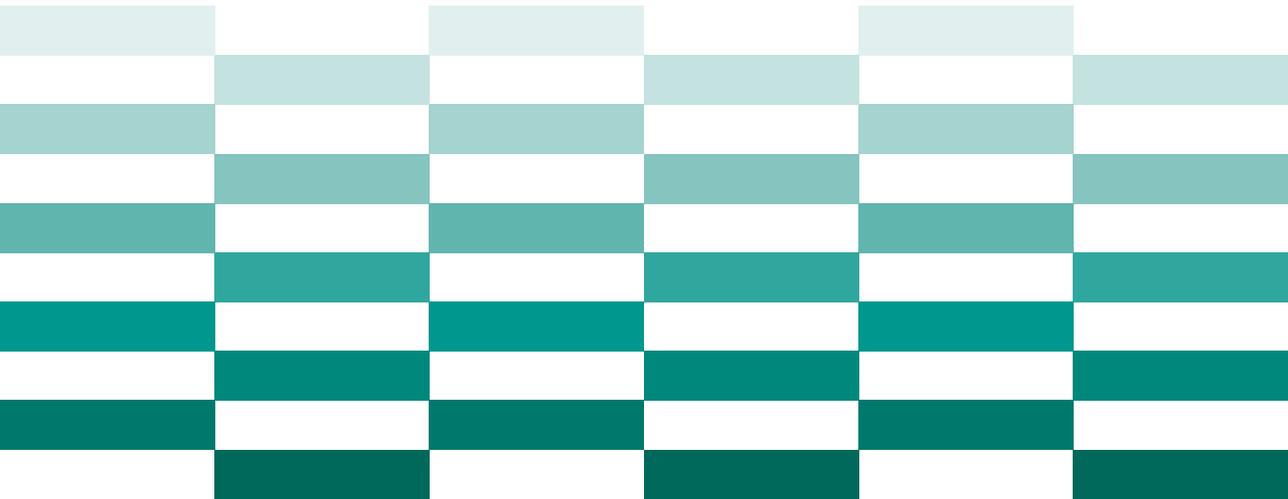


Raad voor de financiële verhoudingen

First the Political Choices, Then the Technical Details

Rules of play for future-proof financial relations

January 2017



Profile

The Financial Relations Council (Rfv) is an advisory council to the government and parliament. The Council was established by the Act of 21 February 1997 (Financial Relations Council Act, Bulletin of Acts and Decrees 1997, No. 106).

Task

The Financial Relations Council's legal task is to give advice to the government and parliament, either on request or on its own initiative, on how the financial resources of the State can best be divided among the municipalities and provinces. The Council aims to establish a balance in the way financial resources are distributed, thus contributing to the effectiveness of the government as a whole.

Composition

The Financial Relations Council is composed of at most nine independent experts in the fields of public administration, politics and government finances. They are selected based on their expertise and social experience. The Council's members are appointed by royal decree.

Working procedure

The Council can provide advice either on request or on its own initiative. The advice pertains to the municipal and provincial funds, tax instruments, and specific grants. The advice encompasses nearly all policy domains, and can relate to both the policy itself and the implementation thereof. In preparing its advisory reports, the Council notes the views of people and organisations with substantive knowledge and/or experience in the particular policy domain. The Council contributes to the political-administrative and societal debate through other activities (publications and meetings) as well. The advisory reports by the Council give specific attention to the basic principles underlying the financial relations, the discretion over policy and spending, and the risks. Legal equality, legal certainty and transparency aspects are examined, too.

Secretariat

A secretariat provides support services for the Financial Relations Council (and the Council for Public Administration (Rob)). The secretary and his/her staff are accountable to the Council for their work. Their activities are guided by the annual work programme and current developments.

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Preface

In May 2015, the Financial Relations Council published the discussion paper ‘*Wel Zwisters, geen geld?*’ (‘To Have the Swiss, but No Money’). This was prompted by the fact that, due to administrative-societal developments in the past 20 years, the balance between municipal tasks, control and revenues had got lost. Given the many responses, it was apparent that there was a great need for further analysis of future relations between the central government and municipalities.

The way in which municipalities fund their tasks now is a result of long-established, often unconscious principles. These are expressed in the Grants to Municipal Authorities Act of 1997. The distribution system based on this Act solved the financial problems for municipalities occurring at that time. In this respect, the system has proved its worth. Partly because of the introduction of decentralisation grants in the municipal fund, it provided a good basis for far-reaching restructuring of specific grants. That is a positive development. Because of this system, the decentralisation of tasks and resources to municipalities has also increased enormously. Most of the benefits of decentralisation, however, only arise if there is sufficient policy discretion.

Due in part to these trends, the original nature of the municipal fund has changed more and more into a funding mechanism for co-administrative tasks. Tension has grown between the generally formulated basic principles and the manner in which they are applied. When it comes to financing the range of municipal tasks, the idea that, for government money to be spent efficiently, the decision-making, payment and enjoyment of the benefits need to be in the hands of one and the same party has increasingly been relegated to the background. The central government and municipalities thus threaten to keep each other in a stifling stranglehold.

The municipalities’ financial independence has been brought into play. Municipalities could take a more self-confident approach and stand behind the choices which they make. The central government could be a bit less prescriptive in dealing with municipalities. Municipalities have just as much democratic legitimacy as the central government. The municipal fund belongs to the municipalities, not the State. This does not, by the way, exclude the possibility of funding co-administrative tasks through the municipal fund.

After all, decentralisation of policy presumes that municipalities themselves are free to determine the *outcome* of the policy. This means, in a financial sense, that municipalities must be able to make their own judgments about the most efficient manner of achieving that result. At the same time, municipalities are highly dependent on the revenues from the State. Yet the recent large-scale decentralisation operations show that the ongoing societal and political debates have made it irresistible for the central government to determine the result to be achieved and the expenditure of the money.

The Council previously observed that the current method of distributing the municipal fund in cost oriented fashion has reached its limits. In addition, the Council has constantly emphasised the importance of transparency and simplicity, and warned against a system in which any possible differences between municipalities are ostensibly taken into account, even though this ultimately has no demonstrable effect on the result of the distribution. Limiting redistribution effects regarding the adjustments to the allocation formula has put further pressure on the balance between a cost-oriented distribution and a broad-based approach. This has undermined trust in the financial relations.

The present financial relations no longer satisfy the condition that funding of local tasks should foster an effective, efficient weighing of costs and benefits. This compromises the legitimacy, strength and flexibility of local government; municipalities cannot respond properly to local issues, because the financial system keeps them from doing so. This involves not only the volume and distribution of the municipal fund, but also the state grants and local taxation area. From the Council's perspective, the funding of the municipalities' set of tasks was therefore examined in conjunction with this.

A properly functioning system of financial relations is predicated on the confidence which the interested parties have in the operation of the system. This necessitates a set of standards and principles based on which the parties concerned can be held accountable. Resources must be distributed pursuant to recognisable, transparent standards and principles.

All in all, the Council finds that there is ample reason to issue this advisory report and thereby propose a set of rules of play to restore confidence and increase transparency. The need to lay down these rules cannot be stressed enough – certainly because, when the new government cabinet takes office, choices will have to be made on incorporating the social domain adjustment grant into the municipal fund, a new indexing system for the general grant from the municipal fund which does justice to the dynamics of the municipalities' set of tasks and which offers the desired stability. A definitive answer about the scope and design of the local taxation area must also be given. The Council strongly recommends that all of this be viewed in relation to one another. Cherry-picking is no longer an option.

The proposed rules could be embedded in the existing Grants to Municipal Authorities Act. It will be up to the new Minister of the Interior to assume his/her role as the person responsible for the financial reasons and to design a careful procedure for creating a future proof system. This not only has to do with funding new tasks, but also funding the current municipal tasks. Laying down rules will not deprive politicians of the opportunity to make political choices; rather, safeguarding the rules for financial relations will lead to clarity about the legislative choices made, and the base of support for the financial relations will be restored.

In formulating this advisory report, the Council had many conversations with representatives of various political, administrative and social groupings. The Council for Public Administration was actively involved in formulating this report, too. A committee made up of members of both Councils – specifically, Chris Kalden, Milo Schoenmaker, Remco Nehmelman, Rik Buddenberg, Remco van Lunteren and Theo Toonen – also contributed here. A special thanks goes out to Maarten Allers, who, as a member of both Councils, played a crucial role in effectuating this report. Finally, this report would not have been possible without the tremendous efforts by the secretariat, in particular, Bart Leurs.

A handwritten signature in black ink, consisting of a large, stylized 'M' and 'A' followed by a smaller 'P' and 'B'.

M. A. P. van Haersma Buma, Chair

A handwritten signature in black ink, featuring a large 'G' and 'A' followed by 'v' and 'N'.

G. A. van Nijendaal, Deputy Secretary

1. Introduction

The various levels of government are responsible for numerous group- and individual-related services for their citizens. The government pays for these services through tax revenues which it receives from individuals and companies. By definition, public resources are scarce; the wish list always exceeds the money available. Hence, the government must carefully weigh the different desires, needs and interests in a democratic manner. Tax revenues must be used efficiently, because, otherwise, the tax burden will not be commensurate with the services provided.

Administrative relations

With its three elected levels of government, the government structure in the Netherlands makes achieving this goal possible. Tasks can be given to the government level which, in light of the scale and interests at stake, is best able to do the balancing. Decentralisation can promote an effective, efficient weighing of the costs and benefits which is in keeping with local preferences: democratic and practical, while bringing the administration as close as possible to citizens.

