

Financial Relationships between Regional and Municipal Authorities: Insights from the Examination of Five OECD Countries¹

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INTRODUCTION

The intergovernmental fiscal relations of local governments are diverse. They vary substantially across countries as do expenditure responsibilities and revenue generating powers. To the uninitiated, the picture can be quite confusing, especially if one is in search of best practices or exemplary cases. The situation is eased somewhat when one realizes that intergovernmental fiscal relations (notably transfers), expenditure responsibilities and revenue generating powers are, or at least should be, an integrated package but a package that can, indeed must, vary to suit different circumstances. Well designed packages can enable local governments to function effectively. Unsuitable arrangements will hamper performance.

This paper reviews the intergovernmental fiscal arrangements of local governments in five countries and provides a comparative assessment with the objective being to derive lessons to aid in the structuring of better fiscal arrangements between local and other governments. Although most local governments are municipal governments, there are often many other types of local governments that are also important but for which arrangements may differ. Hence, because the distinction is often important, the (AUCC), working in conjunction with experts in academia, government and the non-governmental sector in both Canada and the Russian Federation.

practice here is usually to refer to local governments or local authorities unless a specific type (e.g., municipalities) is under discussion. Federal countries get most of the attention here so relations between local and regional (provincial and state) governments are particularly important because they usually dominate, but those with the federal government are not neglected. Financial relations dominate the attention here but important intergovernmental fiscal relationships extend beyond those and so some attention is paid to other matters.

Four of the countries reviewed are classic federal states. There is Australia, which has a small local government sector; Canada and the United States, in which the local governments are of intermediate size, somewhat similar though by no means identical, and which have some unique features; and there is Germany in

imposed or seriously considered (often large scale) amalgamations of their local governments; e.g., New South Wales and, more recently, Tasmania and Victoria.

Efforts over the past two decades to enhance the efficiency and effectiveness of Australian government at all levels have impacted particularly upon local government. Combined federal, state and co-operative initiatives have instituted various programs to increase accountability and efficacy. For example, a minimum share of local budgets must be exposed to competitive bidding (market testing), management reviews are undertaken by the states, there is a national bench marking program to identify best practices and relative performance, and comparative reporting is being practiced. Efforts to identify performance measures are widespread and there are various efforts being made to improve service quality.

2. Local Governments' Expenditures and Revenues

The IMF data for Australia in Table 1 (all tables are at the end of the document) demonstrates the magnitude and pattern of local government expenditures in 1998. Total expenditures were \$12,846 million (Australian) which constituted 6.1 percent of consolidated government expenditures and 2.2 percent of GDP that year. That modest amount of expenditure is concentrated in transportation (27.5 percent), housing and community amenities (18.7 percent) and recreation and culture (17.7 percent) which, along with general services (13.7 percent) represent more than three-quarters of total outlays. Note that education, health and social security and welfare together amount to less than nine percent of the total with most of that (6.3 percent) for social security and welfare. Public order and safety comprises only 2.4 percent of expenditures.

The revenue picture is shown in Table 2.

Despite the designation of the latter, the total amount is effectively untied funding because local governments are not required to use the Commonwealth road grant funds for roads.

The total amount of the Commonwealth financial assistance grants is currently escalated each year for population growth and inflation. In the early years after the Commonwealth first began making general purpose equalization transfers to the local governments (1974-75), the amount of the funding was based on revenue sharing (a share of federal personal income taxes) but, by the mid 1980s, tax sharing was replaced by financial assistance grants (in part to provide more stability and predictability to the revenues).

The distribution of the Commonwealth local financial assistance grant among the states differs by component. The general purpose component is allocated on a per capita basis (about \$45 per person in 1999-2000) but the road component for that year was based on the relative magnitudes of Commonwealth grants to

role in local government affairs despite local government being under the constitutional jurisdiction of the states. This shifting contribution may reflect a less clear distinction of the roles and responsibilities for the various levels of government on the expenditure side than the distinction on the tax powers side or it may reflect a greater willingness to accommodate Commonwealth assistance in aid of local (and indirectly to the state level of) government. Regardless, the federal government's contribution is important and its criteria provides valuable guidance for grant allocations.

Canada⁴

1. Local Governments and Their Relationships with Other Governments

There are approximately 4000 municipal governments in Canada. The most typical forms are cities, towns and villages and, in the rural areas, counties and rural municipalities. In addition to these general purpose municipalities, there are a large number of special purpose local authorities, boards and commissions that have responsibility for schools, police services, public utilities, conservation areas, local health services, etc. Among these specific purpose bodies, school boards dominate in that they are ubiquitous and their expenditures often almost match those of the municipalities and their members are directly elected. The role and even presence of other special purpose bodies varies substantially among the provinces and the degree of their independence from (or integration with) general purpose local governments varies but they are usually minor authorities. Thus, municipalities and school boards are typically regarded as the major forms of Canadian local government.

Local school boards are responsible for schooling (i.e., elementary and secondary education) and municipalities are responsible for a broad (but conventional) range of local services. Municipal services focus on transportation (roadway and public), protection (police, fire and emergency services), environmental services (water, sewerage, garbage collection and disposal), recreation and culture, land use planning and business regulation, local health and social services.

Beyond schooling, local (i.e., municipal) government typically plays a very small role in social services such as health or social assistance where the provinces effectively are the suppliers.⁵ As a share of GDP, local government own revenue (usually 4 to 5%) and expenditure (typically 7 to 8%) have remained relatively constant since 1970. During that time, however, its share of total government spending has declined from one-quarter to about one-sixth largely due to the growth of provincial expenditures primarily in the areas of social expenditures, notably health.

