Local & Regional Europe

Local Finances and the Green Transition

Managing Emergencies and Boosting Local Investments for a Sustainable Recovery in CEMR member countries

Co-funded by the European Union

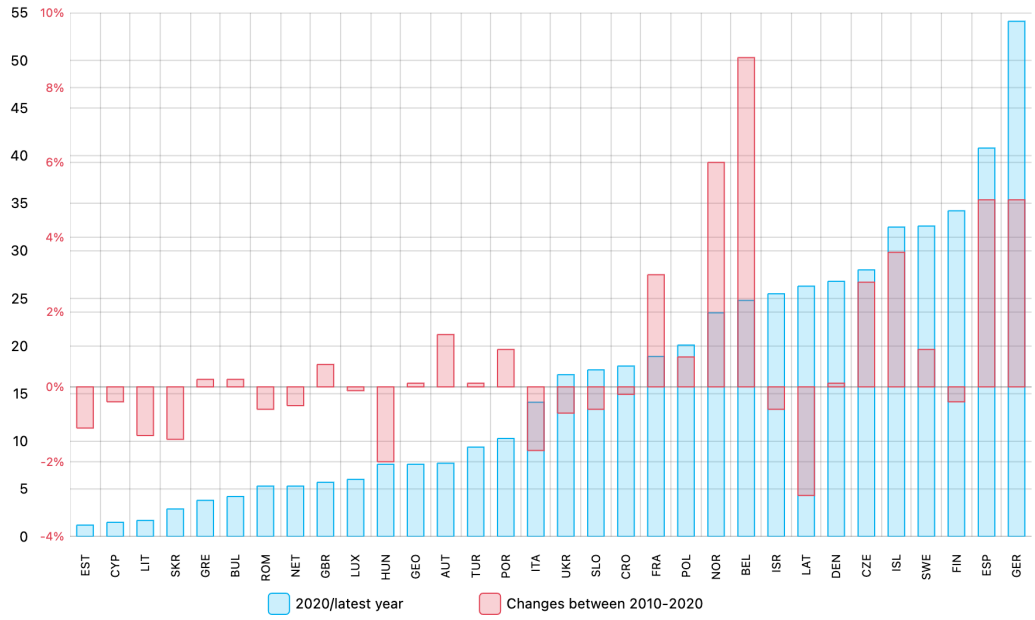
4. Revenue assignment and taxation

Following the analysis of budget expenditure, this chapter will focus on the sources of financing for subnational governments. This key area of local finances is determined by the composition of the four types of local government revenues: own revenue, shared taxes and fees, intergovernmental transfers and loans. Aside from this financial data, the reports available on the countries under study only provide incomplete information about the actual form of fiscal decentralisation, i.e. the degree of revenue-raising autonomy and methods.

Revenue decentralisation and grant dependency

Subnational governments control a significant part of taxes in the more decentralised countries and in the federal countries (Figure 13). In the Scandinavian countries as well as in Germany and Spain, where states/regions have extended responsibilities, subnational taxes represent more than 25% of all government taxes collected (local own-source and shared taxes are reported together). At the other end of the spectrum, there are the less decentralised countries or those that are more dependent on intergovernmental transfers (left-hand side of the chart).

FIGURE 13 SUBNATIONAL TAX DECENTRALISATION, 2010-2020
SUBNATIONAL TAXES AS A % OF TOTAL TAX REVENUE



Responses to the fiscal challenges of the economic crisis differed across the CEMR countries. In countries with higher local tax revenues, the importance of local taxes further increased. Within this group – with the exception of Israel, Latvia and Finland – the ratio of locally collected taxes was higher in 2020 than a decade ago. In the less decentralised countries, those with a lower local tax share were more reluctant to increase own source revenue-raising powers. Consequently, the lower local taxation translates into a further decrease in local taxes.

Local taxation underwent reforms in various ways at different stages of the economic recovery and crisis management (see the cases of Austria and France in Box 14).