Financial relations need to follow administrative relations

The financial relations between the State, provinces and municipalities are intended to make the collection and distribution of tax revenues be as consistent as possible with the various government levels' tasks, responsibilities and powers. The question, then, is always: How much tax may a particular level of government levy itself, and how much revenue should this government level receive from the central government? The financial relations must foster the objectives previously mentioned, that is, democratic deliberation by the right level of government and efficient spending of tax money.

The value of local administration

Local administration is also a value in and of itself. It helps disperse government power and ensures administrative checks and balances. It enables citizens to get involved in the government and customised services to be delivered. Local administration brings about innovation through policy competition, too. That is, it provides opportunities for differences in strategies and solutions which would not have arisen with a centralised approach. One of the benefits of policy competition is that good models are passed on, while the impact of less successful practices remains limited to a single municipality. This effect only occurs, though, if local governments also have the chance to do the balancing themselves. Thus, they must have sufficient freedom to determine the results of decentralised policy.

Municipalities made expenditures of more than 56 billion euros in 2016.¹ They paid for most of these expenditures through the municipal fund. The most important municipal fund grant is the general grant. The funds relating to decentralisation in the social domain are furnished – for now – through the social domain adjustment grant, which likewise falls under the municipal fund.²

Municipal revenues in billions of euros, 2016

Municipal fund	27
Made up of:	
General grant	15
Social domain adjustment grant	10
Miscellaneous	2
Specific grants	6
Property taxes	4
Other taxes	1
User fees	4
Land development	4
Miscellaneous	10
Total	56

Since the decentralisation actions in 2015, municipalities have been responsible for around 30% of all government spending, even though the share of local taxes in the total tax revenues is less than 3%. Local taxes represented 5% of total municipal revenues in 2016.

¹ Municipal fund budget 2017, Lower House of the Dutch Parliament, session year 2016–2017, 34 550 B.

² It has been agreed that the decentralised social domain budgets will in principle be included in the general grant in 2018. Lower House, session year 2013–2014, No. 33 935, No. 7.

Financial relations: a means to effectuating public interests

For local administration to function properly, it must have the means to fulfil its responsibilities. Financial relations must result in an appropriate weighing of the costs and benefits of public services and thereby efficient spending of tax money. Because public services and preferences are implicated, administrative perspectives, in addition to social, economic and political views, underlie financial relations. Financial relations, then, pertain not only to purely technical distribution issues, such as the distribution of the municipal fund or the scope of the local taxation area. Financial relations are a means to effectuating public interests.

The end doesn't justify the means

Given the autonomous value of local administration, financial relations are tied to rules within a decentralised unitary state. Without such rules, financial relations degenerate into merely power relationships, so that municipalities and provinces can no longer fulfil their roles. The Council sees it as its task to render advice on how these arrangements can best be implemented.

The sustainability of the current system is under pressure

As put into place in 1997, the system was geared well to the distribution problems at that time. As a result of the numerous developments and successive adjustments to the system over time, the goal and the means have diverged. The present financial relations no longer satisfy the condition that funding of local tasks should foster an effective, efficient weighing of costs and benefits. This reality compromises the legitimacy, strength and flexibility of local government; municipalities cannot respond properly to local issues, because the financial system keeps them from doing so. Citizens have to be comfortable with the balancing done by their municipalities. The municipalities themselves must have the opportunity to weigh people's desires against one another and, if possible, to respect these. The existing inconsistent application of financing principles for local tasks is at odds with these imperatives. The accompanying lack of clarity undermines the base of support for local administration.

Future changes and issues

The intention is to transfer the budgets for care tasks which have been shifted to municipalities since 2015 to the general grant. Nonetheless, politicians should be aware of the consequences which this entails. Whether implicitly or explicitly, such decisions are preceded by several principle-based choices. The decentralisation of assistance and care is one example, yet the need for change is broader. The increased sensitivity to the global economy means that municipalities and regions must be able to respond rapidly to new developments, On the one hand, developments in economically powerful regions must not be impeded. On the other hand, less promising areas must not deteriorate, because this may be a costly development in the long run, not just in terms of financial costs, but also in terms of societal harm. Local governments will also be called on to act with regard to issues about making the economy sustainable.

Purpose of such re-examination: identifying and analysing the consequences of choices

The new government cabinet will be faced with several important issues affecting the financial relations directly and indirectly. For instance, the new cabinet will have to take a position on expanding the local taxation area or not. This is a decision which can only be taken in conjunction with decisions about other municipal sources of income. The cabinet will also have to express an opinion about the indexing system for the municipal fund. Likewise, it is conceivable that new decentralisation operations or reshuffling of tasks will be decided on. With this in mind, the Council is engaging in this re-examination of the financial relations. The political choices need to be made first; the technical details will then follow.

The purpose of this advisory report is to identify and analyse the political administrative options underlying the financial relations and to ascertain the consequences of the political choices. In this way, a future-proof system will arise. Based on this advice, such choices can be made explicitly in a coherent manner. Appropriate funding methods can then be derived from these choices, based each time on the principle that government money should be spent as efficiently as possible. The extent to which the existing financial relations are still in line with the desired administrative relations and which choices and changes are offered can thus be determined systematically.

In 'To Have the Swiss, but No Money', the Council put forth several targeted questions to find a new balance between municipal tasks, control and revenues:

1. Are municipalities too financially dependent on the central government?
2. Dilemma: local welfare state, national solidarity?
3. Municipalities' own revenues for physical tasks and the municipal fund for social tasks?
4. Regional cooperation: Who determines and who pays?
5. Should regional economic growth be promoted through the financial relations?

Scope

The basic administrative structure will be taken as a given in the rest of this advisory report. The advice will focus on funding local and regional tasks. The provinces will not be addressed in the advice.

2. Developments since 1997

In this section, the Council will explain why the design of the current financial relations no longer fosters efficient spending of government resources. Although the distribution of the municipal fund underwent an ‘overhaul’ not too long ago, the financial relations as a whole are still not in keeping with recent administrative, social and economic developments.

Aard van takenpakket is veranderd

Since 1997, the nature of the municipalities’ set of tasks has shifted from public services, which anyone can use in principle, to more personal services and services in the form of individual benefits. Because of decentralisation in the social domain, the social domain’s share in municipal expenditures has risen from less than 40% to 50%.³ The share of expenditures for physical tasks has correspondingly fallen. Municipalities often have a lot of policy discretion with public services, but this discretion is more limited in many cases for person-related services. This is due to regulations, yet it can also be explained in terms of societal expectations and standards.

Many assistance- and care-related tasks were decentralised in 2015. In theory, municipalities have a great deal of policy discretion here, but this primarily concerns the implementation and, to a much lesser degree, the results of policy. While municipalities are statutorily permitted to offer different care arrangements, social acceptance of differences is very limited.⁴

Changing social relations

The relationships between the government and society have changed. Municipalities are no longer managed by just the town hall. Municipalities must increasingly respond to initiatives by citizens, social organisations and businesses. This has altered the position of municipalities with respect to social partners and, as a result of expanded cooperation, with respect to each other as well.

Scaled-up public administration

Municipalities have grown since 1997, as regards both population and physical size. The number of municipalities has gone down from 572 in 1997 to 388 in 2017.⁵ It is foreseeable that the number of municipalities will drop below 350 in 2020. Administrative mergers are occurring more frequently, too; although municipalities remain independent then, the entire administrative organisation is brought under a joint arrangement or another municipality.

³ Source: Statistics Netherlands, *Gemeentebegrotingen* (Municipal Budgets) 2014, 2015 and 2016. The Council has included the following Statistics Netherlands categories under ‘social domain’: education; social security benefits and social services.

⁴ Allers, M. A., Steiner, B., Hoeben, C., Geertsema, J. B., *Gemeenten in perspectief* (Municipalities in Perspective), 2013.

⁵ Statistics Netherlands, *Gebieden in Nederland* (Areas in the Netherlands).

Regionalisation necessitates a re-examination of existing funding

An increasing number of tasks are being performed at the regional level. Expenditures are made in a regional context. This is the case, for instance, not only with the expenditures for the security regions; the expenditures for youth care, work and income, and care for persons with long-term illnesses and the elderly (under the Social Support Act) are being made to a large extent at the regional level, too. The share of municipal expenditures going through partnerships jumped from 6% in 2006 to more than 17% in 2016.⁶ For smaller municipalities, it is not unusual for half of the expenditures to be made in a regional context.

Funding goes against the grain of chain logic

Further, there are certain tasks which have specifically been allocated to municipalities functioning as 'centres' ('central municipalities'), such as emergency accommodation and sheltered accommodation. Yet it is difficult to view these tasks separately from closely related tasks which have in fact been given to all municipalities. The scale in which the task has been placed is consequently often no longer right for the financial and other steering options. Municipalities are often part of a chain, so that, for example, prevention costs do not wind up as a benefit for the investing party ('split incentives'). Accordingly, numerous border conflicts arise between central municipalities and regional municipalities, between health insurers and municipalities, and between the organisations responsible for carrying out the Long-Term Care Act and the municipal care domain.

It's not just a technical choice, but a political one, too

With the overhaul of the municipal fund, equalising the differences between municipalities regarding costs and tax capacity was presented as a technical choice and was therefore taken out of the political decision-making realm.⁷ At issue here, however, is a very political choice about the degree to which, financially speaking, municipalities must be placed in an equal starting position. This choice, for that matter, need not work out the same for all municipal task areas. The degree of equalisation cannot be seen separately from the policy discretion granted to municipalities.

