

**International Comparisons of Local Government Finance:
Propositions and Analysis**

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Introduction

This paper is intended as a summary and discussion. It is not a fully-referenced summary of all aspects of international experience with local government finance. Rather, it seeks to distil a wide range of important material into a number of key propositions.

Proposition 1: overseas experience of local government finance systems provides a wide range of constitutional arrangements, options for tax systems, equalisation arrangements, grant types, charging regimes and capital control mechanisms. Each appears to have evolved over a long period to fit the needs of a particular country.

1.1 Unlike the UK, local and regional government in overseas countries generally operates within a written constitution. These are generally conservative – inhibiting the kind of regular reform processes that have become normal in Britain. For example, while three different local taxes were used in England between 1990 and 1993, most countries have seen no such upheaval for many decades, if ever.

1.2 The Cardiff study, in common with earlier publications, shows that developed democracies can operate perfectly effectively with systems of local taxation that differ widely from the one used in England and from the similar ones operating in Wales and Scotland. In the Nordic countries, local income taxes provide local government with a buoyant and sound income base. In the United States, individual states and municipalities can select from income, sales, property and other taxes. French local government uses five or six smaller taxes. Spain, interestingly, provides an example of a country that has moved – following an escape from totalitarian government – to introduce significant fiscal decentralisation.

1.3 Equalisation grants are commonly used in European countries and Australia to ensure that local authorities are in a position to guarantee broadly similar levels of service provision from place to place (Darby et al, 2002). England, Wales and Scotland have arrangements that seek to achieve full equalisation of expenditure needs and taxable capacity. Few, if any, countries go as far as those in Britain in the pursuit of full – or near-full – equalisation. The Nordic nations approach full equalisation, while Spain, Italy, France and Germany go some way to iron out the biggest differences between authorities. But in the United States, such equalisation is very limited because service variations from place to place are accepted as the norm.

1.4 Different kinds of grant are used. General grants are a way of providing broadly unrestricted support for authorities in their provision of services: no conditions are applied to the use of the money. But many countries – including those with far greater levels of local tax autonomy than in Britain – use specific purpose or ear-marked grants in an attempt to deliver central government or upper-tier service objectives. In unitary countries, it seems governments are unwilling to forgo the opportunity to use specific or targeted grants to deliver their objectives, despite the centralising nature of such subventions. Federal countries generally use such grants to a lesser extent.

1.5 The freedom to apply user charges for services varies widely from country to country, depending on national approaches to the funding of particular services. Some accept charging for services that in others are always free at the point of delivery. Thus, while compulsory schooling appears to be universally funded from taxation, health care systems are subjected to charges in some countries that would be considered inappropriate elsewhere. Social security systems may provide partial or full payments for

the poor, allowing higher local charges and/or taxes than would otherwise be the case. Even more than local taxation, charging for local services appears to be underpinned by political and cultural factors that differ widely from place to place.

Conclusion: the extraordinary array of options made available by the study of international systems of local government finance is sometimes seen as an obstacle to deciding which tendencies and general principles might be applied in Britain. Thus, the summary of the Cardiff report outlines a number of advantages and disadvantages associated with greater levels of fiscal decentralisation. As in all political decisions, there will be trade-offs between different political needs, principles and expectations. At its simplest, international experience of local government finance system suggests the following:

- ***It is possible to achieve a greater degree of local financial autonomy than is currently the case in Britain within democracies and economies that are broadly similar***
- ***Few local government finance systems have been created as the result of a major, radical, recent reform - Spain being perhaps the best example of an exception, though even there the move from totalitarianism has no parallel in Britain. However, Britain itself has managed dramatic reform to local government finance twice within the past 15 years or so.***
- ***Reform would be possible, either as a free-standing change to local government finance, or in the context of wider constitutional changes such as a full review of local government's purpose as an element within the British democratic system.***

Proposition 2: a country's political culture and history is an essential element in explaining its contemporary local government funding arrangements

2.1 British civil servants, academics and their international colleagues have undertaken a number of comparative local government finance studies in the past 30 years – from the Layfield Committee onwards. These studies have produced a very large number of facts and data. There is, to quote one such paper, “a great deal of diversity in local government financial arrangements around the world” (Caulfield, 2000). The present Cardiff study includes the conclusion that international experiences “occur in quite different political, cultural and societal contexts and cannot simply be adopted en bloc from one country to another”.