Box 14 – Local tax reforms in Austria and France

In *Austria*, three major tax reforms aimed at relieving the burden on companies or the population were introduced in the past decade. They reduced the local revenue from shared taxes, although this revenue shortfall was partly compensated through fiscal equalisation grants. The eco-social tax reform covering the 2020-2024 period is particularly significant as it will lead to municipal revenue losses of EUR 2.1 billion. Revenue from the newly introduced CO2 tax will accrue exclusively to the federal government. No new climate-related taxes have been introduced at the local level.

In *France*, a local business tax (EUR 30 billion) was abolished in 2010 for being too variable, penalising investment and employment. It was replaced by:

- *contribution on companies' added value* (CVAE), which brought in EUR 19 billion in 2020 and was shared between municipalities and inter-municipal cooperation entities (26.5%), departments (23.5%) and regions (50%);
- *property tax on businesses* (CFE), which brought in EUR 8 billion in 2020 and was collected by municipalities and inter-municipal cooperation entities (see Box 4 above).

In addition, companies also pay property taxes on developed real estate (TFPB), which brought in local revenue of EUR 35 billion in 2020, around 33% of which was paid by companies and 66% by households.

In 2021, these taxes on production (turnover, added value, developed land) were further reduced in order to not penalise companies' competitiveness. This was done by halving the CVAE for all companies through the elimination of the regions' share and by dividing the industrial establishments' real estate rental value by two (for CFE and TFPB).

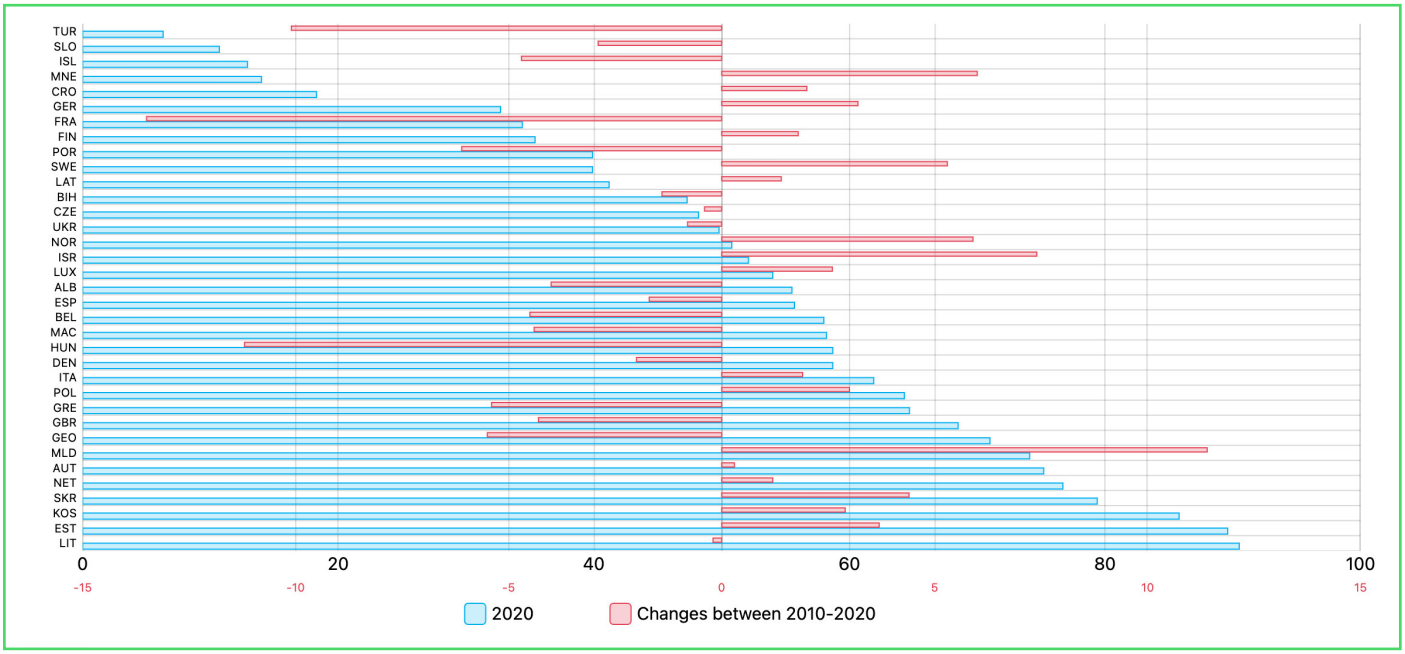
These losses in local tax revenue were offset through State transfers (EUR 3 billion). The regions benefitted from a new VAT share (EUR 9 billion). Municipalities and inter-municipal cooperation entities were compensated through State allocations, which took the tax base into account but not the rates levied.