Heavy financial dependence leads to standardisation

The municipalities' heavy financial dependence on the central government unintentionally has a standardising effect. Many specific grants have been transferred to the municipal fund in the form of adjustment and decentralisation grants. The number of specific grants declined from more than 500 in 1980 to 56 in 1997, and then to not even 20 in 2016.⁸ The biggest specific grant to municipalities is the grant to provide social assistance benefits. As a result, the municipal fund is becoming more and more primarily a funding instrument for co-administrative tasks directed by the State, instead of an equalisation mechanism between municipalities, the purpose for which it was originally designed. State funding of municipal tasks is increasingly turning out to be an economic transaction: a payment for a service to be performed. The goal of the distribution is unclear. Is the idea to put municipalities in the same starting position, or is that actually not the intention?

6 Source: Statistics Netherlands, *Financiën gemeenschappelijke regelingen* (Finances for Joint Arrangements).

7 Financial Relations Council, *Consultatie groot onderhoud gemeentefonds 2015 en 2016* (Consultation on Overhaul of Municipal Fund 2015 and 2016), 14 April 2014.

8 Lower House, session year 2016-2017, 34 550 C, No. 2, p. 18.

Incentive effects and cost orientation are becoming intertwined. In addition, many implicit assumptions and assessments were made about the distribution with respect to the extent to which certain expenditures were necessary or could in fact be attributed to the municipalities' own policy choices.

The resolution of potential imbalances in the distribution of resources is also leading to an ever greater refinement of the distribution of the municipal fund. The number of yardsticks in the municipal fund, including the social domain adjustment grant, exceeds 90 now. The distribution system is widely considered non transparent, which erodes the base of support for the system as a whole.

Compliance with the principles and agreements formulated

The principles for distribution of the general grant are not applied in a consistent way.

Example: reassessment of the Public Housing, Spatial Planning and Urban Renewal Cluster

Small municipalities and expansive municipalities in particular had demonstrably higher costs in this respect on account of statutory spatial planning obligations. Zoning plans were mainly involved. Despite these observed cost differences, the fund managers decided not to fully respect these differences because of the major redistribution effects, especially for the 'Big Four' (that is, the four biggest cities in the Netherlands, to wit, Amsterdam, The Hague, Rotterdam and Utrecht). The Big Four's higher expenditures, though, could largely be explained by the significant measure of policy discretion and the associated differences in self-selected levels of ambition. These municipalities could also compensate for a big portion of the negative redistribution effects through the autonomous increase in property values, hence, without a rate increase.⁹

An additional problem is that agreements on state funding are often not fulfilled. The standardisation of the general grant from the municipal fund – the link to the trend in state expenditures – is, for instance, regularly thwarted through ad hoc cuts in that fund, such as the scaling-up cut and the school buildings cut.¹⁰

Summary

In sum, the situation has got muddled through conflicting and opportunistic choices. The financial relations are no longer consistent with the administrative and political agreements on which the system is based.¹¹ The tasks, scale and control are out of balance.

⁹ Financial Relations Council, *Advies verdeling subcluster Volkshuisvesting, Ruimtelijke Ordening en Stedelijke Vernieuwing (VHROSV)* (Advisory Report on Distribution for Public Housing, Spatial Planning and Urban Renewal Sub Cluster), 25 April 2016.

¹⁰ *Regeerakkoord 'Bruggen slaan'* ('Building Bridges' Coalition Agreement), Appendix A, 'Financial Policy', 29 October 2012, p. 2.

¹¹ Netherlands Court of Audit, *Financiële verhoudingen tussen de bestuurslagen. Geldstromen en verantwoordelijkheden bij decentraal uitgevoerd beleid* (Financial Relations between Central Government and Local Authorities. Grants and Responsibilities for Decentralised Policy), Lower House, session year 2009-2010, 32 249, Nos. 1-2.

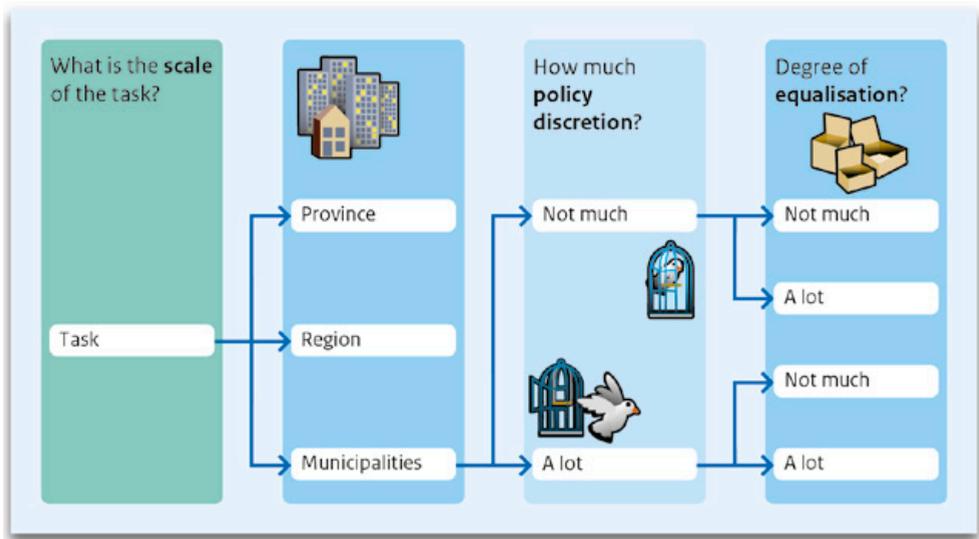
3. First the political issues to be decided

Optimal financial relations depend on choices which are the result of political administrative assessments. The one type of instrument fits better with certain choices than the other one. The point of departure in translating choices into instruments is that financial relations should promote efficient and effective spending of government money. Hence, the party determining the policy should pay for the costs (and not have someone else assume the financial burden).

It is important to make a proper distinction between the political choices on the one hand and the ensuing funding on the other hand. The political choices are unlimited, but, once those choices have been made, the appropriate funding has largely been set. Deviations from this will lead to less efficient spending of public resources.

The societal tasks which need to be accomplished with public money constitute the point of departure. The decision tree in Figure 1 illustrates the associated political choices.

Figure 1: Political choices decision tree



Based on the societal task (which task must be carried out?), the political world must figure out the right scale first; should the task be performed by the municipality, the region or the province? Letting municipalities provide services can result in policy which is better tailored to local needs and circumstances and can boost citizen involvement. On the other hand, a small scale can give rise to external effects in some areas. That is, the reach of local services (or, generally, the effects of local policy) may go beyond municipal borders, making it difficult to properly weigh the plusses and minuses. The benefit of a small scale is that it can save costs through information advantages. In contrast, a large scale can save costs through the existence of economies of scale (combining knowledge, repetition advantage and purchasing advantages).

Consequently, it is not possible to clearly derive an ideal administrative scale from academic principles to quantify the aforementioned effects.¹² Choosing a certain scale level therefore reflects a political-administrative balancing of the plusses and minuses mentioned.

Must the scale be imposed or can municipalities choose this themselves?

The first question is whether it is up to the municipality to determine the optimum scale, or whether this should be imposed by the State. The scale of municipalities is very diverse. This can have an impeding effect if a uniform assignment of tasks to all municipalities is assumed. A potential solution is a differentiated assignment of tasks. Not all municipalities would have the same set of tasks then. This is the case, for example, with central municipalities as regards emergency accommodation.

The region

Assigning the resources to a higher scale level can be efficient. Selecting this option implies that performing tasks efficiently is considered more important than the proximity and customised approach which placing tasks with the local government entails. A higher scale level, such as the region, enables the utilisation of resources to be streamlined and improper types of competition to be avoided. Still, 'the region' is not as such an unambiguous concept and differs for each task. The meaning of 'region' will depend strongly on assumptions and perspectives. If only economic cohesion and commuting (daily urban systems) are looked at, a different classification may be devised than if city and countryside recreational facilities are taken into account, too.¹³

¹² M. A. Allers, *Decentralisatie en schaalvergroting van het openbaar bestuur* (Decentralisation and Growth in Scale of Public Administration), *TPEdigitaal*, 2016, Volume 10(2), pp. 149-162.

¹³ The OECD, for instance, comes up with a classification of 35 Functional Urban Areas in its *Territorial review: Netherlands, 2014*, while the Atlas for Municipalities counts 57 municipalities (Marlet, G. and Van Woerkens, C., *De nieuwe gemeentekaart, Atlas voor gemeenten* (The New Municipal Map, Atlas for Municipalities), 2014.

Choice number 1:

For each task, then, the region will have to be demarcated if tasks, responsibilities and resources must be allocated to it.

The tasks which the Public Administration Study Group¹⁴ has identified concerning regional economic, demographic and spatial developments transcend municipal borders. The first issue is the scale on which the consequences and costs related to population losses or regional economic developments can best be dealt with. Establishing regions of cooperating municipalities or designating the province as the level with primary responsibility is an administrative choice. Moreover, what is precisely meant by 'the region' is a crucial question. The Netherlands does not have a full-fledged democratic level of administration between municipalities and provinces. Accordingly, the efficient use of resources pursuant to the notion that 'the party making the determination has to pay' must be safeguarded differently.

The related political choice is thus whether municipalities and provinces themselves are given the flexibility to make a particular responsibility a regional task and then to take care of the funding themselves, or whether the central government decides the demarcation and funding issues.

Regional services

The region can also affect the costs which a municipality incurs. Insofar as tasks for which municipalities have lots of policy are concerned, the distribution may take into consideration scale advantages and disadvantages and external effects. Say a municipality wants to maintain a theatre or sports centre: Residents of neighbouring municipalities do not pay tax for this, but can use it. In the distribution of the general grant, municipalities will roughly be compensated for such costs through two 'centre yardsticks'.

¹⁴ Public Administration Study Group, *Maak Verschil. Krachtig inspelen op regionaal-economisch opgaven* (Make a Difference. Responding Vigorously to Regional-Economic Tasks), March 2016.