The authority of local government in Canada is derived entirely from the provinces. The Constitution only mentions municipalities to declare that they are the exclusive jurisdiction of the provinces. As "creatures of the provinces," their responsibilities and powers are only those delegated to them by the incorporating province and to which their actions must conform. The provinces have the power to modify those responsibilities and

has dropped from 23 percent to 15 percent. Again, the transfers are almost entirely from the provincial governments. Also, most of the transfers are conditional with less than 20 percent of grants being unconditional (down from 25 percent in 1988).

Provincial conditional grants have typically provided a large and confusing array of incentives to municipal governments. The number or variety, if not the complexity, of these transfers has diminished over the years, in part with the levels of funding. Usually, grants are available to support aspects of the full range of services. Transportation is traditionally an area relatively well supported by transfers. Turning to the somewhat dated but internationally comparable data in the appended table (Table 7), the final column reveals that 25 percent of Canadian local government spending on transportation (and communications) in 1991 was provided by grants. Even of the small amount of spending by local government on health care (1.4 percent), 46 percent came from transfers. The education spending by school boards, of course, is heavily funded by grants and that share has increased; from 67 percent in 1991 to 75 percent in 1998.

Unconditional funding is normally only a fraction of conditional grants. In only three provinces does unconditional funding dominate conditional. Even if the amounts are small, unconditional funding is usually allocated in an equalizing fashion designed to assist (or assist more) the fiscally disadvantaged localities. Equalization played a particularly important role in the assistance to school boards when the boards had access to and utilized extensively local tax sources. With the provincialization of school finances, uniform provincial financing has recently taken over most of that role. Equalization plays a role in the allocation of unconditional funding among municipal governments in most provinces. Auld and Eden (1987) provide an overview of equalization across the provinces. They identify three types of programs being used -- relative fiscal disparity equalizing, fiscal gap equalizing and fiscal need equalizing. The relative fiscal disparity approach allocates the available grant funds inversely to the relative fiscal capacities of the municipalities; e.g., inversely to the ratio of

the per capita tax base of a municipality to the average. All municipalities receive some funds. The fiscal gap equalizing method looks at the difference between each municipality's own and a standard per capita tax base and allocates funds to those municipalities having a deficiency in proportion to the deficiency. The fiscal need approach determines standardized expenditures and standardized revenues for municipalities and provides grants to those with a deficiency between the two. Largely because of inadequate funding, most of the programs were found not to generate substantial equalization. One of the main difficulties with equalization is determining an equitable distribution between rural and urban municipalities and between small and large urban centres.

Revenue sharing is the basis of unconditional, largely equalizing, transfers in three provinces. Normally the shared revenue is defined as a small share of specific provincial taxes (particularly the personal and corporate income taxes as well as other revenues) and the funds are distributed among all municipalities in an equalizing fashion. In three provinces, selected vehicle revenues (e.g., gasoline taxes) are shared with their major cities (Calgary, Edmonton, Montreal and Vancouver).

The United States⁶

1. Local Governments and Their Relationships with Other Governments

As of 1997, there were 87,453 local governments in the United States. Of those, 39,044 (44.6 percent) were general purpose authorities, 13,726 (15.7 percent) were school districts and 34,683 (39.7 percent) were other forms of special districts. General purpose authorities are classified as counties (3,043), municipalities (19,372) and townships (16,629). Although some other types exist, municipalities are usually cities, towns and villages. Counties, which exist in all but three states, originated as administrative units of the states but became general public service providers outside municipalities. In large urban/metropolitan areas, county and city governments have often

merged in various forms. Townships occur in 20 states, largely in the northeast and the midwest. They originated largely to provide roads but their responsibilities expanded with population and needs. Single purpose school districts exist in all but four states and are a major form of local government. Other special districts are numerous, typically designed to provide one or two services (e.g., conservation, fire protection, water and sewerage), growing in number (17 percent more than a decade earlier), and may be hived off general purpose governments as a way

local expenditures. The decline in federal support for the subnational governments is associated with the President Reagan's "new federalism" which was aimed at reducing the federal governments role and its influence over state and local governments. During the Reagan administration, federal transfers were simplified (as well as reduced) by consolidating many categorical grants into a small number of block grants. In 1998, federal direct assistance to local governments amounted to about 10 percent of total assistance and 4 percent of revenues (less than half the contributions in 1978).

State government grants to local authorities have been larger and more stable at about one-third of revenues for many years. The increase in the transfers to school districts prior to the 1980s came from the state governments but that contribution has been stable at about half of school revenues for the past 20 years. Special districts are the only category of local government for which federal grants exceed state grants.

The bulk of intergovernmental assistance to local governments, about 60 percent of the total, goes to schooling. Ninety percent of that comes from the state governments. The role of the states in school finance was growing but received a boost with a wave of court decisions beginning in the early 1970s which declared that local school financing should not depend unduly upon the local property tax base. Thereafter, state aid for schooling rose from 37 percent in 1962 to 50 percent in 1982 and remained at 50 percent in 1998.

Unfunded mandates have become a serious concern of local governments.⁷ The problem might be traced back to a decline in federal transfers to the subnational governments and, as some see it, a switch to the federal use of unfunded mandates to exert its influence over the state and local governments. Especially with financial pressures on the states, unfunded mandates quickly emerged as a tool of the state governments to exercise on local governments. Mandates emerged as a problem throughout the U.S. federal system.

