FISCAL DECENTRALIZATION AND FISCAL AUTONOMY IN THE EU MEMBER STATES

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In the process of fiscal decentralization sub-central governments have gained access to different fiscal resources, but the autonomy in setting the taxes is a key issue when analyzing the degree of decentralization. In this paper we calculated an index of tax autonomy for the EU Member States based on the OECD methodology of classification of sub-central taxes according to the degree of control over these taxes. We have shown that the design of intergovernmental fiscal relations is significantly different among the Member States, and taking into consideration the discretion over sub-national taxes provides a valuable insight on the fiscal decentralization design.

Keywords: fiscal decentralization, tax autonomy, intergovernmental fiscal relations

JEL codes: H71, H77.

Introduction

When analyzing the degree of decentralization we must take into account two important aspects. First, it must be identified the division of responsibilities and resources between different levels of government. The degree of fiscal decentralization is, thus, determined by the volume and importance of responsibilities and revenue assigned to subnational governments. Second aspect, refers to distribution of decision-making powers, i.e., the degree to which decisions to collect and allocate public resources are decentralized. A state in which local authorities have a real autonomy in allocating their expenditure and collecting revenue is more decentralized than another state where local revenue and expenditure are set centrally, although the vertical distribution of public expenditure and revenue is identical in the two states (Stegărescu, 2005: 304).

The indicator most widely used in literature to measure the degree of fiscal decentralization is the share of local expenditure or revenue in total government expenditure, or, respectively, in consolidated general government revenue. Although it is an imperfect indicator of the degree of decentralization, in order to have a standard variable, calculated on the basis of uniform definitions among states, it is used in most studies on the causes and effects of fiscal decentralization (Ebel and Yilmaz, 2002). This indicator's major advantage is, on the one hand, the availability of statistical data, and, on the other hand, the comparability of the results.

An important limit of this indicator refers to the impossibility of determining the vertical structure of decision-making powers. It shows only the revenue and expenditure of subnational authorities, without providing any information on the decision regarding taxation and spending by destinations. Thus, there are many situations where some public spending is performed locally, but the expenditure destination is predetermined by the central government, and they appear in statistical data as expenditure of local government. Also, statistical data do not provide qualitative information on the nature of revenue included in local budgets, because they make no distinction between conditional and unconditional grants, or between tax levies independently

determined and imposed by national legislation. In the analysis of intergovernmental grants, is equally important the distinction between those allocated on the basis of objective criteria using allocation formulas, and those allocated on a discretionary basis.
For these reasons, the share of revenue or expenditures of local budgets in general consolidated budget revenue or expenditure tends to overestimate the degree of fiscal decentralization. Thus, to capture more accurately the degree of decentralization, numerous studies over time have been introduced also non-fiscal variables. For example, Treisman (2002) in order to measure fiscal decentralization has used, along with fiscal variables, a number other variables such as: the number of levels of government, election decentralization or even the share of local public employees in total government employees. Arzaghi and Henderson (2005) have built a decentralization index based on nine variables, including: the vertical structure of government, requirement that local or regional representatives are elected democratically, autonomy in setting local taxes or the ratio between conditional and unconditional transfers.
In this framework, since the share of local revenue and expenditure in total public revenue and expenditure tends to overestimate the degree of fiscal decentralization, in order to have a more accurate descriptor a more detailed analysis of the structure of local tax revenue is necessary.

OECD methodology for classification of tax revenues

In the fiscal decentralization literature there have been several studies that have attempted to quantify the degree of fiscal autonomy of sub-central governments (Pola, 1999; Blankart, 2000; Stegărescu, 2005). Among them is the most detailed study is the one made by the Organization for Economic Co-operation and Development, *Taxing Powers of State and Local Government*, which provided a methodological framework for classification of sub-central taxes according to the degree of autonomy in their determination.
The concept of “tax autonomy” captures various aspects of freedom sub-central governments have over their own taxes. It encompasses issues like sub-central government’s right to introduce or to abolish a tax, to set tax rates, to define the tax base, or to grant tax reliefs. In a number of states taxes are not assigned to one specific level of government but shared between the central and local governments. Such tax sharing measures deny a single local government any control on tax rates and bases, but collectively local authorities may negotiate the sharing formula with central government. Thus, to classify the sub-central tax levies according to the degree of autonomy over them, must be taken into consideration: the powers conferred by law to local authorities to set tax rates, to evaluate the tax bases and to administrate the tax revenue.
Assuming that only taxes that can be set independently and on which local authorities have legislative powers ensure real fiscal autonomy, tax revenues are classified into five categories depending on the degree of control over them. Categories are ranked in decreasing order from highest to lowest taxing power. Category (a) represents full power over tax rates and bases, (b) power over tax rates, (c) power over the tax base, (d) tax sharing arrangements, and (e) no power on rates and bases at all. In order to capture the more refined institutional details the (d) category was further divided into four subcategories to illustrate the many different rules for governments to determine and change their own share.
Local or regional authorities have greater autonomy on revenue included in categories (a) to (d.2.) and on the other, from (d.3.) to (e) they have no control. Basically, the latter are very similar to intergovernmental grants.