Choice number 2:

How much policy discretion should municipalities have?

The second major political choice pertains to how much policy discretion municipalities should have (Figure 1). 'Policy discretion' here mainly means the degree to which municipalities are themselves free to determine the *outcome* of the policy. A lot of policy discretion entails that major differences in levels of services are accepted by citizens and the central government. Policy discretion can also relate to the *manner* in which municipalities carry out tasks, but we expressly do not mean that here. The possibility of determining the outcomes at a local level encourages a more effective, efficient weighing of costs and benefits.¹⁵ Most of the benefits of decentralisation only arise if there is sufficient policy discretion.¹⁶ This is an argument for expanding policy discretion at the local level.

So why do municipalities have very little policy discretion regarding some tasks? First of all, because some municipal 'products' have to be the same throughout the country, such as passports and Lower House elections. Secondly, uniformity may be desirable from a solidarity standpoint. Everyone should, for instance, be able to receive the same amount of social assistance benefit under the same conditions throughout the country.

Policy discretion primarily gets limited through laws and regulations by the State. It may also be limited indirectly through social views about the acceptability of major differences for citizens living in different municipalities and through regional arrangements which lead to uniformity.

In practice, municipalities principally have policy discretion when it comes to public services, such as parks, playgrounds, sports facilities and group-related welfare facilities, including community centres. Differences are not as well accepted for personal services (such as mobility scooters and household assistance). This need not, though, preclude decentralised implementation of centralised legislation.

The degree of policy discretion may change over time as a result of political decisions or social developments. If, however, the standards become more uniform and the freedom in outcomes grows more limited, this will have consequences for the most efficient manner of funding. This will be explained in Section 4.

¹⁵ Financial Relations Council, *Verdelen, vertrouwen en verantwoorden* (Distribution, Trust and Accountability), November 2011.

¹⁶ M. A. Allers, *Het dogma van decentralisatie* (The Decentralisation Dogma), *Binnenlands Bestuur*, 1 May 2016, 35-37.

Choice number 3:

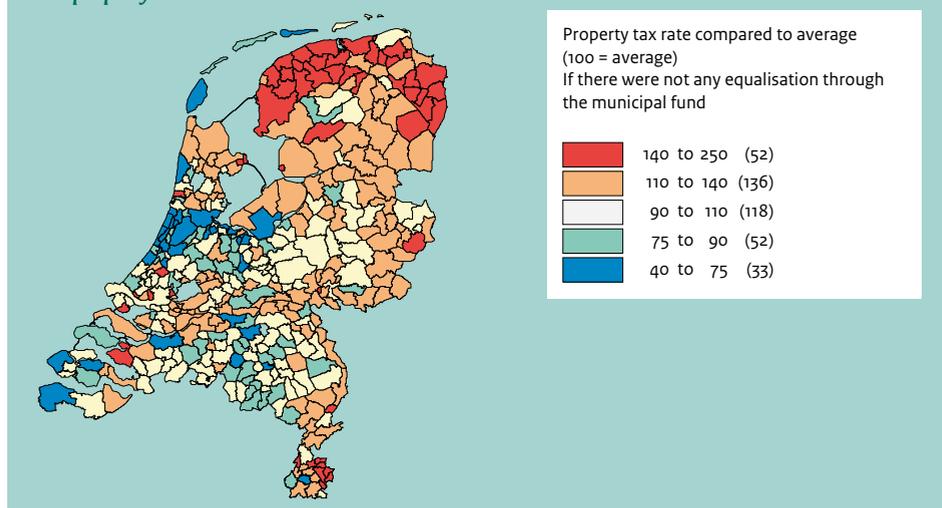
How much equalisation should there be?

The third major political-administrative choice has to do with the degree to which differences between municipalities in costs and opportunities for raising income should be equalised (Figure 1). In other words, to what extent is it important for municipalities to have an equivalent financial starting position? This choice is not entirely separate from the choice concerning local policy discretion. Specifically, if there is not much policy discretion, all municipalities must have sufficient resources to satisfy the stated requirements. Equalisation may be necessary to achieve this situation.

Example: What if every municipality 'had to pay its own way'?

This example is intended to get a feel for the need for equalisation and for the maximum differences if there were not any equalisation. For each municipality, there was a determination of the amount of the current grant from the municipal fund (without the social domain adjustment grant) and the property tax rate which they would have had to levy if they did not receive any grant from the municipal fund, but maintained the same level of expenditures. In that case, 52 municipalities would have had to levy 140% to 250% of the average rate, while 33 municipalities could have got by with 40% to 75% of the average rate (Figure 2). There was more than a factor of 6 between the highest and lowest rate. Not everyone will consider such huge differences justifiable. Furthermore, they provide an incentive for households and companies to locate in certain areas. These types of location incentives through government policy are economically undesirable.¹⁷

Figure 2: Need for equalisation: rate differences if municipalities had to fund everything through their own property taxes.



¹⁷ James M. Buchanan, 1950, Federalism and fiscal equity, *The American Economic Review*, 40, 583-599.

Aspiration levels in equalisation

At present, the goal in distributing the general grant is that each municipality with an equal tax burden must be able to finance an equivalent (hence, not the *same*) level of services (the so called ‘third aspiration level’). The policy outcomes are not *necessarily* the same, but all municipalities have the financial starting position to realise all of the same outcomes.

Municipalities receive a higher general grant the higher their costs are and the lower their tax capacity is. ‘Costs’ refer to cost-driving factors which the municipalities themselves cannot or can hardly control, such as the physical size, soil conditions and socio-economic structure. ‘Tax capacity’ refers to the notional amount which municipalities could bring in if they applied the countrywide average property tax rate. Hence, this is *not* about the actual tax revenues, which are determined by the actual rates in the municipalities.

Goedhart’s aspiration levels¹⁸

Goedhart distinguishes five ambition levels concerning equalisation:

- At the zero level, there is no equalisation of services capacity whatsoever. Municipal tasks are financed entirely from the municipalities’ own revenues. This may produce major differences in services levels and tax burdens.
- At the first aspiration level, the biggest differences in tax capacity are compensated for. In addition, compensation for major differences in the costs of services occurs at the second aspiration level.
- At the third aspiration level, services capacity is more or less fully equalised. It must be possible to realise the same services level with the same tax rates. Cost differences must also be considered (road maintenance, say, is more expensive when the sub-soil is bad rather than good). If a local government wants to offer its citizens a higher (or lower) level of services than average, the tax rate will be higher (or lower).
- At the fourth aspiration level, all local governments have the same services. The central government fully determines the local governments’ revenues.

Equalisation between municipalities, though, is not the same as income redistribution between households. The prices of homes are rising in municipalities receiving a higher general grant.¹⁹ This benefits homeowners, a group that generally does not have the lowest incomes. Support for poor households, however, can be regulated better through the tax system or social security benefits.

¹⁸ C. Goedhart, ‘Een theoretisch kader voor inkomensvererving door overheden’ (‘A Theoretical Framework for Generation of Revenues by Governments’, in N. C. M. van Niekerk, ‘Macht en middelen in de verhouding Rijk-lagere overheid’ (‘Power and Resources in the Central Government-Local Government Relation’), the Institute for Public Expenditure Research, Research Series No. 3, The Hague, 1982.

¹⁹ Allers, M. A., Vermeulen W., *Uitkering aan gemeente slaat neer bij woningeigenaren* (Grant to Municipality Flows to Homeowners), ESB, 31 May 2013, 326-329.

Equalisation does not conflict with efficiency

Besides the desire to give municipalities the same financial opportunities (more or less) based on fairness considerations, there are other potential justifications for equalisation. According to Buchanan, equalisation prompts households and businesses to be more efficient in deciding where to locate, as they will not be guided by net profit differences which various municipalities can offer.²⁰ A third argument for equalisation is that it operates as mutual insurance, which aids areas experiencing sudden economic declines. Finally, equalising the financial playing field makes it clearer to citizens how well local administrators are performing, so that administrators who are not performing well can be voted out (yardstick competition).²¹

Disadvantages of equalising tax capacity

One disadvantage of equalising tax capacity is that it removes the incentive for municipalities to broaden the local tax base. Municipalities which, for example, invest in an attractive residential or working environment cannot recoup this through higher tax revenues ensuing from increased property values.²² After all, increased values are in large part pruned away through the general grant's distribution mechanism. In this way, the benefits of the increased values are spread over all municipalities.

The Public Administration Study Group proposes structuring the distribution more towards encouraging regional economic cooperation. A possible solution is letting municipalities keep the extra tax revenues ensuing from the rise in property values. This can be done by freezing the property values based on which the equalisation takes place or by assuming the values of, say, 10 years earlier. The municipality will then continue to profit from the increased values for some time. Another idea is to equalise tax capacity between municipalities based on household incomes instead of property values.²³ Municipalities can then fund investments resulting in higher property values more efficiently from the tax revenues.

Adaptive distribution

The current general grant equalises based on the average cost level of municipalities with the same structural characteristics (composition of the population, soil conditions). The costs are inferred from the expenditures which similar municipalities incur. In this sense, the distribution of the general grant is already adaptive, in that it is adjusted to the cost trends. Adaptive distribution is sometimes taken to mean, however, the desire for resources in the municipal fund to be distributed based on future tasks. This is conceivable, with variables like 'expected number of benefit recipients in 2030'. It must be possible, though, to predict such figures accurately.