Being at the end of the line, unfunded mandates are a particular problem for local

governments. Mandates are seen as distorting priorities, restricting flexibility and imposing costs. Estimates exist that between 20 and 90 percent of local expenditures are to satisfy federal and state mandates and that a high proportion of state laws impact financially upon local governments. A difficult problem in deriving such estimates is making a distinction between the legitimate assignment of responsibilities and illegitimate mandates. Clearly, some of the mandates are designed to realize political gains for state legislators at local governments' expense. Cases where generous exemptions from the property tax base are granted or the level or growth of property taxes are constrained with no compensation offer examples.

Local governments have been active politically and legally in resisting the abuse of mandates. Both the federal and many state governments have taken some steps to reduce the adverse impacts. The federal government passed the Unfunded Mandate Reform Act in 1995. Over 40 states require fiscal notes be attached to proposed legislation showing the estimated cost to local authorities. Some states call for reimbursement or, at least, allow local tax increases to cover all or part of the added costs. Reimbursement requirements are sometimes simply ignored. Requiring a two-thirds majority to pass an unfunded mandate may be a more effective deterrent. The effectiveness of these options is being questioned. Presently, surveys of local officials reveal that large numbers see the mandate problem as not improving if not getting worse.

Some limitations on local governments come not from the state governments but from citizens through voter initiatives and referendums. A majority of states have the option of issues being proposed by citizens and, if they gather sufficient support via petitions, being decided by statewide referendums. Many fiscal issues impacting state and local governments go to referendum ballots. One of the best known cases is Proposition 13 in California (1978) which severely restricted property taxation and property tax growth and which, as a result, considerably changed local and state finance there. Evidence suggests that in states where there is a greater potential for using

M.L. McMillan, *Financial Relationships between Regional and Municipal Authorities:*

voter initiatives, the levels and composition of taxes and spending is different (Matsusaka, 1995).

on state income taxes, the payroll form with filing by the self-employed is more common.

The federal government allows local property and income taxes to be deducted (if personal expenses are itemized) in the calculation of federal personal income taxes. This provision provides a federal subsidy to local governments by reducing the cost of local taxes to the federal income taxpayer and shifting a portion of that cost to the federal government and federal taxpayers generally. Since 1986, local (and state) sales taxes have not been deductible. The federal government also subsidizes local debt in that the interest paid on local government bonds is not subject to federal income tax thus allowing local debt to be issued at lower than market interest rates. Both these deductibility provisions have been criticized on efficiency and sometimes on equity grounds.

Direct aid to local governments comes from both the federal and the state governments. The federal transfers are relatively small, about 3.8 percent of total local revenues, and about 70 percent of that is directed to schools. Almost 90 percent of the grants to schools come from the states. Of the \$160.2 billion in state aid to schools in 1997-98, \$112.2 billion was formula assistance (while the remainder is directed to specific programs such as the handicapped, vocational education and transportation). Formula assistance is typically based on need and fiscal capacity and is distributed in an equalizing fashion. Especially since the 1970s, considerable attention has been paid to these distribution formulas and their ability to reduce local school funding from the local property tax base.⁹

Federal aid to local general purpose governments amounts to only 1.9 percent of revenues while state grants account for 24.4 percent in 1998. Federal grants are specific purpose (categorical) and often aimed at such objectives as urban redevelopment, roadways and public transit. Federal grants are directed primarily to state governments and those funds may percolate down to local governments through state programs and funding. In the late 1990s, over 60 percent of federal grants to state and local governments went to funding federal programs making payments to individuals (notably Medicaid and income security) and less

than 40 percent went towards assistance specifically for state and local governments. For example, in 1996, the federal government devolved responsibility for aid to families with dependent children (AFDC) to the states, many of which passed part of that responsibility on to their counties. Local governments particularly are concerned that the increasing demand upon

the initial decade). By 1987, for example, the number of municipalities had been reduced to almost one-third of that in 1968 and the number of counties from 425 to 237. Still, in 1987, over 85 percent of municipalities had populations less than 10,000 persons. The objectives of the consolidations were to create local governments of a more efficient size for the provision of local services while maintaining an adequate sense of representation and to establish local governments capable of handling functions to be decentralized. To a considerable extent, the consolidation of local government was renewed following the reunion with the east German states. As in many aspects of German politics and government, there was considerable regional variation in the approaches and outcomes of the consolidation initiative; for example, the amalgamations yielding unified versus associations of municipalities. Also, partly in response to local government consolidations, in the larger urban jurisdictions, it is common to have (sub-) districts many of which have directly elected representatives and certain decision-making powers within the local government; that is, a form of internal decentralization.

The responsibilities of German local governments largely fall into three categories; delegated, obligatory or mandated, and voluntary. The delegated functions are those which are the responsibilities of the federal and/or state governments but which those governments have delegated to the local governments to provide, typically with considerable direction and often financial aid. Examples of delegated functions are registration of births, deaths, marriages, etc., vehicle and property registrations, passport administration, building inspection, social assistance and housing allowances (paid for federally), public transport, some roads and highways, and some police services. Services that local governments are required or obliged to provide include school facilities (lower levels primarily by the municipalities and senior levels more by the counties; teachers are provided by the state governments), vocational training (the counties), aspects of health care, food inspection, day care for children, local roads, fire protection, water, sewerage and waste disposal, and cemeteries. In addition, local governments may voluntarily

undertake a wide range of (discretionary) services such as sports and recreational services, cultural facilities and programs, homes for the aged, youth programs, public housing, economic development, markets, further support for education, and various additional public utilities (e.g., electricity, gas, heating). Voluntary services can even extend to saving banks, post offices and health insurance. There is a considerable degree of both horizontal and vertical integration of services -- horizontal in the sense that both levels of local governments are engaged (typically cooperatively) in services to local residents and vertically in the sense that many services delivered by local authorities are services for which state or state and federal governments are involved. One consequence is that responsibilities for services become blurred.

