Financial relations council

The municipality and its finances

Introduction to the financial relations between central government and the municipalities in the Netherlands

Introduction

Every municipality in the Netherlands has a large number of statutory tasks, as well its own policy (and policy intentions). How are these tasks and policies financed? The municipal council has a right to approve and amend budgetary policy, but does it also have rights regarding funding? How does central government divide available funds among municipalities? Can it assign new tasks without funding them? What happens if the municipal budget does not balance?

All these questions relate, directly or indirectly, to the financial relations between central government and the municipalities. They are the sum of all laws, rules and administrative agreements concerning the funding of local government tasks, including the municipalities fund, the specific contributions, the municipalities' own income, and the Provinces and Municipalities (Budgets and Accounts) Decree (BBV).

In this brochure, the Financial Relations Council provides a brief description of the financial relations between central and local government and the myths and misunderstandings that surround them. You may find it useful!

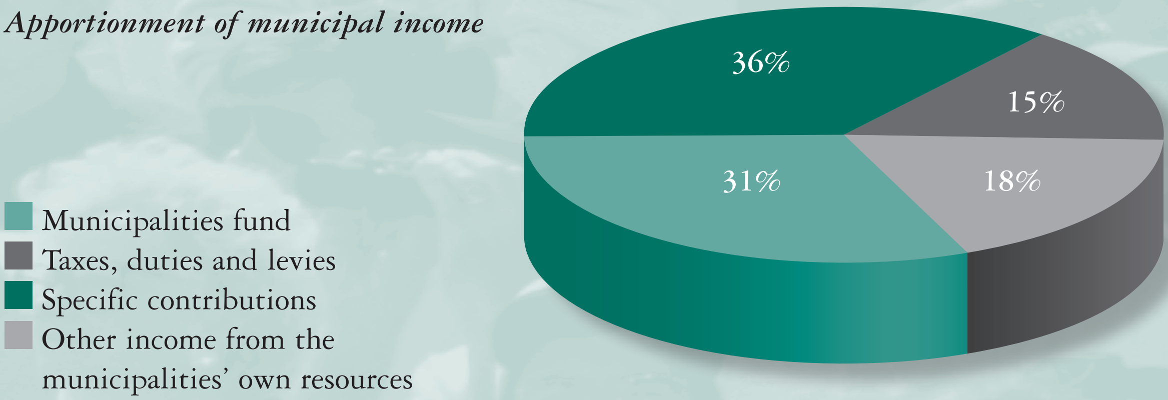
How does the municipality acquire its funding?

Municipalities obviously need money to fund all their tasks and their organisation. Roughly speaking, one-third of the municipalities' income comes from their own resources, one-third from the municipalities fund, and one-third from specific contributions. However, there are considerable differences between municipalities in this respect. In 2008, the municipalities had a total income of more than 49 billion euros. Two-thirds of this amount came from central government (municipalities fund and specific contributions). By way of comparison, the national budget in 2008 was almost 169 billion euros.

Income from the municipalities' own resources
The income that the municipalities generate from own resources consists of the revenues gained from taxes, levies and duties, and other such income.

The most important municipal ***tax*** is the municipal property tax (OZB), which is levied on house owners and owners *and* lessees of commercial property.

Apportionment of municipal income



Data source: Municipalities fund periodic maintenance report 2008, Ministry of the Interior and Kingdom Relations.

More than 78% of municipal tax revenues stems from the municipal property tax. Other municipal taxes are for example parking tax (13%) and tourist tax (3%). The municipal council sets the tax rates. It may not introduce a new tax without further ado. The Dutch Municipalities Act (*Gemeentewet*) prescribes precisely which taxes municipalities may impose; for instance, they may charge dog owners a dog licence fee, but they cannot introduce a fee for cats. The municipality is free to choose what it does with its tax revenues. It is not obliged to use income generated from the dog licence fee for its policy on dogs (although it may of course do so if it wishes).

Examples of ***duties and levies*** include the waste collection levy, the sewerage charge and administrative charges (such as building levies). The municipality also decides on the rates for duties and levies. One underlying condition is that duties and levies may be no more than cost-effective. In other words, they cannot generate a profit. They also always involve a clearly definable product, for example the collection of household waste or the granting of a building permit. That is not the case where taxes are concerned.

Other income from the municipalities' own resources includes interest, dividends from participations, profits from the municipal land agency, as well as revenues from fees. Examples of fees are library memberships or tickets for the swimming pool. The municipality is totally free to determine the fees. Fees and charges are sometimes confused. One key difference is that charges always involve a government task (e.g. issuing passports), whereas fees do not (e.g. the swimming pool ticket).