For further information, see:

Le débat d'orientation budgétaire (D.O.B.) illustré - Janvier 2021 - La Banque Postale

For one diverse group of countries, the ratio of intergovernmental transfers and grants in the subnational budgets is high, accounting for more than 60% of subnational budget revenue. Grant dependency, as a symmetrical indicator of local revenue autonomy, is typically high in the smaller transition countries, as well as in the Netherlands, Austria, UK and Italy (Figure 14). This indicates that local revenue autonomy is determined not only by the weight of intergovernmental transfers but that the grant allocation methods can prove critical as well. Inversely, in countries with significant shared revenue, local governments receive less financing through intergovernmental transfers. This is the case with the group comprising Turkey, three of the Western Balkan countries and the Scandinavian and federal countries.

FIGURE 14 GRANT DEPENDENCY, 2020 AND CHANGES BETWEEN 2010-2020
GRANTS AS % OF TOTAL SUBNATIONAL REVENUE



During the past decade, the grant dependency ratio has changed for both groups of countries. However, no discernible pattern was identified in the countries with higher or lower shares of national budget transfers. The reasons behind the changes were different in each country; overall budget restrictions (e.g. Greece), radical centralisation of local functions (e.g. Hungary) or changes in tax policies (e.g. France) may all have contributed to the cuts in intergovernmental transfers.

National budget programmes often target local environmental investments and service management improvements (Box 15). These fiscal transfer programmes exist both in countries with a greater grant dependency ratio (e.g. Estonia, Austria) as well as in those with higher shared revenue (e.g. Turkey). Considering that the environmental impact of subsidised investments extends beyond the boundaries of a beneficiary municipality, these national or often supra-national (European Union) grants and support programmes are warranted.

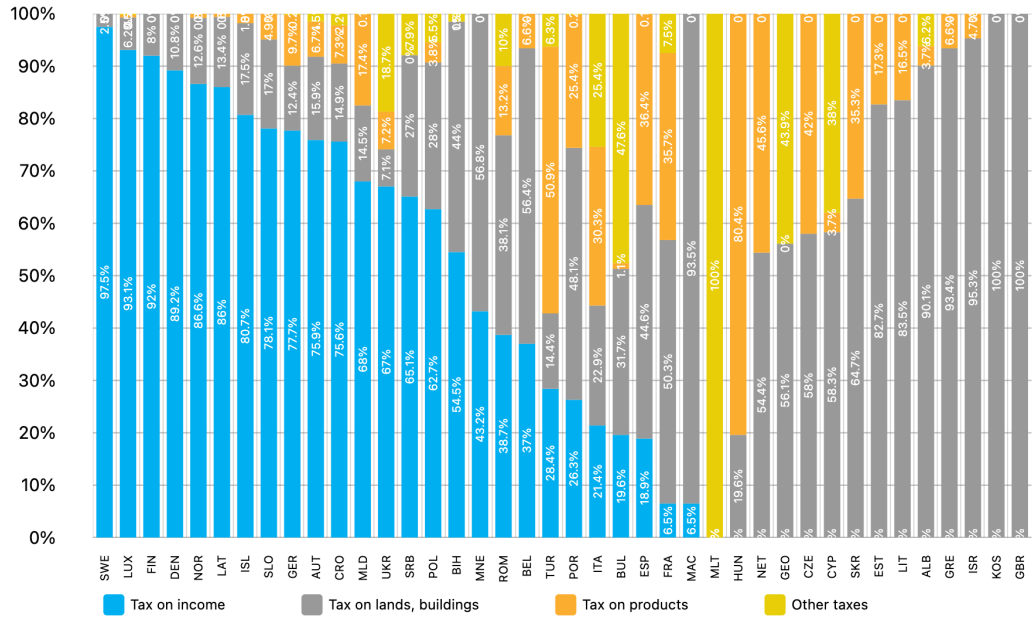
Box 15 – Municipal financial support programmes and subsidies