Table 1 Classification of local taxes according to the degree of autonomy

(a)	SCG set the tax rate and the tax base;
(b)	SCG set the tax rate only;
(c)	SCG set the tax base only;
(d)	Tax sharing arrangements:
(d.1.)	SCG decide the revenue split;
(d.2.)	Revenue split can be changed only with the consent of SCG's;
(d.3.)	Revenue split may be changed unilaterally by a higher level government (by legislation);
(d.4.)	Revenue split may be changed unilaterally by a higher level government (determined annually by budget laws)
(e)	CG determines tax rate and tax base.

Source: OECD, Taxing Powers of State and Local Government, OECD Tax Policy Studies, nr.1, 1999, pp.11.

The study mentioned above preceded to allocation of tax revenues in each of the five categories, and then to calculate the percentage of each category in total, achieving such a detailed structure of tax revenue according to the degree of autonomy in setting them. Of course, this grouping of tax revenue does not fully reflect the degree of local financial autonomy. For example, even if local authorities can determine both the level of tax rates and the tax base, such autonomy may be restricted by law, imposing certain limits that they can choose tax rates between or some assessment criteria of the tax base and, in this case, the revenue generated by these taxes are still falling into category (a). However, we believe that this methodology for the classification of tax levies is a very useful tool to assess local autonomy.

The structure of local and regional taxes in the EU Member States

The structure of public sector internal financial relations and tax legislation differs greatly from one state to another. For this reason, it is impossible to use uniform rules for allocating tax revenues between the five categories. To ensure proper division of taxes, in addition to a detailed structure of tax revenues, also knowledge of tax law provisions in each state is necessary.

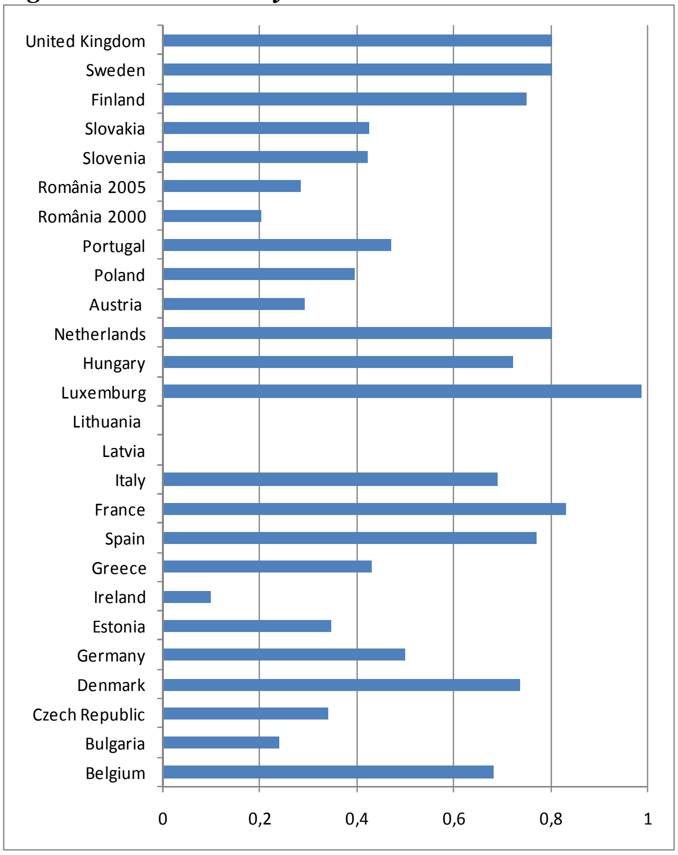
Since 1999, the Organization for Economic Co-operation and Development publishes periodically in the report entitled "*Fiscal Relations Across Government Levels*" detailed information on the structure of tax revenue in OECD member states. Thus, we used the results from its latest publication, "*The Fiscal Autonomy of Sub-Central Governments: An Update*", 2009, for Member States of the European Union. The latest revenue structure, extracted from the mentioned report, is that for the year 2005. For countries that are not part of the OECD, we have taken information from an earlier report, "*Fiscal Decentralization in EU Applicant States and Selected EU Member States*". It was completed to evaluate the status of fiscal decentralization in states that joined the European Union after 2004.

To ensure comparability of results achieved in the case of Romania, with EU Member States we calculated the structure of tax revenue for 2005 and 2000 to show their evolution. Thus, we classified each type of tax in one of five categories, then, using data on local budgets from the Statistical Yearbook of 2007, we calculated the percentage of each category in total.