2.2 Thus, knowing that a northern European country such as Sweden, which has a relatively small population, operates a (by international standards) large local government sector significantly funded by a local income tax can provide an example of how a system could operate differently. However, Sweden's vastly different history and culture

means a direct read-across to Britain or England is not easy. No one has proposed transferring Swedish Parliamentary and constitutional arrangements to the UK, so it would be a major task – though not impossible – to transfer that country’s local government finance system to Britain.

2.3 The possibility of taking models of government or taxation from one country to another is therefore limited by the ease (or otherwise) of fitting the concept or institution into another context (OECD, 2003). There are examples of other countries’ finance options being adopted in this country, such as Business Improvement Districts, development corporations or directly-elected executive mayors, but it is important to note that these are relatively small changes within the wider system of government. Smaller reforms such as the possibility of tax increment finance or smaller taxes linked to infrastructure developments can be easily envisaged. It is possible that a major reform – such as local income tax – could be introduced, provided this were done as a result of local decisions to “float away” from a particular starting point, that is, an existing national rate of tax. Such a freedom was granted to the Scottish Executive under the devolution legislation.

2.4 Accepting these caveats, it is possible to draw wider implications from the systems of local government finance used in a number of countries overseas. Regardless of political, cultural and societal contexts, it is clear that a number of key inferences can be drawn from an analysis of overseas systems of local government finance. These inferences include:

- Developed democracies can often operate with systems of local government finance that fund a bigger range of devolved services than those currently run by British or English local authorities;
- It is unique for local government systems to rely upon a single local tax, particularly one that lacks buoyancy, is highly visible and mildly regressive;
- Few, if any, developed democracies attempt full equalisation of expenditure needs and taxable resources;
- Attempts to influence local government spending patterns by manipulation of special-purpose grants are common.

Conclusion: Evidence shows that it is possible to import modest public finance mechanisms from one country to another. It is also possible for countries to decide to move in the direction of greater decentralised local government finance. However, there is little evidence of transfers of whole systems of local taxation across international boundaries or of countries introducing major new local tax systems from a standing start. This is not to say that such reforms would be impossible, simply that there are currently few examples from overseas to use as models.

Proposition 3: local government finance arrangements within a country are more likely to generate political concern (or at least interest) where local taxation is a small proportion of a relatively large local government sector – because of the inevitable need for resource transfers from one level of government to another.

3.1 No other developed countries have witnessed the regular political difficulties experienced in Britain/England as a result of a widely perceived need to reform the local government finance system. There were serious “crises” affecting local government finance in the mid-1970s, the late 1980/early 1990s and, to a lesser degree, since 2003. It is hard to be sure why these intense periods of difficulty have occurred, though there is no doubt that the problems associated with local tax levels and/or increases have triggered each outbreak of concern.

3.2 The proportion of local government expenditure funded from central grants has see-sawed during the period from the mid-1960s to today, implying radically different policies from the centre over a relatively short period. For example, local taxation raised just 34 per cent of revenue income in 1975-76, yet by 1989-90 the figure was 55 per cent. Rapid changes in the extent of central support, some of which have resulted from systemic reforms, inevitably have a knock-on impact on the proportion of funding that must be raised from local taxation. For individual authorities, year-on-year changes in central funding – caused by central government decisions on changes in the formulae that govern the allocation of grant - can profoundly influence the need to raise local taxation.