Municipalities fund

Every year, central government pays each municipality a contribution from the municipalities fund. The contribution is part of the municipalities' general resources. It is not earmarked, and municipalities are free to determine the purpose for which it will be used. The contribution is also used to finance a great many of the municipalities' statutory tasks. Although the municipalities are obviously obliged to perform those tasks, it is up to each one to decide how much money it uses for this purpose.

The aim of the system used to apportion the general contribution from the municipalities fund is to enable all municipalities to provide services of a similar level if their expenses are the same. This does not mean that there are no differences between municipalities (or that differences are not allowed). The municipalities make no attempt to impose the same taxes or to provide the same or a minimum level of service. The municipal council determines the tax rates and service levels. For instance, not every municipality needs to have a theatre or swimming pool. The apportionment system is intended only to create a level playing field at the outset.

There are also two types of contributions within the municipalities fund that the municipalities can use at their discretion, i.e. the integration contribution and the decentralisation contribution. The integration contribution involves funds that may be apportioned in another manner temporarily, but which become part of the general contribution in the course of time. In the case of a decentralisation contribution, the funds remain clearly separate on the municipalities fund budget, as it has not yet been determined whether and, if so, when they will be apportioned via the general contribution. An example of a decentralisation contribution is the Dutch Social Support Act (WMO).

Specific contributions
Unlike the contributions from the municipalities fund, the specific contributions are granted under certain conditions for a specific purpose. Examples include funds to implement the Dutch Work and Social Assistance Act (WWB) and the Sheltered Employment Act (WSW) and staff and equipment funding for schools. In most cases, all or part of a specific contribution must be repaid if the funding has not been used for the purpose for which it was intended or if the policy objective has not been achieved. Specific contributions vary greatly in size and may range from several billion euros, for example the Work and Social Assistance Act, to only several million, such as the 'bombs fund' for dealing with unexploded bombs discovered during public works. There are also major differences in the purpose for which the contributions are used. Some specific contributions have a broadly-formulated policy objective, which allows municipalities a great deal of policy freedom. One example would be the social programmes that form part of the major cities policy. Other specific contributions are intended to achieve a very specific goal and are therefore far narrower in their application. The funding set aside for heroin experiments are an example.

Supervision and Section 12
Municipalities must have a balanced budget. Municipalities that fail to balance their budget, for example as a result of financial setbacks, are automatically placed under the guardianship of the province. The municipality must then draw up a plan to get the finances back on track. If the municipality does not succeed in doing so, it may request a supplementary payment. This is arranged in Section 12 of the Dutch Grants to Municipal Authorities Act (FVW). The acceptance criteria are strict. Section 12 is the final financial safety net for municipalities. The supplementary payment may be considered a debt management arrangement. It is paid from the municipalities fund and is therefore borne by all municipalities.

He who pays the piper calls the tune?

Approximately two-thirds of the municipalities' income comes from central government. However, this does not mean that central government can tell a municipality how to spend two-thirds of its income. He who pays the piper does not always call the tune. The table shows who is authorised to decide how certain funds should be spent.

Source of income	*Source*	*Authorised party*
Municipalities fund		
• General contribution	Central government	The municipal council
• Integration and decentralisation contributions	Central government	The municipal council
• Supplementary payment (Section 12)	All municipalities (via the municipalities fund)	Central government
Specific contributions (including contributions for a broad purpose and collective-purpose contributions)	Central government	Central government. The municipalities' policy freedom may vary.
Income from the municipalities' own resources		
• Taxes	The public and businesses	The municipal council
• Duties and levies	The public and businesses	The municipal council, but no more than cost-effective
• Other income from own resources	The public and businesses	The municipal council

The growth of the municipalities fund

The municipalities fund is financed from the National Budget. There are two ways in which the size of the municipalities fund may change: to compensate for changes in the municipalities' tasks ('pay on the nail') or owing to the autonomous growth of the fund itself ('up and down the stairs together').

Pay on the nail

Section 2 of the Grants to Municipal Authorities Act states that if central government policy has financial consequences for municipalities, for example in the case of new tasks being delegated to them, central government must indicate how the municipalities can reduce the impact.

Section 2 is also known as the 'pay on the nail' (meaning to settle immediately in cash) section. This name is misleading in some ways. The fact is that Section 2 does *not* prescribe that municipalities will always be given funds to cover new tasks; it only states that central government must indicate *how* the associated costs can be covered. Compensation via the municipalities fund is one of the options, as is offsetting the costs from the municipalities' own resources. For that matter, the reverse is also true when certain municipal tasks no longer apply.

Up and down the stairs together

The size of the municipalities fund keeps pace with most central government expenditure. This is referred to as the standardisation system. If central government spending is cut, the municipalities fund shrinks. If central government increases its spending, the contribution paid out from the municipalities fund also increases. Consequently this system is referred to as 'up and down the stairs together'.