20 James M. Buchanan, 1950, Federalism and fiscal equity, *The American Economic Review*, 40, 583-599.

21 Allers, M. A., 2012, Yardstick competition, fiscal disparities and equalization, *Economics Letters*, 117, 4-6.

22 H. de Groot, G. Marlet, C. Teulings, W. Vermeulen, *Stad en Land* (City and Countryside), CPB Netherlands Bureau for Economic Policy Analysis, 2010.

23 In particular, the tax is also paid from the income, not from the value of the 'bricks'. Allers, M. A., 2003, *Verevening van belastingcapaciteit tussen gemeenten kan beter* (Equalisation of Tax Capacity between Municipalities Can Be Improved), *Tijdschrift voor Openbare Financien*, No. 4, 146-156.

Example: In the recent past, distribution of the general grant from the municipal fund took into account expected future costs for school buildings. These costs did not arise in the end. Due to the political expectations which did not come true, the general grant was cut. Underlying this was the mistaken assumption that extra money within this grant was involved and that an obligation to make expenditures applied within the general grant (which was not the case).

Uniform rights can best be funded through a grant from the central government which covers the costs

The third aspiration level does not apply to all municipal tasks. With social assistance benefits, for instance, people receive the same benefit under the same conditions, wherever they reside (fourth aspiration level). This benefit is therefore not funded through the general grant but through a specific grant to municipalities.

Aspiration level is a choice

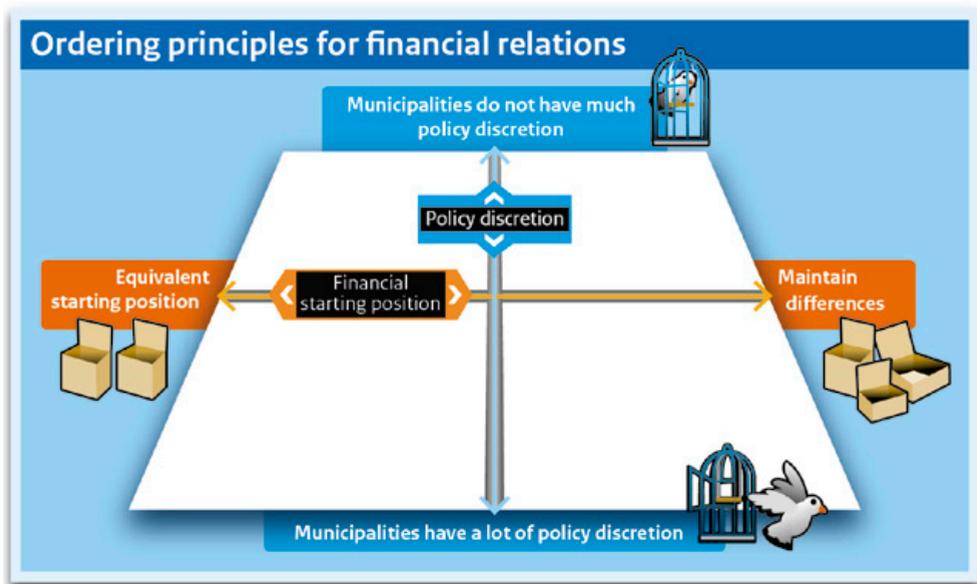
The third aspiration level represents a political choice made earlier, which politicians at the national level can replace with another choice if they so desire. For example, a drawback with equalising differences in the costs of public services is that households and businesses will head to 'expensive' places (say, in areas with soft soil), because they will not be faced with the associated higher costs, which, in the current situation, are borne by everyone.²⁴ On the other hand, many people have simply already located there, and changing the distribution for these reasons may make less sense for situations which have emerged from historical factors.

²⁴ Vermeulen, W., Kattenberg, M. A. C., and Martens, K. (2017), *Een economische blik op verevening* (An Economic Perspective on Equalisation), CPB Netherlands Bureau for Economic Policy Analysis, The Hague. Oakland, W. H. (1994), Fiscal equalization: an empty box? *National Tax Journal*, 47, 199-209.

4. Financial relations follow from political choices: The party making the determination pays the costs

For tasks which are left to municipalities, the political choices to be made can be illustrated through a coordinate system (Figure 3). The degree of policy discretion is shown on the vertical axis. The horizontal axis indicates the degree of equalisation between municipalities.

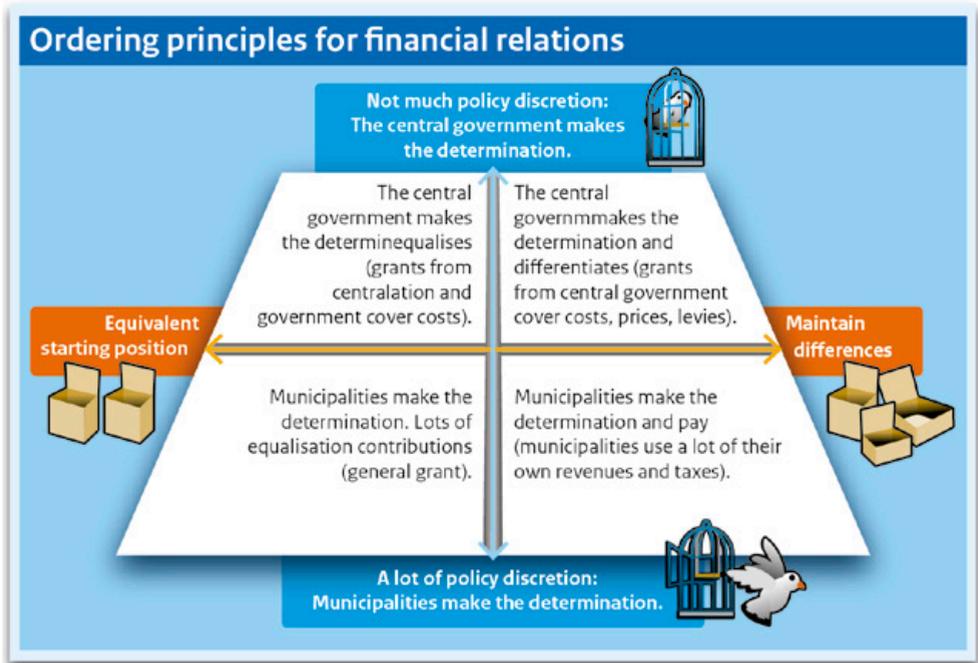
Figure 3: Financial relation as the outcome of political choices



The choice of financing instruments now follows logically and clearly from the principle: 'he who calls the tune pays the piper', that is, the party making the determination pays the costs. This principle is based on the idea that, if resources are to be expended efficiently, *all* of the costs and benefits of government services must be weighed against each other. For an efficient outcome to be obtained, the party making the determination also needs to assume the costs.²⁵ After all, having someone else pay or having the one government formulate policy with no costs involved results in resources being expended inefficiently. The notion that the party making the determination has to pay the costs is therefore the crux of a sustainable system of financial relations between levels of government. In very simplified form, the outcomes in the coordinate system in Figure 3 give rise to the funding methods in Figure 4.

²⁵ Financial Relations Council, Distribution, Trust and Accountability, November 2011.

Figure 4: Outcomes of positioning for financial relations



The arguments are as follows for each quadrant.

Lower right portion of the coordinate system

If there is a lot of municipal policy discretion, the financial considerations must for the most part be weighed by the municipalities, too. This translates into a greater share from their own revenues and from unrestricted state grants. The decision tree (Figure 1) shows this. If not only ‘a lot of policy discretion’ is opted for, but also subsequently for ‘not much equalisation’, admission (or other) prices and municipal taxes become the preferred instruments.

Example: A municipality itself decides whether or not to formulate a tourism, sports or cultural policy. The municipality is free to determine the outcome. If an equal financial starting position for municipalities is not deemed necessary (a political choice), the position falls in the lower right portion of the diagram. If this is required, however, the task winds up in the lower left portion of the coordinate system.

In the case of prices (for, say, the swimming pool or the theatre), the user weighs the costs against the benefits. The same party decides, pays and has the enjoyment here, thereby ensuring a proper balancing. Yet price instruments are not always possible or desirable (see box). Funding by the municipality through its own tax revenues is the alternative then. This forces administrators to make a very careful weighing of the costs and benefits of local services, as taxes are never popular with local voters.

Prices as an instrument: when not to do this²⁶

Funding through admission prices, fees or earmarked levies is not always possible or desirable, for technical or moral reasons. Government services are sometimes in the nature of a public good. This means that use by the one person is not at the expense of another person (non rivalry) and people cannot be excluded from the service (non-exclusivity). In the latter case, pricing mechanisms are not possible; in the former case, they are not desirable. The extra costs of the use by more people is specifically zero then. A moral reason for not utilising pricing as an instrument is that the government sometimes encourages the use of a service, because it believes that this is good for us (merit and demerit goods, such as museums). Some services are regarded as fundamental social rights (education, housing, health care) which should be accessible to everyone, irrespective of income.

Customised taxation

Now that municipalities sometimes consist of dozens of centres (even up to 80 centres in one instance) due to re-division, giving them the option of providing ‘customised taxation’ for their residents merits consideration. Residents of villages or districts who want more group related services in the neighbourhood than average would thus pay more municipal taxes than residents in other villages or districts. Villages which themselves maintain the green facilities could pay less.

There are reasons for not letting the share of the local taxes be too high; see the end of this section. Consequently, it may be necessary to partially fund tasks in this quadrant through a general grant. The distribution of this grant can be rather broad-based, because equalisation is not deemed necessary here. That makes the system more manageable.

Lower left portion of the coordinate system

With the choices ‘a lot of policy discretion’ and ‘a lot of equalisation’ (the lower left portion of the coordinate system), the major funding instrument becomes a general grant from the central government. The services capacity of municipalities can (for the most part) be brought to the same level through the distribution of this grant. While there is a lot of equalisation, municipalities are free to decide how to use the equalisation contribution. This is the third aspiration level. A somewhat lower ambition level is also possible, of course. It boils down to a political choice.