3.3 In a system where local government was responsible for, say, 50 per cent of all public expenditure without commensurate local tax raising responsibility, the impact of changing levels of central support would be far greater than when the figure was, say, five per cent. Britain and, indeed, England have a medium-scale system of local government: smaller than those in the Nordic countries, but rather larger than those in countries such as France, New Zealand or Japan. Local government in the UK is equivalent to broadly 12 per cent of the whole economy, compared with over 25 per cent in some countries and below 7.5 per cent in others. However, the British system leaves a larger range of services at the local level than in federal systems like those in Australia, Germany and the United States (where a “state” level has significant responsibilities).

3.4 The fact that Britain has a medium-scale local government system, but with a relatively small local income from taxation, means there is a need for major transfers of tax income from central to local government. Figure 1 shows this phenomenon clearly. The small local tax income in relation to the much larger overall expenditure figure inevitably means that small changes in the total of such transfers will have a magnified impact on local taxation. Conversely, if local tax income were a larger share of the total

and/or if the scale of local government activity were reduced, the risks of local fiscal “crises” would be reduced.

Conclusion: as long as local taxation represents only a small proportion of local government income in a system where local government is providing a major share of public services, only a fixed link between local expenditure and the (much larger) proportion of resources provided by transfers from the centre would be likely to ensure there were not rapid and uncontrollable changes in local taxation. Such a fixed link of this kind could be seen as inflationary – unless there were a central limit on the total of local expenditure.

Proposition 4: the existence of welfare services (e.g. health, education, personal social services) among local government’s service responsibilities is more likely to generate involvement by central or other upper tiers of government, than where such services are provided by other means.

4.1 Evidence from other countries suggests that even where local taxation represents a far larger proportion of local government income than in Britain/England, it is still likely that upper tiers of government are likely to be involved in seeking to influence the detail of provision within public welfare services. In countries with developed “social” models, particularly in Europe, national governments appear concerned to ensure that particular public service standards are achieved.

4.2 Thus, governments in the Nordic countries may use specific-purpose grants in services such as health, education and social housing to influence local provision. The growth in specific-purpose or targeted grants in England does not leave the local government finance system there out of line with practice in other countries, although the rapid recent increase in the scale of such grants is unusual. In countries where welfare services are largely provided through central government, such as France or New Zealand, there is no need for extensive specific-service grants of this kind. Equally, in states where there is less concern to deliver a universal or equal set of welfare services – such as the United States – there is little upper-tier funding of this kind.

Conclusion: Targeted or specific purpose grants (and the central control they imply) appear more likely to be used in countries where “welfare” services are provided by local government and where there is an expectation of equity in the delivery of these services. It may be difficult to move away from such grants unless central government can be convinced that there will be no move away from broad equity. More awkward is the possibility that targeted and specific grants are used partly for micro-management, regardless of equity objectives.

Proposition 5: central or other upper tier financial intervention is likely where (a) there are relatively significant differences in social characteristics and/or income from place to place and (b) there are expectations of broadly similar service levels for people living in all areas.

5.1 Although British local authority units are the largest in the world in population terms, they nevertheless display very considerable differences in terms of social and demographic variations. Thus, the gap between councils with the highest levels of objectively-measured expenditure needs or deprivation and those with the lowest levels are almost certainly greater in England than in most other developed countries. Because there are no recognised ways of comparing this gap from one country to another, it is necessary to rely on an international measure that is comparable.

5.2 Differences in personal income inequality are currently measured using the so-called Gini Coefficient, published by the United Nations (UNDP, 2004). This indicator gives a broad indication of the level of personal income inequality from country to country. Thus, among the developed nations, the United States has a relatively high Gini coefficient, suggesting relatively high levels of personal income inequality. The United Kingdom, Ireland, New Zealand, Italy and Australia fall in an “upper middle” group in Gini index terms, with lower readings in France, Canada and Spain and significantly lower ones (suggesting much greater income equality) in Norway, Sweden, Belgium, Japan, Finland, Denmark and Germany.

