Financial autonomy of local and regional government: recent developments in the Netherlands

Dr. Hans de Groot
The Netherlands Court of Audit

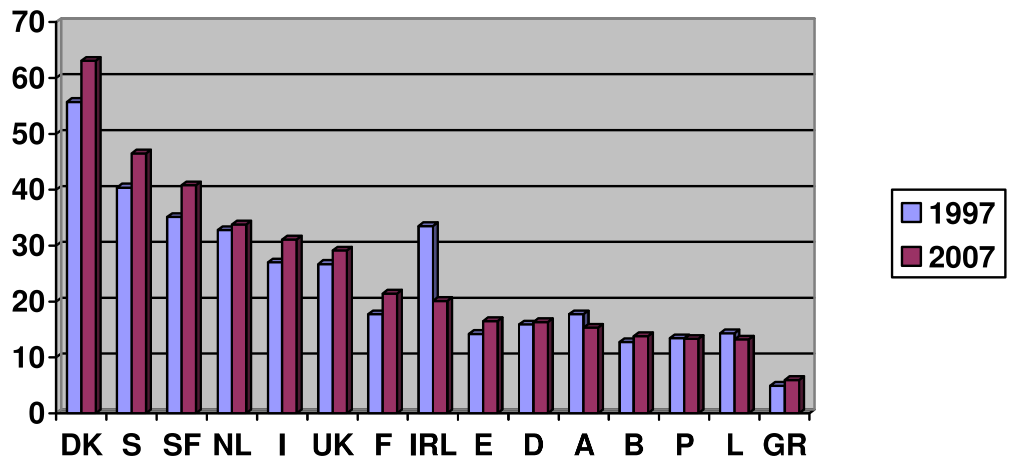
Paper for the conference:
Innovation for Good Local and Regional Governance - A European Challenge
Enschede, the Netherlands, 2-3 April 2009

Abstract
In line with current recommendations of the Council of Europe and already for more than two decades it has been the official policy of the Dutch central government to encourage the financial autonomy of local and regional government (municipalities and provinces). Among others, instruments of this policy are the decentralisation of public services and the reduction of earmarked grants to subnational government. This paper takes a critical look at the actual outcomes of the policy, also discussing recent challenges posed by the world-wide credit crunch and economic downturn.

Introduction
One of the cornerstones which determine the activities of the Council of Europe (COE) is the European Charter of Local Self-Government (COE, 1985). It was adopted as an international treaty on 15 October 1985 and ratified by a large majority of its member states. Article 9 stipulates that 'local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers'. European ministers, in particular those responsible for relations with local and regional government, have reconfirmed these principles time and again and translated them into recommendations for action by both central and local authorities. As a recommendation in 2005 succinctly summarizes: 'local self-government implies a degree of financial autonomy' (COE, 2005). Interesting research work sponsored by the COE has been done to identify and promote a preferred structure of financing local and regional governments, generally consisting of a mix of local taxes, general and specific grants. The findings of the study Local finance in Europe (COE, 1997) in our view still form a useful baseline for discussions on local and regional finance.
It emphasizes the need for local taxes to enable local (or regional) authorities to weigh the benefits and costs of local (or regional) public services. It also recognizes the need for transfers from central government, as nation-wide preferences often require public services that should be equally accessible in poor and rich local communities. Equalization transfers from central to local government in the form of an unconditional general grant are an instrument to compensate for local differences in income and wealth, without interfering with local preferences for public services. However, in many nations it is also accepted that for certain public services – for instance welfare or unemployment benefits – standardized levels of service are imposed independent of local preferences and wealth. This can be solved by introducing specific, earmarked grants from central government to local government, or, alternatively, decentralized units of central government that provide those services. Of course, external effects of local public services – for instance a local road that also serves non-local users – are a