²⁶ Allers, M. A., 2006, *Decentralisatie, Verevening en de Bekostiging van Overheidsvoorzieningen* (Decentralisation, Equalisation and the Funding of Government Services), in Boorsma, P. B., Allers, M. A., *De financiële verhouding onder de loep* (A Closer Look at Financial Relations), VNG Uitgeverij, The Hague.

If funding comes through the general grant, the local administration must weigh the benefits of proposed policy against the benefits of using the grant from the State in another way. The local administrative, moreover, pays the price if it does not work with the grant efficiently. Such local balancing does not occur with a specifically earmarked grant. Hence, this is only suitable if the spending purpose has been set and the State does not allow much room for local balancing.

Stability and predictability

For sound financial policy, municipalities must be able to have a stable and predictable source of income. The grant which they will get from the central government needs to be made known in a timely manner. This is not so with the existing coupling of the general grant to the actual expenditures by the State – which, in particular, does not become known until the budget year has ended. Many modifications have also been made to the size of the municipal fund in contravention of the agreed rules. Coupling the grant to the State's four-year expenditure frameworks, without interim modifications, may provide the desired stability, though.

Lower left portion: smaller role for municipalities' own tax areas

Supplementary to the general grant, municipalities can employ their own tax money if they wish to offer a relatively high level of services. If desired, it may be decided at the national level to partially equalise differences in tax capacity through the distribution of the general grant.

Example: road management

As the road manager, the municipality must ensure good, safe infrastructure, but can itself determine the level of quality, such as decorative paving or not, and separate bicycle paths or not. The costs for achieving a particular maintenance level nonetheless differ between municipalities, for example, because of differences in soil structure. At present, the political administrative choice is that it is reasonable to compensate municipalities for cost increasing factors. The municipalities' starting positions are thereby equivalent. For this reason, road maintenance is placed in the lower left quadrant.

Upper left portion of the coordinate system

For tasks which municipalities are required to perform by the central government ('not much policy discretion' option), the State takes the decision and, hence, the financial balancing should occur there as well. If equalisation is desired (position in the upper left portion of the coordinate system), a central government grant which covers the costs is appropriate. Every municipality thereby has sufficient resources to satisfy the standards set by the State.

Earmarked or general contribution?

If the State wishes to ensure that the resources are really expended for the stated goal, a specific grant is appropriate. Such a grant is earmarked and requires municipalities to account for the expenditures made. Accountability obviously entails administrative burdens. If all that matters is that municipalities carry out a certain task properly without a spending obligation being needed, an unrestricted adjustment grant from the municipal fund is a better choice. The recordkeeping is less with this, and municipalities have the opportunity to spend any surpluses in a way which generates the most benefit for the local community.²⁷ If an adjustment grant is used instead of the general grant, the distribution of the resources can be organised such that every municipality has sufficient resources to carry out the task in question. Further, with consideration for the dynamics of the situation, a different growth rate for the budget can be opted for than for the general grant.

Another disadvantage of specific cost-covering grants compared with adjustment grants is that they do not provide an incentive to municipalities for efficient implementation. This can be solved by letting municipalities spend any surpluses as they see fit (such as with the specific grant for social assistance benefits) or by having some of the costs go through the general grant.

Example: social assistance benefits

In furnishing social assistance benefits, municipalities enjoy a large measure of implementation discretion, but the outcome has been set by the central government. This ensures that these benefits are furnished in a uniform manner. The criteria for determining who is eligible for a social assistance benefit, as well as the amount of this benefit, are decided by the national government. Each municipality, though, must be provided with sufficient resources from the State to pay the benefits. This results in a position in the upper left portion of the coordinate system: not much policy discretion and a lot of equalisation. To encourage municipalities to nevertheless implement this efficiently, they may spend any social assistance benefit surpluses entirely as they see fit.

Upper right portion of the coordinate system

As regards tasks with not much policy discretion, the central government can also sometimes decide to have the user pay, through fees (passports) or levies (rubbish collection). This is logical if 'not much equalisation' (upper right portion of the coordinate system) is opted for. But fees or levies are not possible or desirable for all services (see box on page 22). This option is only possible if all users can pay the amounts involved, as municipalities, because of limited policy discretion, must provide a certain minimum level of services (various environmental standards apply to sewerage, for instance). The resources needed must, though, be available.

27 Although these resources may be expended unconditionally, they are, because of their nature, nevertheless often expended in the associated policy area. (Kattenberg, M., Vermeulen, W., 2015, The stimulative effect of an unconditional block grant on the decentralized provision of care, CPB Netherlands Bureau for Economic Policy Analysis, The Hague).

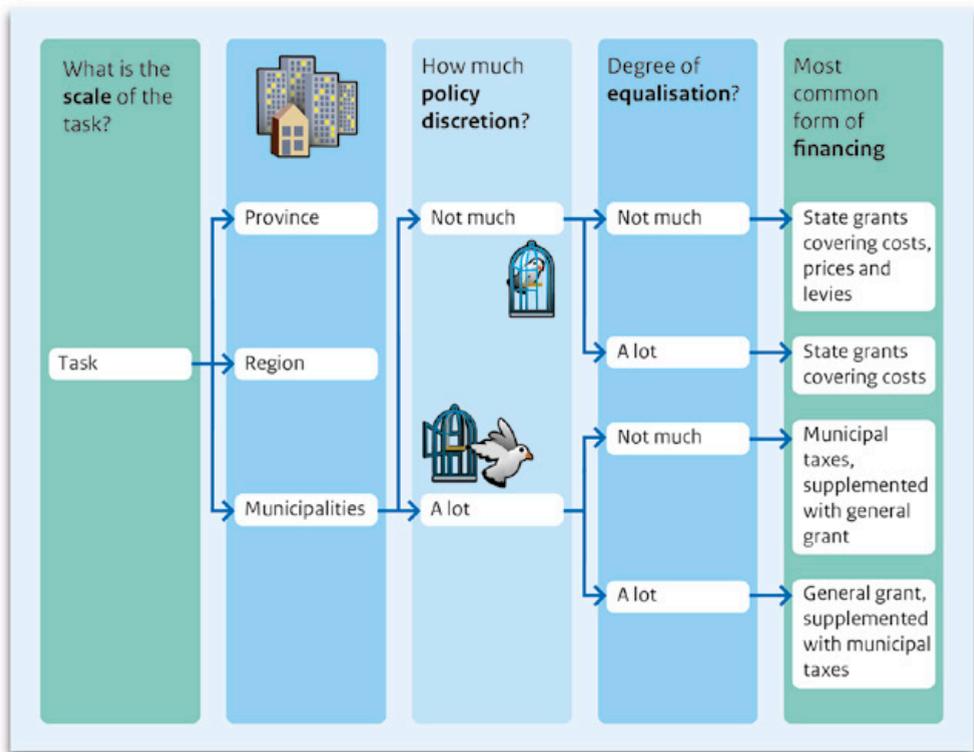
Example: sewerage

Municipalities do not have very much policy discretion with respect to sewerage. Cost differences between municipalities are only equalised to a limited extent, however. Sewerage thus falls in the upper right portion of the coordinate system. It is mainly paid for through local levies.

Summary: political choices and funding methods decision tree

The political choices to be made, with the ensuing results for the most suitable funding instruments, can be summarised in the decision tree below.

Figure 5: Political choices decision tree with associated funding methods



Obviously, designing a unique financial relation for each separate task is impractical. The uniform demarcation of tasks for the new rules for structuring the municipal budgets potentially offers good reference points for a clear-cut clustering of tasks in the coordinate system.²⁸ Tasks which end up next to each other in the coordinate system can be combined into groups. For the one group, local taxes may be used as the primary financing source, while the position in the coordinate system for the other group will necessitate, say, a general or specific grant.

28 Provinces and Municipalities (Budgets and Accounts) Decree, Bulletin of Acts and Decrees 2016, 101.

Preconditions and limits

If funding instruments for separate groups of tasks are opted for, what this leads to as a whole must then be examined, for not every combination is possible. There are, for example, critical preconditions for local taxes. For various reasons, the share of these in the entire municipal revenues cannot be too high. Taxes constitutes an important instrument for the central government in the national budgetary policy and the income policy. This instrument must not be weakened too much through transfer of taxes to municipalities. Secondly, excessive differences in local taxes and charges must not cause residents to relocate, in an undesirable way, to other municipalities. Where the ceiling can precisely be found cannot be stated, but experience in other countries shows that the municipal taxation area in the Netherlands can be expanded considerably without bumping up against the aforementioned limits. Even if it were doubled, the local taxation area in the Netherlands would still be small by international standards.²⁹

29 Bloechliker et al., *Fiscal Autonomy of sub central governments*, p. 5, Fig. 1, OECD, 2005.

5. Consistent application leads to other choices

The political choices listed in the decision tree (Figure 5) determine the administrative relation. The central government must always clearly indicate how much policy discretion municipalities have with tasks, hence, the extent to which differences in services levels between municipalities are acceptable and which degree of equalisation is desirable. The optimal financial relation then follows from the adage that ‘he who calls the tune pays the piper’. The government level making the administrative balance whether and how a task should be carried out must also weigh the costs against the benefits. If the State makes the determination, it must pay the costs through sufficient grants to municipalities. If the municipality is the determining party, it must do the financial balancing itself, bear the consequences of this and explain the decision to its electorate.