In *Austria,* the municipal investment programme of the federal government is an investment package of EUR 1 billion, primarily covering 2020/2021, and a second municipal package of EUR 1.5 billion for 2021. It is a matching grant with 50% federal funding and the remaining 50% partly covered by the state (*Land*) or EU funds and partly by the municipalities. The amount of funding per municipality is capped according to demographic conditions. This **second municipal package** consists of EUR 500 million in *additional aid* for 2021 (a EUR 400 million increase in revenue shares and EUR 100 million in structural funds) and EUR 1 billion in *advances on future revenue shares* to resolve the urgent problem of securing liquidity. In light of the favourable economic environment, municipalities are not required to repay the advances. There is also the **fiscal equalisation extension**, which is partial compensation (EUR 310 million) for the shortfall in local revenue resulting from the eco-social tax reform.
The **Disaster Fund of the Federal Government of Austria** was established in 1966 to finance measures to avert future disasters and repair any damages that occur. The majority (75%) of the Disaster Fund's resources (EUR 480 million in 2019) have been used for preventive measures, mainly to mitigate future flood and avalanche damage, e.g. passive flood protection and water quality surveys. The remaining funds have gone towards damage management and firefighting equipment.
Subsidies for preventive measures (EUR 352 million) have been used to a large extent by the federal government. In 2019, municipalities received EUR 20 million for damage control and EUR 43 million for fire department emergency equipment. In the event where there is damage to the assets of the provinces and municipalities, the Disaster Fund reimburses 50 percent of the loss.
In *Estonia*, centrally subsidised local energy efficiency programmes aimed at supporting local government energy saving investments in public buildings have been operating since the middle of the past decade. They are financed by CO2 sale revenues. This budget support is available to promote the construction of nearly-zero energy local government buildings (EUR 20 million) and the conversion of existing local government buildings (EUR 10 million). These energy-saving measures reduce the maintenance costs of public buildings. Other increasingly common local energy efficiency development measures involve the retrofitting of street lighting with LED technology, the increased use of new heating technologies by renovating boiler rooms and heating systems and transitioning consumers to local heating networks.
In *Turkey*, the National Zero Waste Project aims to manage waste in accordance with sustainable development principles, leaving a clean Turkey and a liveable world to future generations. The programme was launched in 2017 and is being implemented by the Ministry of Environment, Urbanisation and Climate Change and localised by the Union of Municipalities of Turkey (UMT).
Municipalities have been encouraged to use zero-waste models in their public buildings. UMT has been providing technical assistance to municipalities to ensure their preparedness for the higher-level certification. The Zero Waste Blue Project has also been launched to protect the seas and coasts of Turkey.
The Zero Waste Project hopes to reach a 35 percent recovery rate target (proportion of waste recycled from all recyclable materials) in 400 000 buildings by 2023. Potential economic savings have been calculated at TRY 17 billion, with direct employment for 100 000 people and annual savings of TRY 20 billion. The project is based on the "Zero Waste System", a seven-step roadmap to be followed by the companies, institutions or organisations involved in the programme. The roadmap was developed by the Ministry of Environment, Urbanisation and Climate Change. UMT has been organising national contests for municipalities to promote certain topics, e.g., the Zero Waste Project and Idea Contest organised in 2020 that awarded grants of TRY 500 000 (EUR 31 000) to20 municipalities.
As of 2020, the Zero Waste Management System has been implemented in 76 000 public buildings, with an initial recovery rate of 13% that has continually increased, eventually reaching 19%. Between 2017 and 2020, the project helped save 397 million tons of raw material, 315 million kilowatt-hours of energy, 345 million cubic meters of water and 50 million barrels of oil. During the same period, 17 million tons of usable waste were collected, 2 billion tons of greenhouse gas emissions were prevented and 209 million trees were saved by the project.

Differences in local revenue policies

Local tax systems in the CEMR countries are predominantly structured around income (personal, profit) or land and building taxes (Figure 15). According to the OECD tax statistics, in the 16 countries that receive revenue from taxes on income, this source represents more than half of their total local tax revenue (left-hand side of the chart). Personal income taxes can be allocated to the place of origin, where they were raised, or they can be reallocated using a formula. The most progressive income tax-sharing mechanism is the surtax method, whereby subnational governments have the power to set their own rates (e.g. Scandinavia, Germany, Croatia).