Social services dominate local government spending. One-quarter of local outlays go to social security and welfare with somewhat smaller amounts (14.5 and 13.0 percent) going to health and education (Table 1). Those three areas represent fully half of expenditures. In addition, there is housing (and community amenities) which represents another 15.3 percent. In contrast, transportation amounts to 6.0 percent, recreation and culture 5.7 percent, and protection 3.4 percent. Total expenditures by local governments represents 18.0 percent of consolidated government expenditures and 9.2 of GDP. Interestingly, despite the intention of local government consolidation to prepare local governments for expanded responsibilities and reference to the expansion of the responsibilities delegated and mandated to local governments, the 9.2 percent of GDP figure is only slightly larger than the 8.5 plus percent values observed from 1965 to 1980 (and values below the 8.5 percent level have been observed during the 1990s). Any significant down loading of responsibilities is not immediately obvious in local government spending as a percentage of GDP. Social services have expanded as a share of local budgets since the 1960s while infrastructure investment has declined.

Excluding the small amount (4.2 percent) of capital revenue, the revenues of local governments are split almost evenly among taxes, nontax revenues and grants (Table 2). This pattern has been quite stable although the

tax share may have diminished somewhat during the 1990s after reunification. The major locally determined tax is a tax on local businesses (a portion of which is shared with senior governments). Local governments also levy a property tax. In addition, local governments receive a share of the personal and corporate taxes and the VAT (among some other minor shared taxes). This shared tax revenue is considered in the data comprising Table 2 as local taxes although local influence on the taxes and their shares is minimal. The taxes and tax sharing arrangements have also been quite stable. Nontax income is relatively high and quite important in local budgets. Intergovernmental transfers come in a variety of forms. Local governments may borrow but debt is generally used carefully and tends to be subject to at least the informal scrutiny of state governments.

Local government is a constitutionally recognized level of government in the German federation. Directly elected representatives are to manage local affairs.¹¹ The responsibilities of the three levels of government are defined under the Basic Law. Local government, however, is the responsibility of the state governments (although both the federal and the state governments legislate in areas that impact upon local government; e.g., taxation, education). As a result of the state responsibility, there is considerable variation (often regional) among the specific provisions across the states. The federal and state governments can delegate their responsibilities and many are delegated to the local governments, often with a considerable degree of supervision making the local governments effectively agents of the senior government in those areas. In addition, the state governments frequently use local governments, the counties particularly, as a level within their own administration. Beyond delegated and mandated responsibilities, the local governments are guaranteed the right to manage their own affairs. That is, manage their own affairs within the limits of the law. This authority is interpreted as being able to act in those areas not explicitly assigned to or reserved for another level of government. Local government is also granted the right to self-administration within the law; that is, it has the right to address its problems in those ways that it sees fit. Sources

for own revenue and the distribution of major shared taxes are set in the Constitution. While following subsidiarity has resulted in the devolution of responsibilities in the German federation, taxes tend to quite centralized -- a feature which may constrain local autonomy.

The state governments provide the main supervision of local governments. The state department responsible for local government is the main general supervisory authority with departments focussing on specific functions (e.g., education, health) monitoring the related local activities under their jurisdiction acted on by local government and notably those delegated to local governments. The federal government has a similar interest in delegated services. With respect to the voluntary undertakings, a county committee comprised of county officials and the county chief executive officer, acts for the state governments to rule on the legality of municipal actions. As for other potential disputes about government action (intergovernmental or otherwise), the courts provide an avenue for resolution.

The intertwining of responsibilities across levels of governments and the interdependence of service delivery requires substantial negotiation and consultation if the federal system is to work smoothly. Intergovernmental consultation and efforts towards consensus building is a characteristic of the German system which can be typified as a form of co-operative federalism. It has been noted that those in the various governments recognize the individual and collective roles of the various levels in providing a comprehensive network of public services. Illustrative of the interrelatedness is the fact that it is not unusual for councillors from local governments to serve as members of the state legislatures. In addition to other services, associations of local governments play an important role as representatives of local governments in addressing intergovernmental concerns. It has been noted that "The system

may also be levied. Such taxes generate very little revenue.

Nontax revenue, at one-third of the total, is a major source of local funds. Revenue from sales, fees and fines represents most of the nontax revenue and one-quarter of total revenue. There is an expectation that, where feasible and not contrary to social norms, charges will be relied upon. Local governments have discretion in setting fees and charges but they are not to exceed the costs of the service. Some fees, the real estate transfer fee for example, are state government regulated.

The sources of revenue referred to above are primarily municipal revenues. County governments do not share in the income and value added taxes. Their own taxes account for very little (e.g., three percent) of their revenues and they also generate limited fees. Instead, counties levy assessments on the municipalities within their boundaries at a rate (a uniform state approved share) of local taxes. Differences among municipalities in their reliance upon county services and county equalizing support of financially weaker municipalities contribute to some county-municipal controversy over these requisitions; a controversy partly moderated by some degree of cross membership between county and municipal councils. Counties rely heavily as well on grants from federal and state governments and upon compensation negotiated for required and other services.