The Council noted earlier that the situation has got muddled through conflicting and opportunistic choices in recent years. The financial relations are not consistent with the administrative and political choices about municipal tasks.³⁰ The tasks, scale and control are consequently out of balance. The current inconsistent application of the assessments for funding local tasks has therefore resulted in inefficient spending of government money. Municipalities cannot perform their roles properly. Ultimately, this will erode the base of support for local administration.

It is not the Council’s place to make the political choices. The Council can, though, cast light on the current funding of municipal tasks by putting the political choices made into the decision tree and deducing the ensuing funding. Such consistent application leads to other funding choices than the present ones, but these choices are more in line with the societal tasks.

Decision tree works both ways

The approach which the Council proposes does not essentially differ from the preferred sequence and the principles underlying the distribution of the general grant as articulated in the Explanatory Memorandum to the Grants to Municipal Authorities Act from 1997.³¹

All the same, the existing financial relations do not correspond well to the choices ensuing from the decision tree. The first reason for this is that the basic principles are not consistently applied and taken to their logical conclusions. Secondly, the municipal set of tasks is not always looked at in conjunction with changes in the financial relations. If the assessments from the decision tree are followed based on political choices made by the government and parliament, the problems become plain.

³⁰ See also Netherlands Court of Audit, Financial Relations between Central Government and Local Authorities. Grants and Responsibilities for Decentralised Policy, Lower House, session year 2009-2010, 32-249, Nos. 1-2.

³¹ Lower House, session year 1995-1996, No. 24-552, No. 3.

If a funding method emerges from the decision tree which is not consistent with the existing practice, there are two options. The most obvious option is to adjust the funding method. Another conclusion, however, is that the political choices previously made should be reconsidered. In that case, the underlying choices, not the funding method, will be adjusted. So the decision tree can go both ways. The point of departure needs to be 'comply or explain!' If the outcome is not the one desired, a prior political choice must be reconsidered. The role of the fund managers is to ensure such consistent application.

Shift from national taxes to municipal taxes

Application of the decision tree leads to the conclusion that municipal tasks should be funded to a greater extent from local taxes than is now the case. National policy documents constantly emphasise that municipalities themselves need to make the assessments.³² A large measure of local taxation discretion exists for municipal services in such areas as sports, culture and green facilities. There seems to be no reason for equalising the costs in as far-reaching manner as occurs at present. Expanding the local taxation area, in combination with a smaller and more broadly-based distribution of the general grant, will be the result. National taxes can be lowered then. Funding for a portion of the government tasks will be shifted from national to local taxes. This will be in keeping, too, with the recommendations from various advisory and other reports over a series of years.³³

Yet municipal taxes only account for a small part of Dutch government revenues.

Example: political choices and the scope of the municipal taxation area

A possible end situation is a taxation area of double the size through which municipalities fund tasks where they have a lot of latitude for policymaking, such as in the areas of sports, culture and green facilities. The tax capacity can be equalised (in whole or in part). To ensure that each municipality can finance a base level and to keep local taxes from being too high, the municipalities' own revenues will be supplemented with a general grant. In this situation, the grant will be lower than the present general grant. When this is distributed, consideration need only be given in a general way to cost-increasing factors which a municipality should not reasonably have to pay for in full. Additionally, for tasks where municipalities have little policy discretion, such as in providing person-related services, they will get a few special purpose, cost-covering grants in which an efficiency incentive has been built in.

If, on the other hand, politicians at the national level feel that a larger municipal taxation area is undesirable, then, reasoning back from the decision tree, municipalities will be given less policy discretion. Perhaps the existing municipal range of tasks will have to be limited in that event. New decentralisation operations will also not make as much sense.

³² See, for example, the above-mentioned Explanatory Memorandum to the Grants to Municipal Authorities Act 1997.

³³ Financial Relations Council, 2011, Distribution, Trust and Accountability. A Reorientation of the Financial Relations in the Netherlands, The Hague. Financial Relations Council, 2015, *Uitbreiding lokaal belastinggebied* (Expansion of Local Taxation Area). CPB Netherlands Bureau for Economic Policy Analysis Policy Brief 2015, *Een ruimer lokaal belastinggebied* (A Broader Local Taxation Area). Commission on Financial Room for Municipalities (Rinnooy Kan Commission), *Bepalen betekent betalen* (Making the Determination Means Making the Payment), 2016.

Maximising local tax revenues or rates will not be appropriate with a shift of taxation to municipalities. The amount of local taxes is determined by local, not national, democracy. Municipal taxes and charges have increased very moderately in recent years,³⁴ specifically because municipal taxes are very visible.

With respect to a proper democratic balancing, a tax which is paid for by as big a group of residents as possible – voters, in other words – works the best. This is in line with the general notion that the decision-making, payment and enjoyment of the benefits need to be in the hands of one and the same party. The basis for local taxes should be made consistent with the tasks which municipalities have. Reinstating the occupier's share for property taxes, in combination or not with the introduction of a residents' tax, seems logical. Everyone will pay then (leaving aside tax remissions). Financing for municipal tasks will not rely on a group within the municipality which is too small.

Transfer of the tax burden to non residents can be avoided by instituting a relative limit which maximises the taxes levied on non-residents at a particular percentage of the taxes levied on residents. To simplify the local tax system, the tourist and second-home tax can be combined into a 'stay tax'. Minor taxes like the dog licence fee, advertising tax and second-home tax can be eliminated.³⁵

Social domain funding: don't touch, or pay for it yourself

The intention is to include the social domain adjustment grant in the general grant. Nonetheless, it is important for politicians to be aware of the principle-based choices implicitly made with this.

The Council observes a trend in the social domain tending towards standardisation and uniformity from the national political level, such as making sheltered employment mandatory. This trend could also be seen with the previous decentralisation of household assistance.³⁶ It limits municipal policy discretion, causing the advantages of decentralisation and the related efficiency gains to disappear. Municipalities can no longer provide customised services and can no longer weigh the costs and benefits against each other.

Example: sheltered employment

By transferring the participation budget (intended for such purposes as funding work re-entry projects) to the municipal fund, the State wanted to give municipalities spending discretion. They obtained the opportunity to create, for example, sheltered employment sites. As the number of sites to be realised has fallen short of expectations, the national government intends to require municipalities to utilise this instrument. Seeing as this limits spending discretion, a cost-covering state grant is the most fitting approach. After all, it is the central government which is the one making the determination here.

³⁴ Centre for Research on Local Government Economics (COELO), *Atlas van de lokale lasten 2016* (Atlas of Local Taxes 2016), Groningen, 2016.

³⁵ Financial Relations Council, *Expansion of Local Taxation Area*, 26 March 2015.

³⁶ See, for instance, the introduction of nationwide minimum rates and court decisions.

If politicians at the national level want to dictate how municipalities should spend the social domain budgets, the central government should also make sure that municipalities have a sufficient budget for these services. If 'The Hague' is calling the shots, it is more efficient for the central government to furnish a cost-covering grant to finance the decentralised tasks. If the State desires a spending obligation, this means that there should be a specific grant; with an obligation to achieve a particular result, an adjustment grant is best.

Based on the philosophy behind decentralisation, it makes more sense, however, to give municipalities policy discretion. Real, local customised services can be delivered, and the balancing between costs and benefits is more efficient, since this is the most in keeping with the local situation and needs. Such policy discretion, though, must be maintained in a consistent manner.

General grant: efficiency incentive has already been built in

The argument is regularly put forward that an efficiency incentive should be built into the distribution of the general grant from the municipal fund. Leaving aside the question how this ought to be done, this is not very well-suited to situations in which a general grant is the most appropriate instrument, for municipal policy discretion applies here. In terms of spending the money, municipalities are only accountable to the municipalities' own elected representatives with respect to both the efficiency and legitimacy of the spending. Every municipality foots the bill for its own inefficiency. An efficiency incentive is therefore inherent to a general grant. The municipality can use the gains from operating efficiently to either provide more services for its residents or to lower the municipal taxes.

Regional cooperation: form determines funding

For practical reasons, some tasks can be better organised on a regional scale. The most suitable option for tasks with not much policy discretion which are required to be performed regionally is a cost covering specific grant to these regions established by the government. After all, municipalities and regions can hardly influence the costs, and they cannot fully weigh the various policy goals. Moreover, there is a danger that financial risks will be shifted to chain partners.

Example: the security region

The security region is a mandatory form of cooperation, and the standards which these regions must fulfil is determined to a large extent by the State. In accordance with the decision tree in Figure 5, then, direct financing of the regions with a cost-covering state grant should be used. The security regions are, however, for the most part financed now by the participating municipalities from their own general resources. Each security region has formulated its own cost apportion formula, sometimes after a lot of discussion. These formulas are typically based in part on the distribution from the municipal fund through the general grant by way of the 'public order and safety' cluster. Not only is this cumbersome, it also makes it difficult to find cost factors based on which this cluster in the general grant is distributed to municipalities; the apportion formula is self-explanatory then.

Funding through central municipalities

Municipal tasks with a regional scope are sometimes placed with central municipalities. This gives rise to differentiation of tasks between municipalities. The advantage of this is that there is an administrative party which is responsible. The disadvantage is that non central municipalities can pass on their problems to the central municipality. Hence, a cost-covering state grant is fitting. For several tasks, this risk is so big – and the influence of all municipalities so important – that such tasks can better be given to all municipalities.

Example: sheltered accommodation

Under the Social Support Act 2015, the responsibility for sheltered accommodation was assigned to 43 central municipalities which received an adjustment grant for this. This was based on a situation arising from historical factors. The way in which individual municipalities have fleshed out their responsibility for Act-related tasks, such as providing home care, support assistance and daytime activities, affects the demand for sheltered accommodation. Given the desire to provide more support for the home situation and to prevent problems from being passed on, an obvious choice is to furnish all municipalities with the resources for the care and support, and thus not only have central municipalities carry out this task.³⁷

Where there is voluntary cooperation between municipalities, direct funding by the State to the region is not appropriate. It is up to the individual municipalities in that instance to contribute to the financing of the regional tasks.³⁸

³⁷ Advisory Committee on the Future of Sheltered Accommodation (Dannenbergh Commission), *Van Beschermd Wonen naar een beschermd thuis* (From Sheltered Accommodation to a Sheltered Home), November 2015.