5.3 The extent of inequality will – unless there is a very even distribution of less well-off people from authority to authority – have profound implications for efforts to equalise for authority-to-authority variations in spending needs and taxable capacity. Put simply, in a country with limited income variation (particularly if the rich and poor are mixed in each area) there will be less need for equalisation than in a country where there are wide income disparities (especially if the poor are concentrated in a number of places).

5.4 Pressures on equalisation grants will also depend on political and societal expectations about “fairness” and equity. If a country has relatively modest expectations concerning the equal availability of public services (as is certainly the case in the United States), few demands would be placed on any inter-authority equalisation arrangements. However, in a nation where any variation in public service availability is a major political issue, as appears to be true in England today, demands for full and fair equalisation will be intense. According to Professor Glen Bramley “the British system ‘fully equalises’ for differences in needs and resources, whereas in many other countries, equalisation is only partial” (Bramley, 2002).

5.5 It is, therefore, possible to see why the local government equalisation arrangements are so much more problematic in England than in any other country. Inequality is relatively significant (though it may have been reducing in recent years) while demands for public services that achieve equal outcomes have grown. Indeed, the requirement that outcomes – of schools and other public services – should as far as possible be equal means that the public services must compensate for all the differences

in background that result from the wide personal and territorial income variations that exist.

5.6 In effect, even though the British electorate do not appear to want a rapid movement to the narrower levels of income variation that exist in many other European countries, the same electorate wants public services to treat everyone precisely equally and, indeed, to achieve equal public service outcomes. Local government equalisation grants are, in part, the solution to this problem: they are supposed to provide councils with the resources that would allow them to avoid “postcode lotteries” (Boyne & Pownall, 1995)

5.7 Figure 2 attempts – in a stylised way – to represent this issue. It shows the UK and other countries on a chart that indicates both their Gini coefficient (a broad measure of income inequality) and the extent to which each country expects public services to deliver equal outcomes. Because there is no existing measure of different countries’ expectations of service equity, they have been arranged into four groups, on the basis of the scale of equalisation demanded by their local government grant arrangements. In these terms, countries such as Britain and Australia have relatively “high” equity demands, while the United States, unsurprisingly, scores “low”. The Nordic countries have relatively high service equity expectations, while those such as Italy and France score lower.

5.8 The table is revealing. It puts the UK alone in a corner of the chart, suggesting that the local government equalisation arrangements (and other public provision) must deal with the need to compensate councils sufficiently to provide services that can fully overcome any disadvantage caused by income and other deprivation disadvantages. In other countries, the demands on equalisation are less severe.

Conclusion: as long as local public services – particularly welfare and other redistributive services – are expected to achieve equal outcomes regardless of relatively wide income and other societal differentials, there will be significant pressure on equalisation grants. This pressure will often require central government interventions as a national response to demands for guaranteed, equal, service delivery standards. The scale of personal income and other differences in Britain and England, together with the desire for equal standards, means demands for centrally-determined equalisation will continue unless the electorate can be convinced that local variation is an inherently beneficial concept.

Proposition 6: where local government is dependent on more than one tax and where such taxes are perceived as neither regressive nor very visible, there is likely to be less difficulty with local taxation than where there is a single, visible, regressive tax

6.1 The international evidence brought together in this study suggests it is unusual for countries to rely on a single source of income. This point has been made in a number of comparative studies of local government finance. Figure 3 shows the types of different taxes in use in a number of countries, regardless of their capacity to raise resources. Some revenue sources, for example taxes on property, are less able to raise resources than others, such as taxes on income. But the clear message of most international studies is that systems of local government finance generally do not rely on a single tax.

6.2 Taxes differ substantially in their visibility and in the extent to which they bear on individuals with different levels of income. Thus, a tax which must be paid as a single sum in response to a demand from a taxing authority will be more visible than one which is deducted invisibly as part of a series of financial transactions. Equally, a tax which bears heavily on people with fixed and/or lower incomes is likely to produce a different level of tolerance from one which is borne by those with relatively higher and/or buoyant incomes. The perceptibility of year-on-year tax rate changes will also affect tax tolerance, as will the overall size of the yield and the extent to which other taxes are in use. In addition to these issues (though clearly related to them), is the question of any public discourse about different taxes. If a tax is the subject of debate and criticism in politics and the media, it is less likely to be tolerated than one that is rarely discussed. Evidence bringing together the international impact of all these issues is, predictably, not easy to find.