FIGURE 15 INCOME AND PROPERTY TAX-BASED LOCAL TAX SYSTEMS, 2020



The other group of countries (right side of the chart) relies on local property taxation. They are the less decentralised and smaller countries. However, the preponderance of this tax on land and buildings in these countries is due either to tradition, as the only existing main local tax revenue (e.g. UK), or to its introduction during the transition (Kosovo, Albania, Lithuania, Estonia).

Changes in local taxation

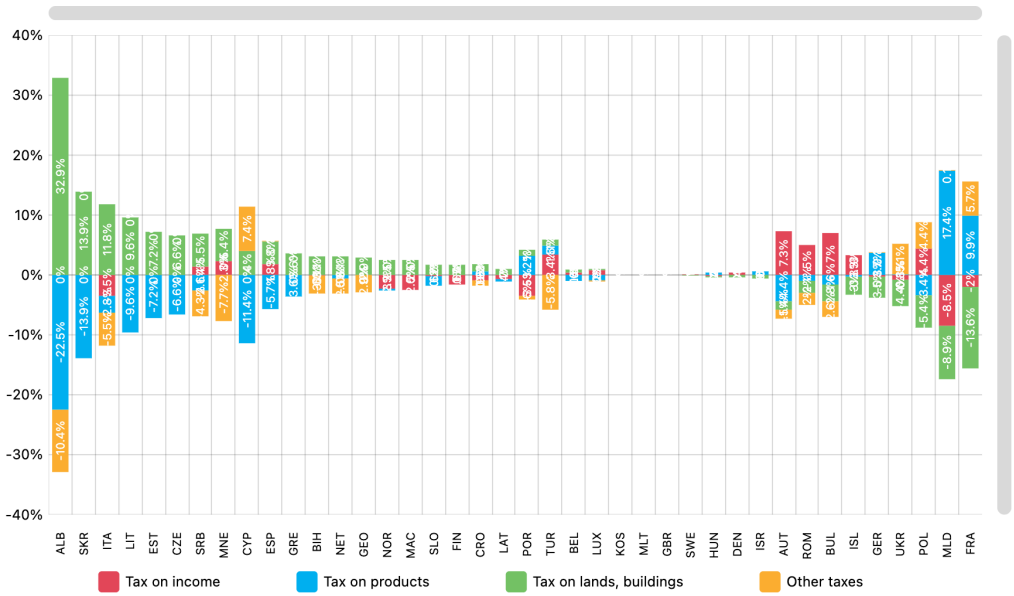
The local tax systems underwent minor reforms during the post-crisis period (Figure 16). Two trends can be identified in the CEMR countries. First, in line with the economic policy goals of the time, the local tax burden on businesses and production was reduced. The composition of local taxes shifted towards property taxation in these countries. A tax on buildings and land has a less direct distorting effect on business activities while also being a more stable source of local revenue. Various forms of taxing land value increases are also increasingly being developed (see Box 16).

Box 16 – Development charges in Austria

The development charge is a mandatory, one-time payment to the municipality. The levy becomes due once a plot of land has been designated as a building site or a building permit has been issued. The development charge is usually levied on the plot area or other indicators (e.g. building class, assessed value). The amount varies by state (Land). Its usage is not earmarked, but it finances, for example, roads, sidewalks, street lighting and drainage systems.

The second trend can be seen at the opposite end of this chart (Figure 16) with the countries that have moved away slightly from property taxation, experimenting either with income-based taxes (income, profits, capital gains) or taxes on products (sales, excise, motor vehicle, etc.). It should be noted that the tax on land and buildings includes not only recurrent taxes on immovable property, but the property transaction tax as well.