The tax autonomy index

Using the calculated structure of tax revenue we built an index of tax autonomy for the EU Member States. The index's values indicate the degree of local and regional governments control over their own tax revenues, ranging from 1, signifying a complete autonomy in determining local taxes, and 0, no control over taxes, i.e. all taxes are set by the central government. In this setting, we multiplied the shares of each taxes that fall in the (a) category with 1.00, (b) with 0.8, then, categories (c) to (e) with 0.7, 0.6, 0.5, 0.3, 0.2, 0, and, respectively, 0.1. For federal states we calculated an average of indices obtained at regional and local level, weighted by the tax revenue volume raised by these two levels of government.

Figure 1 Tax autonomy index in the EU Member States

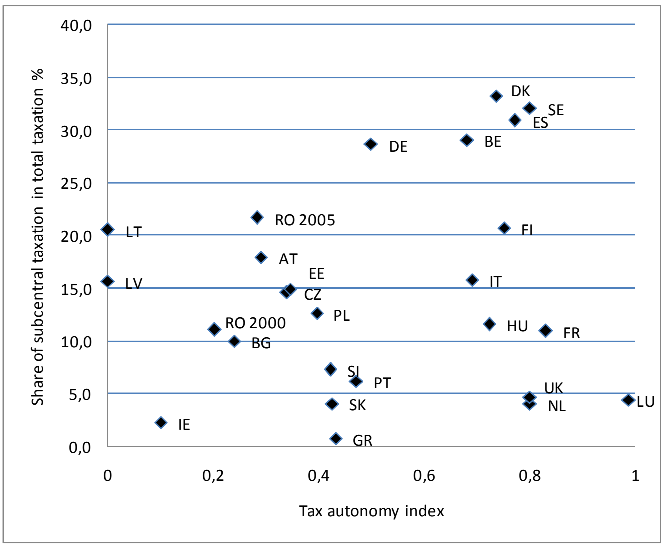


As shown in Figure 1, there are significant differences in terms of fiscal autonomy of local and regional governments in the EU Member States. In Lithuania and Latvia all local taxes are determined by the central level, while in Luxembourg, local authorities enjoy almost complete freedom to set taxes. In this state 98.5% of local tax revenues are in category (a), local authorities having exclusive competence to determine tax rates and tax bases. Other states where local authorities have greater control over local taxes are France, Britain, Netherlands and Sweden.

In Romania, the index increased from 0.2022 in the year 2000 to a value of 0.2825 in 2005. The most important factor contributing to this change is represented by changing the methodology for determining the share of splitting the income tax, which in 2000 could be modified through the annual state budget law, and in 2005 they had a fixed level, established by legislation (Local Public Finance Act).

In Figure 2 we grouped the EU Member States both in relation to the importance of subnational taxes and on the basis of tax autonomy. Tax revenues of local budgets include, in this case, also revenue from tax sharing arrangements. Their distribution by level of government is taken from the Eurostat report, *Taxation Trends in the European Union, 2009 edition*.

Figure 2 Tax autonomy index and the importance of sub-central tax revenues



Thus, we can group the Member States in four categories:

- states where local governments receive a large share of total taxation and have high autonomy in terms of their determination, such as: Sweden, Denmark, Spain, Belgium, Germany and Finland;
- states with a high volume of tax revenue available to subnational governments, but they have limited powers in setting those taxes, like: Lithuania, Austria and Romania;
- states where local authorities have significant powers to set taxes, but their tax revenues are modest, such as Luxembourg, Netherlands, Britain, France and Hungary;
- states where subnational governments have only a small share of total tax revenue and also have limited decision making power to determine them, such as Greece, Ireland, Bulgaria, Slovenia and Slovakia.

Conclusions

Fiscal decentralization tendencies are obvious in the majority of EU Member States in the recent years, and, thus, increasing subnational governments' responsibilities requires more tax revenue at this level. But since traditional local taxes (property taxes, user charges) are insufficient to meet the requirements, many subcentral governments rely heavily on various tax sharing arrangements and intergovernmental grants. In this setting, fiscal decentralization literature shows that the common measures of fiscal decentralization, i.e. the share of local expenditures and revenues, clearly tend to overestimate the degree of fiscal decentralization.

We have shown that regional and local governments in the EU have little discretion over their own taxes. Typically, in the old EU Member States subnational governments have superior control over their own taxes. In the federal states such as Belgium and Germany the local governments have greater autonomy in setting taxes than regional governments, while in Spain and Austria regional authorities enjoy greater taxing powers.

The correlation between different measures of decentralization is weak. For instance, some states with high share of local taxes permit only little discretion over the tax rates and tax bases, while others enjoy great tax autonomy but have limited fiscal resources. Thus, the design of fiscal relations across levels of government varies greatly among EU Member States and there is no single pattern of fiscal decentralization.

Acknowledgements
This paper received financial support through the project, "*Post-Doctoral Studies in Economics: Continuous training program for elite researchers – SPODE*", funding contract No. POSDRU/89/1.5/S/61755, financed by European Social Fund, The Sectoral Operational Programme for Human Resources Development 2007-2013.

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