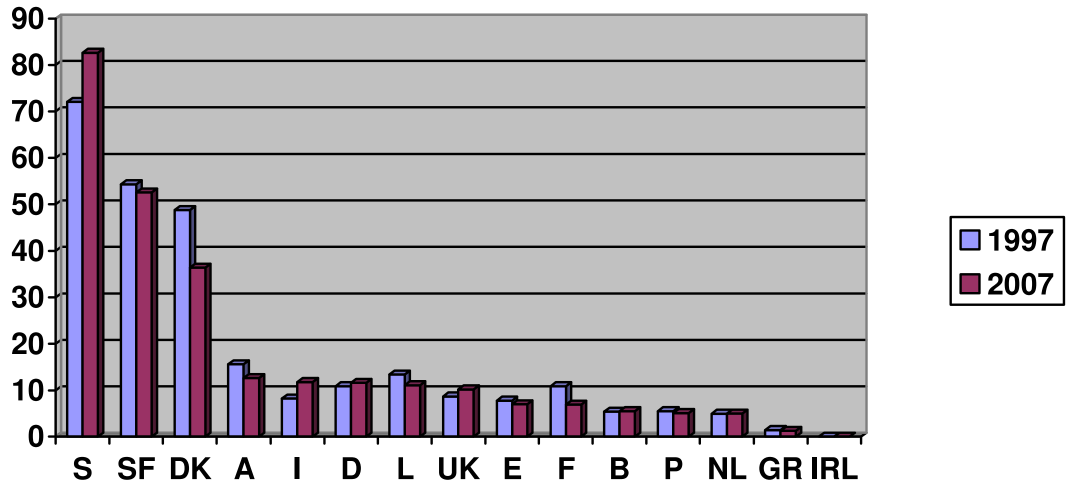
classical argument from public finance for interference from regional or central authorities in terms of regulation or financial incentives.
Some idea of the relative importance of local government in the European Union within the public sector can be derived from the share of local expenditures in total or general government expenditures. General government includes central government, state government, local government and social security funds. Figure 1 gives this share for the first 15 EU-members for the years 1997 and 2007 (source: Eurostat, 2009a). The median share for this group of countries in 2007 is around 18 percent. Denmark, Sweden and Finland show the largest shares (for Denmark as high as 63 percent) followed by the Netherlands, Italy, the United Kingdom and France. Note that Denmark and Sweden spend social security expenditures mostly through local government, where other countries usually have centralized public funds to do that. Between 1997 and 2007 the average local expenditure share increased slightly, in particular as a result of relatively increasing local expenditures in the Scandinavian countries. Ireland is an exception with a substantial relative decrease of local public expenditures.

Figure 1: Share of local government in total government expenditures for EU15



Note that the relative size of local government in terms of expenditures does not necessarily correlate with the relative size of local government in terms of tax revenues. Figure 2 shows the share of local taxes in total government taxes on income and wealth for 1997 and 2007 (source: Eurostat 2009b). In this case the median share for the EU15 countries is around 10 percent. Again Denmark, Sweden and Finland show the highest shares, but for the rest of the EU15 there are remarkable differences with the ranking based on the share of local government expenditures in total government expenditures. Except for the Scandinavian countries and Italy, which have both relatively high local expenditures ánd relatively high local taxes, many countries change places when comparing both rankings. A rather extreme example is the Netherlands. It has the fourth largest share measured in local versus total government expenditures, but the third smallest share in terms of local versus total taxes.

Figure 2: Share of local taxes in total direct taxes for EU15



Local finance in the Netherlands

Financial relations in the Netherlands – often characterised as a decentralised unitary state - between central government and its 12 provinces and more than 400 municipalities are embedded in the basic structure of three politically independent layers of government. Central government is controlled by the two chambers of the national parliament (Eerste en Tweede Kamer), provinces are controlled by provincial councils (Provinciale Staten) and municipalities by municipal councils (Gemeenteraden). Typical for Dutch public finances are a relatively large local government – as measured by expenditure levels relative to the total public sector – but at the same time very limited local or regional taxes, as already shown in the previous paragraph.