FIGURE 16 RESTRUCTURING LOCAL TAXATION 2010-2020:
A) FROM TAX ON PRODUCTS TOWARDS PROPERTY TAX
B) FROM PROPERTY TAX TO INCOME TAXATION



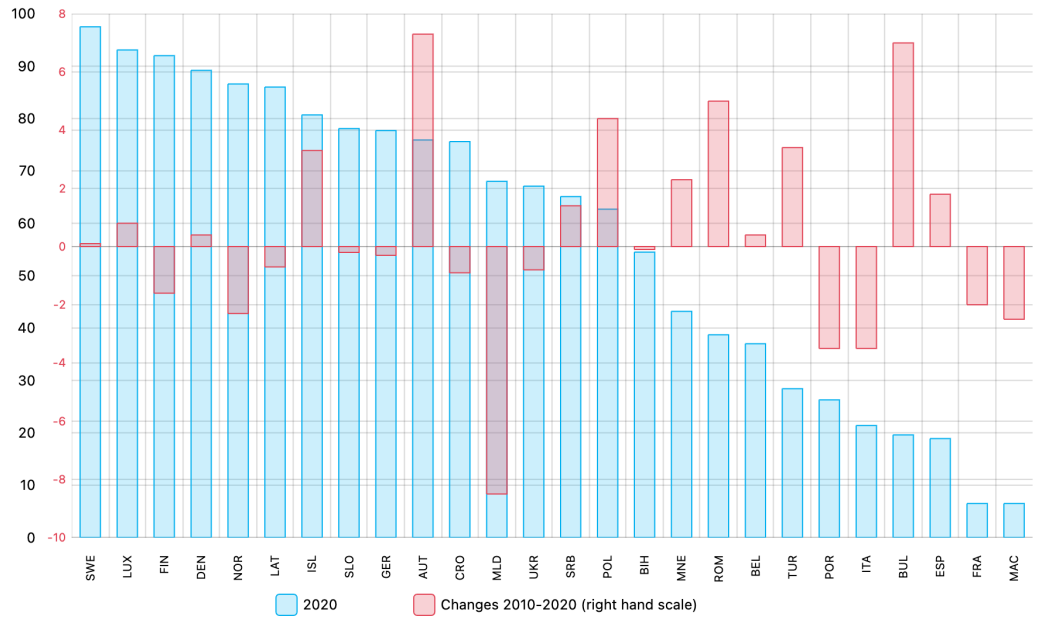
Box 17 – Local tax reforms in Serbia

The local property tax was previously assessed, collected and enforced by the national government, but its yield has been returned to local governments on the basis of origin. Since 2007, local self-governments have been responsible for administering the tax and setting the rates within limits. in 2012, the legal tax framework was amended by limiting the local business sign tax and eliminating the local motor vehicle fee. In 2014, the land use fee, the second most important source of own-revenue was eliminated so that it could be integrated into the property tax. In the meantime, the national government raised other central taxes including the VAT, capital income tax, excise and social contributions.

The personal income tax (PIT) is by far the most important local tax revenue source. In 2019, the PIT accounted for 63% of local self-government tax revenue and 33.5% of total revenue. PIT is levied by the central government on gross wages, as a payroll tax and on self-employed income. In June 2013, the government reduced the rate of the tax on wages from 12% to 10% while increasing the threshold for non-taxable income. These changes led to a direct loss in local revenue of around EUR 200 million. As of 2016, cities receive 77%, municipalities 74% and the City of Belgrade 66% of the revenue on gross wages.