Local governments obtain about one-third on their revenues from intergovernmental transfers. Almost all of these grants come from the state governments. The constitution limits direct federal government transfers to local governments to only those in aid of infrastructure. However, federal funds can and do flow to the state governments to assist state support of local operations. The states are responsible for adequate local government funding. The Basic Law requires that the state governments share a percentage of their general tax revenues with their municipalities and counties. The states determine what taxes are to be shared and the percentages. The percentages of state tax revenues shared have been significant, averaging about one-third during the 1970s, with some variation among the states.

These funds are used for unconditional grants and are distributed on an equalizing basis. Unconditional funding represented somewhat over one-half (54 percent) of transfers to local governments in 1995. The states take account of revenue generating capacities and fiscal needs in allocating those funds among the local governments.

Conditional or specific purpose grants account for the remaining (almost half) of the transfers. Part of those funds goes to pay for those functions delegated to the local governments by the federal and state governments, part goes to support other activities, and about half may go to aid capital expenditures. Social assistance is a major delegated function which (indirectly via the states) receives federal support. Some insight into the funding and support of specific expenditure areas comes from the appended table (Table 7). Most, about three-quarters, of Germany's expenditure for education comes from the states with local authorities spending almost one-quarter. Of the local share, about 13 percent was funded by transfers in 1991. Local governments also account for about one-quarter of total transportation expenditures but, in this case, almost one-third of that is funded by transfers. Most of the national health spending is by the federal government (72 percent). Local governments' health expenditures represents 15 percent with very little (3.82 percent) of that funded by transfers. The major financial responsibilities for functions vary among governments and the grant support for the local government share of those expenditures also varies by function.

Denmark¹³

1. Local Governments and Their Relationships with Other Governments

Denmark is not a federal country. It has only the central and local levels of government. There are two levels (perhaps better, two types) of local government in Denmark; counties and the local authorities (municipalities). There are 14 counties and 275 local authorities (including in the latter the two capital metropolitan area jurisdictions of Copenhagen and Frederiksberg which hold the dual status of both county and municipality). Counties and municipalities are

equals with different tasks. Counties do not supervise municipalities.

The numbers of local governments were greatly reduced as a result of amalgamations under the Local Government Reform legislation enacted in 1970. Counties were reduced from 25 to 14 and municipalities from 1391 to 275. A major consideration was to consolidate local governments into their respective social and economic communities. An objective was to create municipalities of adequate size to support a primary school of at least 175 students. Approximately 5000 persons was considered a minimum size. Currently, 241 municipalities are in the 5000 to 50,000 population range. Counties were to be of a size to support a modern hospital. Nine counties are in the 200,000 to 400,000 population range with only one smaller. Amalgamation was only one part of the reform. Following the amalgamations, greater responsibilities were placed on Danish local governments during the 1970s and 1980s. The subsidiarity principle was followed in the decentralization -- that is, devolve services to the most local level of government capable of providing the service competently. The objective was that the government responsible for a service would be as close to the citizens served as practical.

Local governments in Denmark have substantial responsibilities. Counties are responsible for hospitals, health insurance, upper secondary schools, care and education of the handicapped, intermunicipal transportation (roads and public), environment, planning and business development among other tasks. Municipal responsibilities include primary schools (up to age 16), day care, children's health, recreation and culture, care of the elderly (home care, day facilities, housing, etc.), social assistance to those not covered by unemployment insurance, transportation, environmental protection, water, sewerage and refuse, other public utilities, fire protection (police is a central government function), and planning and business regulation. In addition, the municipal governments activate and administer most social programs even if financed by the central government. For example, old age pensions and child allowances are managed by the municipalities but are

centrally funded. Partial central support is provided for programs like sick pay and subsidized housing. Social security and welfare spending accounts for more than half (57.5 percent in 1998, Table 1) of combined local government expenditures.

The magnitude of local responsibilities, particularly with the substantial social programs, means that local government have large expenditures. As noted in Tables 1 and 2, the expenditures and revenues of local government represent just under one-third of GDP and more than half of consolidated government in Denmark. In a country where government is large (total government expenditures were almost 56 percent of GDP in 1998), local government is large as well. The revenues of local government come from central government grants (40 percent), nontax revenue (about 9 percent) and taxes (51 percent). Taxes revenues are almost entirely from locally levied personal income taxes.

The reforms initiated in 1970 were a comprehensive and systematic combination of amalgamations, decentralization of responsibilities, and financial reforms. The plan was to establish viable local governments, transfer responsibilities to them, and see that they had the resources to meet those responsibilities. The shift of responsibilities followed amalgamation. For example, during the 1970s and 1980s, responsibilities for hospitals and upper secondary schooling were shifted to counties and social security responsibilities were turned over to local governments. Local governments already played a major role that was supported in large part by conditional grants. Such specific purpose grants were considered unsuitable for supporting the expanded role of local governments.

also to enhance and ensure local accountability for funding and performance. The increased burden largely fell on the local income taxes, taxes which local governments had utilized since 1904. Because local governments' fiscal capacities varied, the increased expenditure and revenue responsibilities would only work effectively and fairly if accompanied by a strong

services through their own departments, operate enterprises, contact out to private firms, to nonprofit agencies or to other governments, enter into intermunicipal agreements for services, or other arrangements as they see fit. Public utilities must be self financing through user charges. Borrowing by local governments has been subject to varying restrictions over the years but is generally permitted for infrastructure needs.