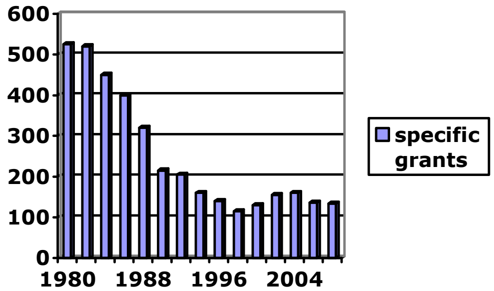
Effectively therefore, most of local and regional government revenue in the Netherlands derives from central government grants. Two types of grants are typically distinguished. The first type is that of the unconditional (or general) grant, the second type is that of the conditional (or earmarked or specific) grant. Unconditional grants are the robust backbone of local and regional revenues. Through a sophisticated allocation formula money is distributed over municipalities and provinces. In the case of municipalities, a system with about 60 parameters has been set up, based on objective indicators of the recipient's need for a basic package of public services, as well as its ability to generate local tax revenue. Examples of indicators are the size of the population, differentiated in terms of age, income and occupational status, as well as population density and area size. Tax capacity is measured by the sum of local property values. Periodically the system is adjusted to observed changes in volume and price of local public services actually provided. A similar, but simpler system is used for unconditional grants to provinces. They have a different tax base, proportional to the national motorvehicle tax. The unconditional grants can be spent at the discretion of local or regional authorities, and has to be accounted for only towards local or regional representative bodies. The conditional grant is another story. In that case central government has specific goals it wants to achieve through the grant. As a consequence, the money has to be spent according to the conditions imposed by central government. Accountability is required not only with respect to local representative bodies, but also towards central government. A large flow of information, both financial and non-financial,

between local or regional government and central government is the result. Typical examples of specific grants to municipalities in the Netherlands are welfare benefits for unemployed and poor citizens and grants to primary schools, supplied through the municipalities. Specific grants to provinces are used, among others, to support regional public transport and environmental protection.
For municipalities unconditional grants accounted for 44 percent of total revenues in 2007, conditional grants accounted for 36 percent and other income including minor local taxes accounted for 20 percent. For provinces, unconditional grants accounted for 23 percent of total revenues in 2007, conditional grants for 52 percent and other income including minor regional taxes for 25 percent (Allers et al, 2008).

Principles and practices

Already more than two decades central government stipulates a preferred policy mix when new local public services are to be provided and financed. First preference is the use of local and regional taxes. This should ensure an optimal balance of costs and benefits of locally provided and consumed public services. When equity reasons prohibit the use of the tax instrument – for instance when services should be available largely independent of the level of local income and wealth – the use of unconditional grants is the preferred instrument. Finally, when central government has very specific objectives it wants to achieve, the preferred financing policy would be the transfer of specific grants. In that case local spending of the grant should be accounted for both towards local authorities and central government. Generally, conditions with respect to the level and quality of services, maximum costs per unit and user contributions are tied to specific grants. Monitoring by central government of the outputs and outcomes of the programs financed by such grants is also a regular requirement. The Netherlands Court of Audit recommended in a recent performance audit that the reasons for choosing a particular type of grant should be made explicit and part of the political debate (Tweede Kamer, 2006). This audit showed that in practice that type of information is often lacking.
As a consequence of the preferred policy mix described before subsequent Dutch cabinets have formulated ambitions to reduce the number of specific grants in favor of general, unconditional grants or taxes. Indeed, between 1980 and 2000 the number of specific grants (more precisely: the number of different types of specific grants) has been reduced from about 500 to 100, with some increase in more recent years (Figure 3; source: Ministerie van Binnenlandse Zaken en Koninkrijksrelaties, 2007). In money terms, the reduction has been far less spectacular. Between 1980 and 2007 it can be estimated as a 40 percent reduction, from 25 billion euro in 1980 to about 16 billion euro in 2007 in constant prices of 2007 (Allers et al, 2008).

Figure 3 : Number of specific grants 1980-2007



The current cabinet has the ambition to reduce the number of specific grants with another 50 percent. Actually, a reduction of more than 70 percent is planned, from 134 specific grants to 37 in 2012 (Ministerie van BZK, 2008). This would imply that the cabinet ambition would be more than met. Again, in money terms the reduction is only 15 percent to a level of about 14 billion euro in 2012. In particular, large specific grants for welfare benefits, reintegration of unemployed and primary education will continue to exist.

Recent developments
It would be tempting to conclude from the foregoing paragraph that the financial autonomy of local and regional government in the Netherlands is steadily growing. On a closer look, this conclusion has to be challenged, in particular given some recent developments. In the first place, expansion of locally levied taxes seems not to be an option anymore. As recent as in 2006 the property tax for users (not owners) of municipal property has been abolished: local tax revenues decreased with more than 1 billion euro (Allers et al, 2008), almost a third of its previous level. Given the already relatively small local taxes compared with other EU-countries, this is a surprising move, albeit understandable from the apparent lack of popularity of the property tax with many voters.
Much less attention has been paid in the political debate to recent amendments of the law which governs the financial relations between central and local or regional government (Staatsblad, 2008). I will not discuss some amendments aimed at reducing the administrative burden, in particular for local government, of specific grants. These changes have broad support and, among others, amount to opening of legal possibilities to use the same documents to account for the spending of specific grants towards both central and local authorities. More fundamental changes are discussed in the next paragraph.