³⁸ Council for Public Administration, *Wisselwerking. Naar een betere wisselwerking tussen gemeenteraden en de bovengemeentelijke samenwerking* (Interaction – Towards Better Interaction between Municipal Councils and supra-municipal partnerships), 2015.

6. Summary and recommendations

In the discussion paper 'To Have the Swiss, but No Money', the Financial Relations Council raised discussion points about the municipalities' role in fulfilling their societal tasks.³⁹ Societal and administrative relations have changed dramatically in the past 20 years. Many tasks have been decentralised to municipalities. The municipalities' role and responsibility to respond, in consultation with local social partners, to local needs has become more complex due to the relationship and mutual dependence. Further, municipalities have grown bigger and their cooperation with one another has intensified.

The Financial Relations Council presented five discussion points in the paper 'To Have the Swiss, but No Money' which were discussed with many interested parties and experts in the last six months. These will be examined point by point below. First, however, we will look at the analytical framework developed in this advisory report within which these discussions can be conducted in a systematic way.

Discussions about financial relations are often limited to particular aspects, such as local taxes. But financial relations need to be seen as a coherent whole. Solutions for sub problems which do not bear this whole in mind muddy things up. To analyse, in a systematic way, the extent to which the existing financial relations are still satisfactory, the Financial Relations Council identified the underlying political issues first. The consequences which choices have for the financial relations were then ascertained.

Determination and payment in the local administration

The financial relations must foster an effective, efficient weighing of costs and benefits. Placing government tasks with municipalities results in resources being expended better in line with local preferences. Municipalities have to be able to engage in an effective, efficient weighing, though.

In the current financial relations, some other party often has to pay for the determinations made. The central government imposes standards which limit municipalities in this weighing process.

The point of departure should be 'he who calls the tune pays the piper', that is, the party making the determination pays the costs. The government level (State, province or municipality) deciding whether a particular task must be carried out and, if so, in which manner should also be the one to balance the financial considerations. The manner in which the current financial relations are designed leads to inefficient spending of government money. Municipalities cannot fulfil their role properly, thereby eroding the base of support for local administration.

39 Financial Relations Council, *Wel Zwitsers, geen geld? Naar een nieuwe balans tussen taken, sturing en inkomsten van gemeenten* (To Have the Swiss, but No Money. A search for a new balance between municipal tasks, control and revenues), May 2016.

A good financial system for municipalities is not just a technical question. To the contrary, several political choices need to be made first. An efficient financing method will then follow from the ‘the determining party pays’ principle. The three choices are:

1. Should a task be performed by the municipality, region, province or State?
2. How much local policy discretion is there? May services differ between municipalities?
3. Should all municipalities have the same financial opportunities? Or is this less important?

The most efficient funding method will follow from the choices made. The decision tree in Figure 5 (p. 26) makes this clear. If these consequences are not pleasing, the choices may still be modified.

Recommendation 1

Examine the existing financial relations systematically by using the decision tree in this advisory report. Explain the underlying political choices, and draw the consequences as to the optimal funding method for the municipal tasks. Use this method, too, if municipalities are allotted new tasks.

Safeguard a maintenance cycle for the distribution system in which the funding of municipalities is examined once every four years by taking into account, in a consistent manner, the assessments and considerations set forth in the decision tree.

Stability and predictability

The first discussion point in ‘To Have the Swiss, but No Money’ relates to the degree to which municipalities are financially dependent on the State. Municipalities are carrying out more and more government tasks. Every year, they spend more than 56 billion euros. For the vast majority of their revenues, however, they rely on contributions by the State; they only pay a small portion from local taxes and levies.

Stability, transparency and predictability are extremely helpful in achieving sound municipal financial policy. This enables municipalities to serve their citizens properly, which is very necessary, because, otherwise, the base of support for local administration will disappear.⁴⁰ The Grants to Municipal Authorities Act must be adjusted in these respects to maintain confidence in the financial relations. Specifically, good financial relations are based on agreements under which government bodies can call each other to account.

Municipalities must obtain long-term certainty about both the volume and distribution of state resources. At this time, fluctuations in the central government’s budget have a huge impact on municipal budgets. Often, this leads to ad hoc, short-term modifications. The lack of stability undermines balanced, long-term financial policy by municipalities, so that the intended policy goals are not effectuated.

40 Council of State, *En nu verder! Vierde periodieke beschouwing over interbestuurlijke verhoudingen na de decentralisaties in het sociale en fysieke domein* (Take It from Here! Fourth Periodic Analysis on Inter Administrative Relations after the Decentralisation Operations in the Social and Physical Domain), October 2016.

Recommendation 2

Design a new indexing system for the general grant from the municipal fund which does justice to the dynamics of the municipalities' array of tasks and which provides the desired stability. This can be done by making a link to the State's four-year expenditure ceiling instead of to the actual state expenditures. Interim cuts to the fund should only be possible in emergency situations.

Policy discretion

The second issue raised in 'To Have the Swiss, but No Money' concerns the extent to which national solidarity is at odds with the local welfare state regarding the social domain. National solidarity is expressed through the equalisation of the distribution. The current policy choices are based on local customised services, which produces differences between municipalities. This basic principle is under pressure. There is a strong tendency towards uniformity and having individual claims to local services laid down at the national political level, thereby limiting municipal policy discretion. The benefits of decentralisation and the associated efficiency gains evaporate, too. Municipalities can no longer deliver customised services or weigh costs and benefits against each other.

The intention to include the social domain adjustment grant in the general grant does not fit with this. If the central government wants to prescribe how municipalities should spend the social domain budgets, it needs to also ensure that municipalities have a sufficient budget for these services, for the advantages of an effective, efficient weighing of costs and benefits by being able to offer customised services will be lost in that case. If the State wants decentralised tasks to be financed from the general grant, it should refrain from such meddlesomeness as mandating minimum levels.

Recommendation 3

If tasks are decentralised, make a choice between 'don't touch and stay away' and 'the State determines, so the State pays'. This choice will depend on the discretion which municipalities have in determining the outcomes of their policy.

Municipality's own resources and general grant

The third issue is for which type of municipal task there is latitude for funding from the municipality's own taxes. The distinction between 'physical' and 'social' is not distinctive enough. It primarily pertains to person-related versus group-related services. With regard to financing municipalities' current range of tasks, doing the balancing again makes paying for group-related tasks on a municipal scale, such as parks and swimming pools, from municipal taxes the best option. National taxes can be lowered then. Now that municipalities sometimes consist of dozens of centres due to re-division, giving them the option of providing 'customised taxation' for their residents merits consideration. Residents of villages or districts who want more group-related services in the neighbourhood than average would thus pay more municipal taxes than residents in other villages or districts. Villages which themselves maintain the green facilities could pay less.

Recommendation 4

Tasks with a lot of policy discretion which do not exceed the municipal scale (such as roads, sports and green facilities) can mainly be funded from municipal taxes. Municipal tax revenues can be doubled, and state taxes can go down proportionately.

Recommendation 5

Enable municipalities to differentiate tax rates geographically, so as to reflect differences in services levels.

For tasks entailing a great deal of municipal policy discretion in which equalisation of cost differences between municipalities is desired, the general grant is the most appropriate financing instrument. If they wish, municipalities can likewise employ local taxes to finance extra services. A smaller role for the general grant means that the distribution can be simplified, which, moreover, is already possible with retention of equalisation.⁴¹

Recommendation 6

Simplify the distribution system for the municipal fund's general grant.

Regional cooperation

The fourth issue has to do with financing regional cooperation. Municipal tasks are increasingly being dealt with at a regional level. To get a proper balancing between utility and sacrifice and to maintain democratic control, the payment and the determination should as much as possible be made by the same party. If the State has imposed a regional scale and municipalities do not have much policy discretion, funding through a specific grant to the region makes sense. If the participating municipalities want additional things, they should contribute to this themselves. The plusses and minuses of regional cooperation need to be with the government authorities responsible for the cooperation chosen.

Recommendation 7

Stick with the principles of financial relations in funding regional tasks – that is, ‘he who calls the tune pays the piper’, or, phrased differently, the party making the determination pays the costs.

41 Financial Relations Council, *Vereenvoudiging algemene uitkering gemeentefonds* (Simplification of Municipal Fund General Grant), 2011.

Stimulating growth

The final discussion point is whether regional economic growth can or should be stimulated through the financial relations. Enhancing administrative capacity for regional economic tasks is an issue which merits its own attention and has only been addressed indirectly in this advisory report.⁴² Nonetheless, it may be stated that expanding the local taxation area can provide a major boost for regional economic development. Municipalities must, though, be able to profit from the increased property values in their region. These increased values should not largely be pruned away through the general grant's distribution mechanism. It is better for municipalities to use the tax revenues to finance investments leading to higher property values. Municipalities might also take advantage of the option of setting up a regional business improvement fund analogous to the local business improvement zone (BIZ).

Recommendation 8

Considering structuring the equalisation of the tax capacity in the distribution of the general grant such that increased values are less likely to lead to a lower grant or only lead to this with some delay in time.

Recommendation 9

To stimulate regional economic development, utilise the opportunities which the system already offers now, such as regional business improvement funds.

⁴² The Council intends to examine this in a separate advisory report.