2. Local Governments' Expenditures and Revenues

The distribution of local government expenditures in Denmark is reported in Table 1. Social security and welfare outlays account for 57.5 percent of the total. That, combined with 16.2 percent for health and 12.4 percent for education, makes a total of 86.1 percent for social programs and almost 90 percent if recreation and culture were included. Obviously, social spending dominates local spending. Relatively little of local outlay goes toward the "hard" or what are often referred to as property related services; that is, transportation (2.7 percent), economic affairs and services (2.2 percent), and protection (0.3 percent).

Further insight into the expenditure pattern is provided by Table 6 which shows the allocation among levels of government and distribution by function for each level for 1994. In financial terms, counties play a smaller role in the local government sector than do municipalities. County expenditures are dominated (about 60 percent) by health followed by that (almost 12 percent each) for education and for social policy. Municipal spending is primarily for old-age pensions (35 percent) which is closely followed by that for social policy (33 percent, largely for care of the elderly and social assistance). Schooling is the next largest item at 12 percent. Note that although unemployment is primarily a central (and a large central) responsibility, it is a recognizable outlay of the municipal governments (4 percent). Copenhagen and Frederiksberg have a combined county and municipality status. A somewhat different accounting for 1994 expenditures in OECD (1997, p 172) provides further insight into the responsibilities of the county and municipal governments. There, the majority of municipal expenditures are allocated to primary

M.L. McMillan, *Financial Relationships between Regional and Municipal Authorities:*

single rate taxes applied on income above a
basic personal exemption. The local tax is

models that have been observed. This analysis is aided by appeal to a conceptual framework that has emerged from the experience of observing and analysing the performance of subnational (and particularly local) governments in many countries by many people; a framework built largely upon the theory of fiscal federalism. There is not space here to develop and rationalize that framework. The principles employed and guidelines being followed will largely have to be accepted. Those principles have been presented and argued elsewhere.¹⁴ The following exercise will briefly sketch the widely accepted criteria applicable to a particular topic (e.g., functions, finances, etc.) and evaluate local government in these five countries to illustrate, demonstrate, and guide policy makers.

The Activities and Expenditures of Local Governments

What local governments do matters for determining intergovernmental fiscal relations. That is, the activities of local governments are critical to the determination of a structure of intergovernmental fiscal relations that will enable local governments to perform their tasks effectively. Indeed, the expenditure assignment, the revenue assignment and the transfers, which together comprise the core of the intergovernmental fiscal arrangements package, are closely integrated.

The responsibilities assigned to local governments vary greatly among countries. Table 1 shows local government expenditures ranging from 2.2 percent of GDP in Australia to 32.6 percent in Denmark. Among advanced economies, local government in Australia is uniquely small being confined essentially to the basic or core activities of local authorities; primarily roads, recreation, waste management, housing, and regulation of local activities. Other than for other Scandinavians; countries, local government in Denmark is local governments have been

(responsibilities for social services, (total)-7.3%) (T)T0.00083Tc0.001 Tw(Tsocial welfare assistance and health reduction that was 2.21(e)7.9(e)7.9(e)-7.6(assigned to local)T)T0.0019 Tc0.0005 Tw(government)8.2(e)2.1(nts vor, in De

two countries. (2.7 percent vs 27.5 percent), Danish local government is 27.5 percent of GDP, while in Australia it is 2.2 percent.

2.2 percent of GDP, while in Australia it is 2.2 percent of GDP. Local governments

While there are undoubtedly exceptions among the provinces and states, general purpose local government neither gets the level of total support or the extent of general purpose funding that is found for local governments in Australia,

A Note on Fiscal Imbalance

It is not uncommon to find reference to fiscal imbalance, especially in discussions of local government. In the simplest form, fiscal imbalance refers to situations in which a government's expenditures exceeds the revenue from its own sources. One can refine that definition to relate to the more difficult to measure concepts of expenditure requirements to meet expected services and own revenue generating capacity but the simple expression is adequate here. Fiscal imbalance implies grants, the source of funds covering the deficiency between expenditures and own-source revenues. Often, fiscal imbalance is associated with arguments for need of expanded tax capacity, additional transfers, reduced responsibilities, and may come with negative connotations or a negative spin such as those relating to poor management on one side or unreasonable demands or burdens on the other.

The point to be made here is that fiscal imbalance as expenditures exceeding own revenues is not a meaningful concept. One could have situations in which local governments' own revenues equal expenditures and (despite good management) local public sector needs are attended to poorly. Alternatively, one could have situations where there is a large gap between the two and the local public sector is sufficiently funded and well managed. For example, if local government is responsible for provision of a service having substantial spillovers, balancing expenditures with own revenues will result in inefficiencies and under provision of that service. There is nothing necessarily magical about local own revenues matching expenditures. The question of fiscal (im)balance is more complex.