'Decentralization grants'
The amended law introduces a new type of grant alongside the existing unconditional grants to municipalities and provinces. The big difference is that the distribution of a decentralization grant over receiving governments is not determined by the standard distributive system – using more than 60 parameters - that aimes at providing resources for a broad package of local public services without prescribing actual service levels. It is geared towards the specific purposes of the grant and allocated to local governments, not necessarily all of them, according to specific criteria. However, as with the general grants, there is no requirement to account for the spending of the grant, as it is at least formally an unconditional grant. It should be noted that such a grant was also

possible under the previous law, however only for a limited period of time, before such a grant was embedded in the standard distributive system. Criteria to choose a decentralization grant instead of a general grant or specific grant are absent in the law. The law only reiterates the need to reduce specific grants and administrative burdens. Practical experience with this type of grant reveals, however, that – in contrast with the general grant based on the standard distributive system – central government often imposes strict conditions on local governments before they qualify. Box 1 gives a typical example of the conditions imposed before qualifying for a decentralization grant aimed at increasing the participation of citizens in local or regional cultural life. In fact, the conditions for obtaining the grant are quite similar to those for specific grants, except the lacking requirement to account for the way it is spent..

Box 1: Decentralization grant on Cultural participation

- successor of a previous specific grant
- aims to encourage participation of citizens in cultural activities
- aimed at all provincies and 35 large municipalities
- annual budget 5,8 million euro for municipalities, 8,1 million euro for provinces
- to be implemented by the national Fund for Cultural Participation (FCP)
- municipalities require a positive assessment from FCP of their plans
- municipalities promise 'to use the grant to encourage cultural participation and cooperate in the exchange of expertise, annual monitoring, evaluation and research'
- municipalities are required to submit 'a four year plan with an analysis of strengths and weaknesses, a strategic vision plus foreseen objectives and results'

Source: Septembercirculaire Gemeentefonds 2008

In 2008 and 2009 about 20 decentralization grants have been created, which otherwise possibly would have been constituted as specific grants. The financial importance of these grants is still limited: about 150 million euro, about 1 percent of the total unconditional grant to municipalities. The reason for choosing this type of grant is usually not clear. In some cases the reduction of administrative burdens or reduction of the number of specific grants is explicitly mentioned.

Assessment

From the previous paragraph it becomes clear that alongside the unconditional grants to municipalities and provincies quasi-specific grants are emerging, however without the usual accountability requirements. Superficially, this seems to indicate a win-win case for both cwentral and local government: the administrative burden for local government is reduced (no accounting information after qualifying for the grant) and central government retains some possibilities to influence – ex ante – the direction of spending of the decentralization grant. This possibly explains why the amendment of the law on financial relations between central and local government was approved by parliament without too much discussion. However, two important advisory bodies of central government were quite critical during the legislative process. Both the Financial Relations Council (Raad voor de Financiële verhoudingen) and the Council of State (Raad van State) disapproved of the creation of the new type of grant (Tweede Kamer, 2008a en 2008b). Both institutions challenge the added value of this amendment with respect to its stated objective: enlarging the discretionary financial powers of local and regional government. The Financial Relations Council even stated in a later advice on the annual budget related to the grants that the system had been fundamentally changed and actual implementation contradicted the presumed unconditional character of this type of grants (Raad voor de Financiële verhoudingen, 2008; Goethals and Kooistra, 2008). The cabinet did not respond to the arguments raised. It did, however, add a paragraph to the law, stipulating that an annual reappraisal of decentralization grants has to be carried out. This could lead to repositioning the grant as a traditional unconditional grant.

In my view, the current arrangement is sub-optimal for both central and local government. Central government and parliament loose track of the realization of national objectives and related spending. At the same time, local fine tuning of public services becomes virtually impossible given the detailed conditions that have to be fulfilled to qualify for a decentralization grant.

It should be noted that there is an importante advantage for central government by introducing this type of grant. The cabinet's ambition of a substantial reduction of specific grants would be served directly by changing specific grants into decentralization grants. It seems that reduction of administrative burdens has prevailed over the legitimate accountability needs of of central government. In this respect, the current policy deviates from the basic requirement for specific grants and other transfers: if you impose conditions on the spending of those grants or transfers, you should be able to verify compliance with these conditions.

