in their expenditures and the operation of the grant system that accompanies it.

However, it is more difficult to achieve equalisation at the municipal level because of greater differences in size, fiscal capacity and expenditure needs.

In the case of Italy, the financing system does tend to equalise operating expenditures for municipalities, but equalisation is not fully achieved.

In the case of Croatia, operating expenditures for cities and municipalities across counties is even more unequal than GDP per capita in those same counties. This is probably due to the heavy reliance on a progressive PIT (and on the CIT) in the context of a relatively fragmented system of local self-government.

**Fragmentation**

Fragmentation, meaning small size and a large number of local units, is a traditional characteristic of local government in Europe, deriving from its political and social history. However, fragmentation in local governments has three adverse consequences:

- higher costs of service provision, due to the non-exploitation of economies of scale
- a smaller range of services—for example because not all small municipalities can provide cultural services or effective public transportation services (unless they cooperate)
- more inequalities in service provision because disparities in fiscal capacity are inversely correlated to the size of local government units—the more you merge units, the more you reduce disparities
Solutions to Fragmentation in Europe

1. **Amalgamation** (merging more small units in a bigger one) and **consolidation** (aggregating small units in a big existing unit): This strategy was carried out the 1960s-1980s in Northern Europe. Sweden, Denmark and Great Britain eliminated more than three-fourths of their local governments. Belgium and Germany also restructured their local government system. (The German “philosophy” was that effectiveness and equal access to services required a larger size of local government). Attempts to merge in France, Spain, Italy and Switzerland have been largely ineffective because of strong local resistance. Some Eastern European countries have even increased the number of local units, as in Hungary and the Czech Republic.

2. **Contracting out services**: This is an increasingly frequent practice in all countries. A telling example is provided by school canteens. By outsourcing the service to big catering firms small local governments can reap the benefits of scale and preserve their autonomy.

3. **Contracts between government units** situated at the same and at different levels: This is possibly the most salient feature of the evolution of governance with reference to inter-governmental relations. The EU has been a crucial promoter of contracting. France provides possibly the most advanced examples of public contracting having also introduced specific legislation to facilitate it.

4. **The Promotion of cooperation** through the creation of specific organizations (such as associations and syndicates of municipalities and other local governments) and of supra-municipal bodies (such as pluri- and mono-functional governments for urban and/or mixed urban and rural areas): While most European countries provide examples of these new instruments, France is possibly the leading case (being also stimulated by its large level of municipal fragmentation). More specifically, France has used the allocation of general grants to foster the creation of pluri- and mono-functional government units at the supramunicipal level (Communautés urbaines, Communautés de communes and Agglomérations Urbaines). These new units are induced to merge their business tax (taxe professionnelle) to reduce undue tax competition and disparities in fiscal capacity and they receive supplementary general grants during an initial period, through which arrangements are made to exploit scale economies.

Sources:


OECD 2 Revenue Statistics, Paris, various years.


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Istat (1), Conti economici delle Amministrazioni pubbliche. 2005 Rome


MOF(Hr) Data on Regional and Local Government Units for 2002-2005 at [www.mfin.hr](http://www.mfin.hr).