Rather than raise the spectra of fiscal imbalance, the more relevant approach is to determine the most appropriate fiscal balance in particular circumstances. As noted, finance follows function. If responsibilities are extensive, revenue sources need to match both in terms of providing the capacity for adequate revenue and in terms of providing an appropriate cost-benefit link between taxes and expenditures. Are local authorities provided revenue sources that will allow own revenues to

meet expenditures (even if spillovers are not an issue)? It is possible that charges and the property tax, for example, will be insufficient and access to an additional tax source such as a local income tax may need consideration. Alternatively, if other tax sources are deemed inappropriate, a fiscal gap-filling transfer is necessary. The issue then is the suitability of the amount and distribution of the transfer. Similarly, if a local government with little revenue generation capacity and larger expenditure requirements receives equalizations grants, that does not imply a faulty fiscal system that removing the fiscal imbalance would rectify. And again, if important externalities exist, corrective grants are called for. Thus, "fiscal imbalance" (as the deficiency of own revenues to cover expenditures) may exist for legitimate reasons. The valid assessment of fiscal imbalance has to address whether the total fiscal arrangements -- expenditure responsibilities, revenue sources, amount, allocation and type of transfers -- is appropriately structured to provide local services efficiently and effectively to community expectations. Such assessments must be carefully done and can be complex tasks. It is possible that the outcome might be smaller or larger transfers. Simply noting that transfers exist and their relative magnitude reveals nothing about fiscal (im)balance.

Infrastructure¹⁶

Local governments provide a number of capital intensive services. Roads and streets, public transit, water and sewerage systems, and drainage probably dominate the list but capital facilities are also important to recreational and cultural activities, schooling, health care, etc. in which local government is frequently also involved. Overall, local governments typically account for about half of total government capital spending.

Local capital expenditures are usually financed from a combination of own funds, transfers and debt. Own funds are normally reserves that have been accumulated from taxes, charges and other sources of revenue. It is not at all uncommon that many specific purpose grants are designated for specific capital expenditures;

course, are intertwined. Good, but somewhat different, information is essential for both.

Information is necessary for financial management and control. This information is directed at ensuring that resources are used as intended. Avoiding corruption and misappropriation of resources is, of course, important but also important is simply avoiding careless management of funds. Senior governments are interested in assessing the need for their grants and tracking the utilization of those funds, especially conditional transfers. Independent external audits are essential for control but internal control mechanisms are vital as well for an effective system.

Local governments should be making information on their finances and operations public on a regular, timely basis to promote accountability and public awareness. One set of criteria for public disclosure is that it be complete, comprehensible, comparable, verifiable, and public. Senior governments have an interest in and they can do much to promote consistent and reliable local government information systems through combinations of regulations and incentives and they can do much to ensure public disclosure. Senior governments are in a unique position to provide information about local governments on a comparative basis to aid assessment. Australia's initiatives in this direction received special note. In part because of the efforts of senior governments but also partly because of local needs and demands, local governments in the five cases considered above have extensive and high quality information systems reporting internally, to citizens, to other governments, and to the public generally. Undoubtedly, this exposure contributes to the performance of local governments in those countries.

To perform their tasks effectively, local governments require a civil service that has competence, integrity and motivation. The civil service needs to be accountable to local elected officials. Accountability does not imply political appointees. Rather, the call is for a skilled and trained public administration whose recruitment, advancement and retention is based on their performance in meeting the programs and policies of the council. Germany is somewhat

unique among the countries examined in having the more formalized training programs for local bureaucrats but also for permitting the local authorities the least control over that staff in lacking the authority to dismiss.

Local autonomy also contributes to effective performance. Management autonomy or flexibility in the local approaches to problem solving is the main focus here. Generally speaking, local governments among these countries have considerable flexibility in determining how to solve local problems. While many do not have general competence powers, may be bound by the strings of conditional grants in some programs, and may be constrained in their revenue sources, there is still reasonable flexibility, if not autonomy, in addressing issues. This is not to argue that, in cases some relaxation of restrictions might be helpful. Appropriate independence not only enables accommodation to local circumstances but also encourages innovation.

Local governments in the five countries are primarily responsible to their citizen-voters. The organization of elections, councillor representation (e.g., wards versus at large), terms of office, number of representatives, etc. varies substantially and there are wide-ranging views of the pros and cons of the numerous alternatives but the elected representative system is common and vital. Senior governments typically, at least within guidelines, provide the basis for the representative structure. Public participation in local government goes well beyond elections. Hosts of citizen groups and interest groups with varying degrees of formal organization plus concerned individuals serve to monitor, evaluate, advocate, reveal preferences, etc. and, thus provide input into and influence the political processes and decision making. Information is, of course, important to the roles of voters and citizen groups.

LESSONS AND CONCLUSIONS

This review of local governments focussing on regional-local government fiscal relations affords a number of lessons. The inspection of local government situations in Australia, Canada, the United States, Germany and Denmark is valuable in that there is a great diversity in arrangements but all rank relatively

Table 2
Local Government Revenues, Selected Countries, 1998^a
(Percentage Distribution and Amount)

	Australia	Canada	Denmark	Germany (1996)	United States
Total Tax	44.8	43.2	50.9	30.6	38.9
- income and profit	---	---	47.7	23.9	2.4
- property	44.8	40.3	3.2	6.4	28.4
- goods and services	---	0.0 ^b	0.0 ^b	0.3	8.1
- other taxes	---	2.8	---	0.1	---
Non Tax Income	32.6	17.5	8.1	32.8	23.9
- enterprise and property	3.0	2.9	1.2	3.4	10.8
- fees, sales, fines	24.3	13.9	5.8	24.7	11.7
- other non tax	5.3	0.7	1.1	4.7	1.4
Capital Revenue	6.2	---	0.7	4.2	0.1
Grants	16.4	39.3	40.3	32.5	37.0
Total Revenue					
- percent ^c	100.0	100.0	100.0	100.0	100.0
- millions (domestic currency)	12,572	73,049	361,943	321,240	774,290
- as % of consolidated gov't revenue	5.9	17.9	54.3	18.8	25.0
- as % of GDP	2.1	8.0	31.1	8.9	9.0
Other Government Expenditure as a % of GDP					
- local	1.8	5.0	18.6	6.1	5.7
- state	10.1	18.6	---	10.1	9.4
- federal/central	23.9	21.5	38.6	31.6	21.1
- total government	35.8	45.1	59.8	47.7	36.1

Source: Calculated from data in the Government Finance Statistics Yearbook, (Washington, D.C.: International Monetary Fund, 2001).