Challenges ahead

As can be inferred from the observations above, there is some reason to be worried about the progress made on the road to local self-government, as promoted both by subsequent Dutch cabinets and in recommendations of the Council of Europe. The recent world-wide credit crunch and economic downturn most likely will add to these worries. National public finances will be stressed heavily as the result of support to the national and international banking sector on one hand, and fast rising expenditures on welfare and unemployment benefits plus other crisis measures on the other hand. Sooner or later this will affect local and regional public finances as well. In the Netherlands we already have seen some competition between central and local governments to recover assets deposited with international banks that went bankrupt. Central government asked local governments to wait with claims until negotiations on behalf of all affected governments could start, while some local governments pushed forward separately. The implementation of additional central and local public investment programs, aimed at fighting the consequences of the current crisis, also needs careful coordination between different levels of government. It should also be noted that the rules of the European Monetary Union address the *total* public sector deficit and debt, and therefore create a legitimate incentive for central government to constrain local public finances when necessary. Recent legislation in the Netherlands - already developed before the current crisis - does indeed provide for this possibility. However, flexibility in dealing with these rules at the national level, now discussed within the European Union at different places, would ask for a similar approach at the local and regional level.

Another challenge ahead in the Netherlands is the *reassessment of the system of general grants to provinces.* In recent years provinces collected substantial revenues from dividends of public utilities such as electricity producers and

distributors, traditionally owned by a number of provinces and - in some cases - municipalities. Also, increasing privatization of the European energy market generates revenues when regional governments sell their shares.
A recent report of the Financial Relations Council proposes changes in the system of general grants by taking into account these sources of revenue, and also looking more carefully at the required funds for tasks to be carried out by the provinces (Raad voor de Financiële verhoudingen, 2009). The net result would be a reduction of the level of general grants to provinces or a lowered cap on provincial tax rates plus a redistribution between provinces. The discussion, which will soon reach the political arena, once more illustrates the need for a careful discussion of the distribution of responsibilities and funds between different levels of government, while at the same time respecting local and regional financial autonomy.
To end with an optimistic note, it should be stressed that the old-fashioned but still valid arguments for promoting local self-government are also helpful in fighting recession and troubled public finances. Indeed, the possibility to adapt to the local needs and capacities of citizens in times of crisis, the creativity and flexibility to come up with taylor-made solutions to many unpredictable challenges ahead, would be the essential services that local government in liaison with other authorities could provide.

References

Allers, M.A. and A.S. Zeilstra (2008) , *Decentrale overheden*, in: Jaarboek Overheidsfinanciën 2008**,** Den Haag: Sdu.
Council of Europe (1985) *European Charter of Local Self-Government*, 15 October 1985.
Council of Europe (1997) *Local finance in Europe*.
Council of Europe (2005) *Recommendation (2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities*, 19 January 2005.
Eurostat (2009a) *Total general government expenditures by level of government.*
Eurostat (2009b) *Current taxes on income, wealth etc. by level of government*.
Goedvolk, E.A.M and G.S. Kooistra (2008), *Bestuurswetenschappen,* nr.5, pp. 93-102.
Ministerie van Binnenlandse Zaken en Koninkrijksrelaties (2007/2008), *Overzicht specifieke uitkeringen 2007/2008*.
Raad voor de Financiële verhoudingen (2008), *Advies Periodiek Onderhoudsrapport Gemeentefonds 2009.*
Raad voor de Financiële verhoudingen (2009), *Naar een herijking van de financiële verhouding tussen Rijk en provincies.*
Staatsblad (2008), nr. 312, *Wet van 3 juli 2008 tot wijziging van de Financiële-verhoudingswet en enkele andere wetten.*
Tweede Kamer (2006), vergaderjaar 2005-2006, *Beleidsvrijheid en specifieke uitkeringen*, 30498, nr. 2.
Tweede Kamer (2008a), vergaderjaar 2007-2008, *Wijziging financiële-verhoudingswet, Memorie van toelichting*, 31327, nr.3.
Tweede Kamer (2008b), vergaderjaar 2007-2008, *Wijziging financiële-verhoudingswet, Advies en nader rapport*, 31327, nr.4.