6.3 Figure 4 presents a simplified, partly judgemental, comparison of a number of taxes currently in use in the UK, plus a number that are used overseas. The scoring is based on an analysis of each tax based on the current yield, method of collection, size of yield and so on. It is immediately clear that taxes which score heavily in terms of the criteria used in the chart are likely to be those whose legitimacy is challenged. Council tax scores very heavily because of its method of payment, its impact in relation to incomes and the visibility of rate changes. On the basis of such an analysis, many taxes used in other countries are likely to be more easily tolerated.

Conclusion: basing British local government finance on a single, visible, mildly regressive tax has produced a significant degree of controversy. Other countries tend to use more than one tax and do not rely as heavily as Britain on a single, domestic, property tax. So long as there is just one tax of this kind, it is unlikely this controversy will abate. Reducing the level of council tax, introducing more local taxes or making council tax less visible and/or regressive would be likely to reduce the awkwardness of the tax

Proposition 7: tax competition between local authorities has both negative and positive consequences

7.1 Tax competition between local authorities has not been an important issue in Britain or England in recent years, largely because local taxation constitutes a very small

proportion – around four per cent – of all taxes paid. The question of whether or not local tax variations might distort businesses’ choice of location in England was debated in the late 1980s, notably in the context of varying non-domestic rate burdens in neighbouring authorities. Although the evidence base was weak, the government of the day used the risk of such distortions as one of its justifications for moving to the national non-domestic rate in 1990 (Department of the Environment, 1986, following University of Cambridge, 1985).

7.2 International literature of the kind summarised in the Cardiff report shows that “The potential mobility of the tax base across sub-national jurisdictional boundaries can encourage regional and local government to compete actively to attract individuals and/or businesses from other jurisdictions”. There are a number of potential distorting impacts of local taxation, including the under-provision of public goods and the possibility that costs and benefits from one area will spill over into others. The key issue that determines the extent of these difficulties seems to be the degree of competition.

7.3 Equalisation grants will significantly affect the differences in tax rates (and possibly the taxes used) from place to place. If there is full or near-full equalisation of tax capacity and/or expenditure needs, there are likely to be narrower differences between authorities in their rates of tax – and thus less fierce competition. No equalisation would lead to very wide variations in tax rates and, almost inevitably, to significant distortions. Depending on the extent of their taxation and expenditure responsibilities, higher levels of authority (for example, city-wide or region-wide authorities) will generally lead to more automatic tax equalisation across areas within their jurisdiction.

7.4 If a larger proportion of the existing system of local government were to be funded by local taxation, there would almost certainly be greater tax competition and locational impacts. The work of Charles Tiebout and many subsequent researchers has investigated such issues in detail. On the positive side, competition might encourage authorities to behave efficiently, to keep taxation low and to provide better services for their residents and businesses. More negatively, tax competition between authorities might lead to migration, social segregation, widening tax differentials and/or the inefficient location of businesses – although central controls and levels of equalisation would impact on this.

Conclusion: tax competition is not always a bad thing. It will depend on the extent of competition and also the type of taxes used. Migration of individuals would be more likely to be affected by a local income tax than by a property tax, though differences in personal income would significantly affect this likelihood. Business might be more likely to move to low tax areas if there were variations in the level of a sales tax, so that they could take advantage of lower prices, or if there were substantial differences in other business taxation, such as a payroll tax. Although, as argued above, it proved difficult to establish that non-domestic rate variations had negative consequences caused by competition between areas. Competition between local or regional governments could be seen as an element in political choice or competition agendas.

International evidence makes it clear that tax competition would have locational consequences, although these need not be problematic.