If central government has extra money, this does not automatically result in a larger contribution being paid from the municipalities fund. It depends on the particular situation.

If the extra money comes from a higher income, for example from the sale of natural gas, the municipalities fund will not be affected. If the extra money is the result of underspending by central government, the contribution will fall. The municipalities fund increases only if central government has extra money from income *and* spends this extra money *and* includes this spending in the standardisation system. National debt repayments, for instance, do not count.

Spending of municipalities fund increases

Municipalities are free to choose how they spend fund increases. It is sometimes agreed in consultations between central government and the Association of Netherlands Municipalities (VNG) that municipalities will use part of the annual increase in the municipalities fund for a certain task or joint objective. Such targeted use often leads to confusion. It is important to remember that no extra funds *on top* of the increase and no spending obligations are involved.

Clusters

The municipalities fund is divided into broad policy clusters, such as social care. Central government uses these clusters to investigate whether the apportionment of the municipalities fund is in line with municipal expenditure. The clusters are not a guideline for spending by a municipality on a certain task, and the municipalities fund is not the sum of the amounts to be spent on various tasks. It is therefore impossible to say how much money there is in the municipalities fund for task X.

Municipalities fund apportionment system

The municipalities fund apportionment system takes into account the costs incurred by municipalities (cost orientation) and the income that they are capable of generating (support).

Cost orientation

The apportionment system looks at objective cost-determining features of municipalities, for example the number of inhabitants, young people, seniors and benefit recipients, as well as the surface area, the number of population centres, etc. These characteristics are referred to as criteria. Each criterion is linked to an amount per unit. A municipality receives funds for every inhabitant, every young person, etc. There are more than 60 criteria, one of which is the redivision criterion, which compensates for the costs incurred when municipal boundaries are redrawn. A municipality that has high costs, for example one with many low-income inhabitants, receives more from the municipalities fund than a municipality with fewer costs. The idea that expanding municipalities benefit more from the apportionment system is a misconception. They *are*, however, compensated for costs that are objectively higher. The calculation is in fact based on p x q (price x quantities). It is therefore a misunderstanding that 60,000 inhabitants is a significant limit for the contribution from the municipalities fund.

Support

The apportionment system also takes into account the extent to which municipalities can generate income. The most important factor in this respect is the municipal property tax capacity. The tax revenues that a municipality can generate on the basis of a calculation rate that is equal for all municipalities are a minus item (negative criterion) in the calculation. Whether a municipality actually has a high or low municipal property tax rate is irrelevant. A municipality that is *capable* of generating a relatively large income from the municipal property tax will receive less money from the municipalities fund, relatively speaking, than a municipality that is *capable* of generating only a small income. The municipalities fund also assumes that municipalities cover 5% of their spending with other income generated from their own resources. In reality, they often generate more than that.

Payment factor

The combined criteria scores of all municipalities do not equal the total size of the municipalities fund. That cannot be the case because the size of the fund is linked to central government spending and not to changes in the criteria. The payment factor ensures that the payments to municipalities and the size of the municipalities fund are equal.

Simplified calculation example

Number of inhabitants	x	amount per inhabitant	=	... euros	
Number of low incomes	x	amount per low income	=	... euros	
Number of dwellings	x	amount per dwelling	=	... euros	
Number ...	x	amount per ...	=	... euros	+
Criteria total (= payment basis)			=	... euros	
Payment factor			=	... PF	x
Criteria total incl. payment factor			=	... euros	
MPT capacity criterion			=	... euro	-
Municipalities fund payment			=	... euros	

Financial Relations Council

The Financial Relations Council (FRC) advises the government and parliament. The Council is independent and may issue both solicited and unsolicited advice.

The advice relates to how the financial resources of the State can best be divided among municipalities and provinces. The aim is a balanced apportionment that contributes to the effectiveness of government as a whole.

The advice often relates to the municipalities and provinces funds, the tax system and to specific financial contributions. The FRC advice covers almost all policy areas and may involve both policy and its implementation.

By issuing advice, the Council wishes to influence the quality of decision-making and contribute to a just apportionment of resources. This also involves the quality of the political, administrative and social debate.

Composition of the Council

The Financial Relations Council is made up of a maximum of nine independent persons from the fields of government finance and public administration. They are selected on the basis of their expertise and their experience in public affairs. The members of the Council are appointed by Royal Decree.

Assessment framework

The Financial Relations Council:

- Contributes to efficient and effective government by overseeing proper financial relations.
- Aims for a balance in the division of tasks and powers *and* in the apportionment of financial resources.
- Attempts to guarantee as far as possible the policy and spending freedom of provinces and municipalities by shaping the financial relations between them and central government.
- Ensures that the apportionment systems fulfil the requirements of equality before the law and legal certainty, thoroughness, transparency and verifiability.

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