Notes: a) Except Germany which is for 1996.

b) Negligible amounts.

c) May not sum to 100.0 due to rounding.

Table 3
Australian Local Government Revenue, Expenditure and Grants, 1999-2000

Revenue	Millions	Percentage			
Taxation	6,001	37.2			
Sale of Goods and Services	5,143	31.9			
Interest	406	2.5			
Grants and Subsidies	2,050	12.7			
Other Revenue	2,529	15.7			
Total Revenue	\$16,129	100.0			

Expenditures	Supporting Grants				
	Millions	Percentage	Commonwealth and State Grants Millions	Commonwealth Specific Purpose Grants (2000-01) Millions	Total Amounts as % of Expenditure Millions
General	2,588	17.4	20	---	7.7
Public Order and Safety	281	1.9	65	---	23.1
Education, Health and Welfare	1,051	7.1	16	68.1	8.0
Housing and Community Amenities	3,390	22.8	900	---	26.5
Recreation and Culture	1,938	13.1	128	---	6.6
Transport and Communication	4,378	29.5	549	39.7	13.4
Other	1,212	8.1	782	3.7	19.9
Total Expenditure	\$14,838	100.0	\$2,460	\$111.4	17.3

Source: Australia, National Office of Local Government (2001, Ch 2)

Table 4
Revenues of Canadian Municipal Governments and School Boards, 1998

	Municipal Governments	School Boards
Property Taxes	56.7	21.8
Other Taxes	1.2	---
User Fees	20.7	3.1
Investment Income	4.9	0.1
Other	1.1	0.1
Total Own-Source Revenue	84.6	25.1
Unconditional Grants	2.9	---
Conditional Grants	12.4	74.9
- provincial	11.8	74.7
- federal	0.7	0.2
Total Revenue		
- percent	100.0	100.0

Table 5
Revenues of School Districts and General Purpose Local Governments
in the United States, 1998 (Percent)

School Districts (1997-98)	General Purpose Local Governments (1998)
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Appended Table (Table 7)
Relative Government Expenditures for Selected Countries, 1993

Expenditure by Level (%)						
	Central	State / Provincial	Local	Government Expenditure as % of GDP	Local Government Expenditure as % of GDP	Percentage of Local Government Outlay Funded by Transfers
Total General Government						
Australia (1993)	51.1	42.6	6.4	41.2	2.6	18.6
Canada (1991)	40.8	40.4	18.9	50.8	9.6	43.3
Denmark (1992)	46.0	---	54.0	60.9	32.9	42.7
France	81.3	---	18.7	53.7	10.1	34.7
Germany (1991)	61.3	21.4	17.4	45.4	7.9	27.0
Netherlands	69.8	---	30.2	57.8	17.5	69.2
United Kingdom	72.6	---	27.4	45.6	12.5	73.2
United States	55.9	19.9	24.2	36.2	8.8	39.3
EU - Average	66.2	21.4	29.5	52.7	16.2	49.4
Average	61.0	31.1	24.7	49.0	12.7	43.5
Education						
Australia (1989)	9.8	90.0	0.2	4.6	0.0	60.6
Canada (1991)	4.4	33.7	61.9	6.3	3.9	67.4
Denmark (1992)	54.1	---	45.9	7.7	3.5	8.8
Germany (1991)	1.9	75.1	23.0	3.2	0.7	13.0
United Kingdom	27.3	---	72.7	5.6	4.1	8.3
United States	4.2	24.1	71.7	5.3	3.8	52.6
EU - Average	27.7	75.1	47.2	5.5	2.8	10.0
Average	16.9	55.8	45.9	5.4	2.7	35.1
Health						
Australia (1989)	41.7	57.5	0.9	5.2	0.0	2.5
Canada (1991)	2.0	90.3	7.7	7.2	0.6	46.3
Denmark (1992)	8.1	---	92.0	5.4	5.0	0.6
Germany (1991)	71.8	13.3	14.9	6.9	1.0	3.8
Netherlands	93.6	---	6.4	7.8	0.5	8.3
United Kingdom	100.0	---	0.0	5.8	0.0	---
United States	46.4	40.1	13.6	5.7	0.8	16.9
EU - Average	68.4	13.3	28.3	6.5	1.6	4.2
Average	51.9	50.3	19.3	6.3	1.1	13.1

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references include Ahmad (1997), Bird and Vaillancourt (1998) and Ter-Merassian (1997).

15. In Canada, the extension of natural person powers of local government across more provinces should facilitate and extend local governments' options.
16. For some further discussion specific to local infrastructure finance, see Ter-Minassian and Craig in Ter-Minassian (1997) and von Hagen et al. (2000).