Conclusion

The above analysis is based upon the systems that they currently operate in Britain and other countries. It would be possible to change the relationship between central and local government in England (or Wales or Scotland) so as to make reforms to local government finance more easy to envisage. There is some evidence from overseas experience that in political systems with greater degrees of trust (or a greater propensity for collaborative working) a more relaxed public finance regime can operate between tiers. If Whitehall and local authorities could evolve a stronger and less adversarial relationship concerning expenditure and local taxation, financial reform would undoubtedly be easier to implement. The experience of central-local relations in recent years needs to be left behind to achieve this.

Another unusual feature of British or English local government which has been referred to in this paper is the degree of equalisation and the consequent lack of inter-authority tax competition that is an accidental by-product of the full (or near-full) equalisation arrangements in use. Arguably, the present system of local government finance provides authorities with a number of perverse economic incentives. In designing a reformed local tax and grant mechanisms in England, there would be powerful arguments for the Treasury ensuring that authorities faced rational incentives. For example, councils should have at least some financial encouragement to build up their local tax base and/or to attract new businesses to the area. At present, such incentives are wholly absent from the local government finance system.

Because of the visibility of local government taxation and its recent political importance in Britain, there is likely to be popular pressure to avoid or minimise reform. But as this wider study of international experience has demonstrated, healthy local government finance is a key element in the democratic and constitutional arrangements in virtually all developed democracies. Some commentators would like a one-off revolution. Others would prefer an incremental approach to change. The importance of a firm and effective system of funding for local government cannot be in doubt.

References:

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UNDP (United National Development Programme) (2004), *Cultural liberty in today's diverse world*, Table 14

University of Cambridge (1985) *The Effect of Rates on the Location of Employment*, by Paul Crawford, Stephen Fothergill and Sarah Monk, Department of Land Economy, University of Cambridge

Figure 1 Sub-national expenditure and sub-national taxation as % of GDP

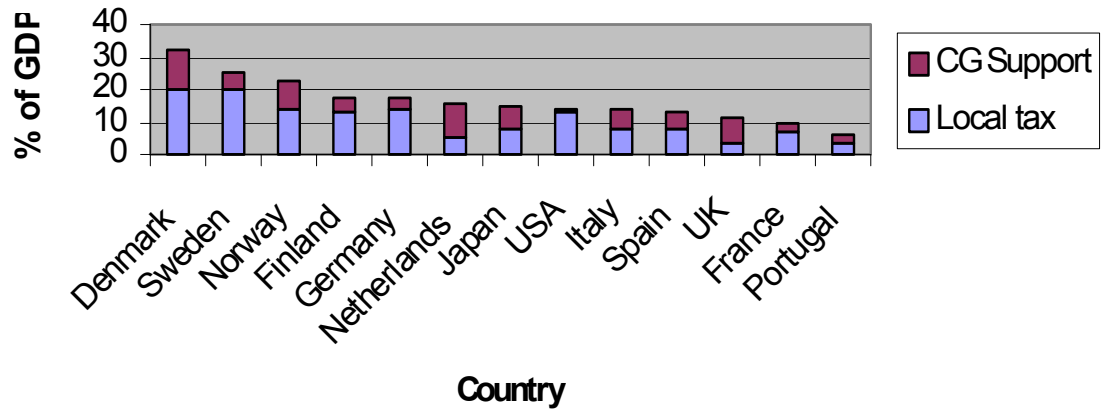


Figure 2
Demands for equalisation/equity vs personal income inequality

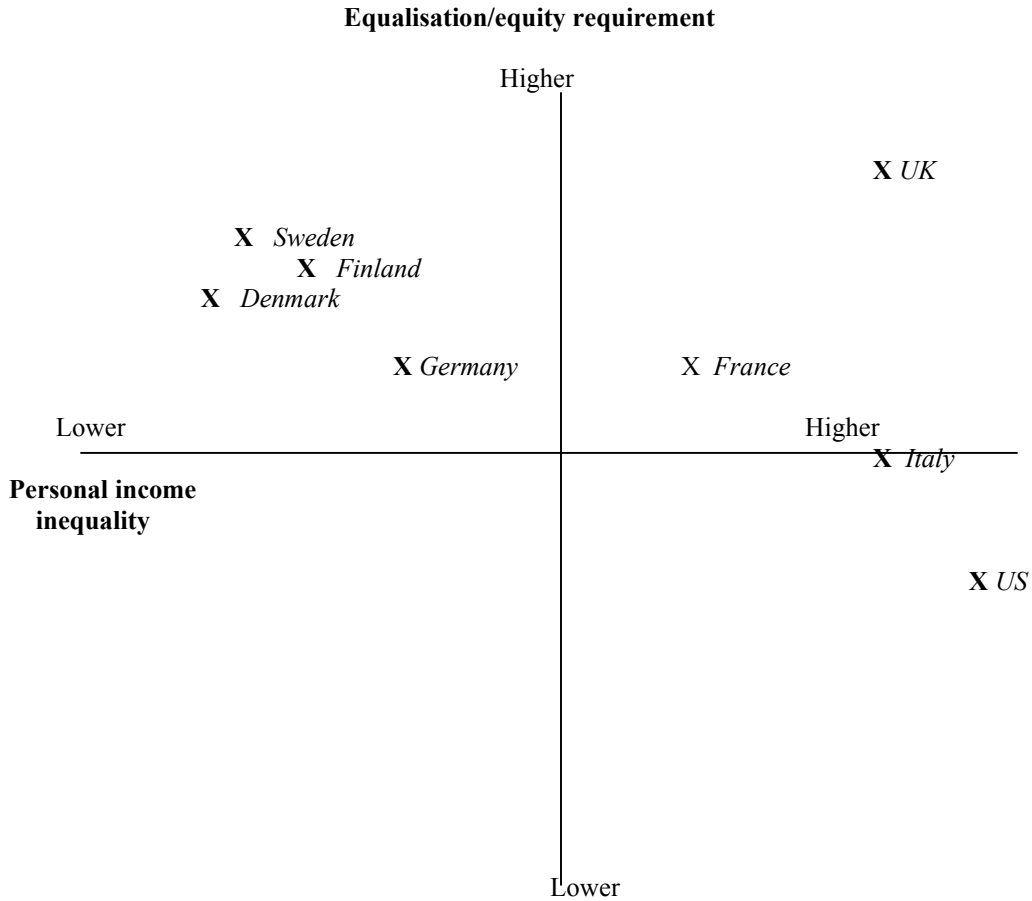


Figure 3
Types of tax in use at state/local level, various countries

One tax
 Sweden
 United Kingdom

Two taxes
 Denmark

Finland
Netherlands

Three or more taxes

France
Germany
Italy
Portugal
Japan
Spain
United States

Note: The above shows the number of different taxes in use, regardless of the revenue generated by them or as a proportion of all sub-national income

Source: “Tax Revenues by Subsectors of General Government 1975, 1985 and 2002”, Chart 6, *OECD Revenue Statistics 1965-2003*, Paris:OECD

Figure 4 **Tax “tolerance”**

	Scale of yield	Perceptibility	Frequency of rate changes	Regressive?	Political salience
<u>United Kingdom</u>					
Council tax	**	*****	*****	****	*****
NNDR	**	***	*****		**
Income Tax	*****	*	*		*
National Insurance	***	**	**	**	*
Value Added Tax	***		*	**	*
Fuel Duty	**	***	***	***	*****

Stamp Duty	*	***	***	*	***
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Sweden, Denmark, Finland

- local

Local Income tax	*****	**	*		**
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United States

- state and local, varies

Local Sales Tax	***	*****	**	***	**
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France

- regions

Vehicle registration tax	*	***	**	***	
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Netherlands

- local

Tourist tax	*	***	**		*
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Note: "Star" score based on estimates of importance, size or salience of the particular attribute for each tax, The larger the number of stars, the greater the importance.