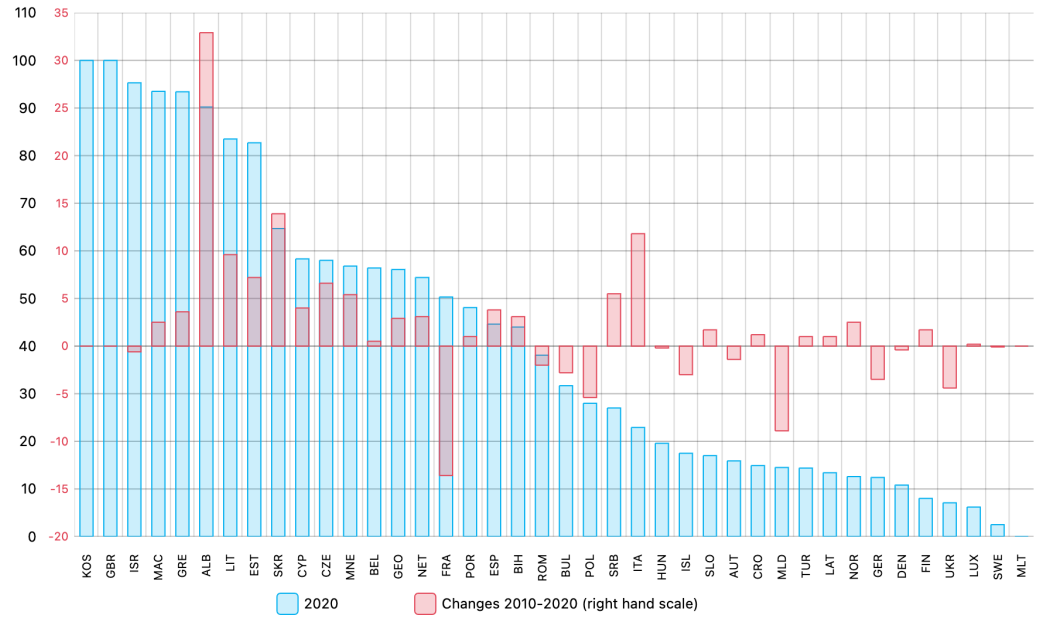
Countries reliant on local income taxation pursue diverse policies (Figure 17). In countries where it already constitutes the major source of local tax revenue (Austria, Israel), the weight of taxes on income (wages) was increased further. The countries who had previously been less dependent on income taxes moved in the direction of an income-based local own source revenue system in the Balkans (Bulgaria, Romania, Montenegro) and in Turkey and Spain. Thus, within this group of countries, some convergence of their local tax systems can be detected.

FIGURE 17 EXPERIMENTING WITH TAX ON INCOME



Property taxation exists in almost all the CEMR member countries. The majority of countries with a high share of taxes on land and buildings in the local tax pool increased their property tax revenue (left side of Figure 18, with France as an outlier). Countries which were less reliant on local property taxes did not fit into any clear pattern in this respect.

FIGURE 18 MOVE TOWARDS TAX ON LAND, BUILDINGS



Local tax reforms have also targeted environmental objectives, such as the tax incentives for municipal waste reduction introduced in France (Box 18).

Box 18 – Tax incentives for municipal waste reduction in France

Household waste is responsible for 4% of greenhouse gas emissions in France. The Energy Transition Law for Green Growth (TECV, 2015) set targets to reduce household waste by 10% (from 2010 levels and by 2020), increase the volume of recycling or organic recovery to 65% (by 2025). Two categories of tax incentives were introduced:

The household waste collection tax incentive for citizens (TEOMI). The household waste collection tax (TEOM) is a property tax paid by citizens (EUR 7.1 billion in 2020). Intermunicipal cooperation entities finance household waste management mainly through the TEOM. Since 2014, local governments have the option of adding an incentive tied to the quantity or type of waste collected. They can also opt to introduce a *charge* (i.e. fee to be paid for the service rendered) instead of the tax. This user service charge is less commonplace (EUR 550 million).

As of 2020, only 55 intermunicipal cooperation entities (out of a total of 1 254) have set up an incentive share for TEOM (EUR 33.5 million). The target for 2025 aims to have 25 million inhabitants taking part in this incentive pricing scheme; but as of 2020, only 5.9 million inhabitants were concerned by both schemes.

The main impediments to implementation are higher costs (communication with citizens, purchase of new equipment, training personnel), risk of counterproductive behaviour, such as illegal dumping or incineration, and lack of political will to carry out a service organisation review.

Gradual increase in State tax on polluting activities (TGAP). The TGAP is paid by local governments according to the volume of waste deposited or incinerated. In order to reduce waste tonnage over the 2021-2025 period, relevant tax rates were gradually increased. At the same time, the VAT rate on sorting activities has been lowered. The central government estimated that the rate increase would cost local governments EUR 104 million in 2021 and EUR 210 million in 2025. It is not possible to offset this increase through a reduced VAT rate or the volume of waste landfilled or incinerated.

For further information, see:

Terra Nova : la gestion du service des déchets ménagers par les collectivités locales en France - La Banque Postale

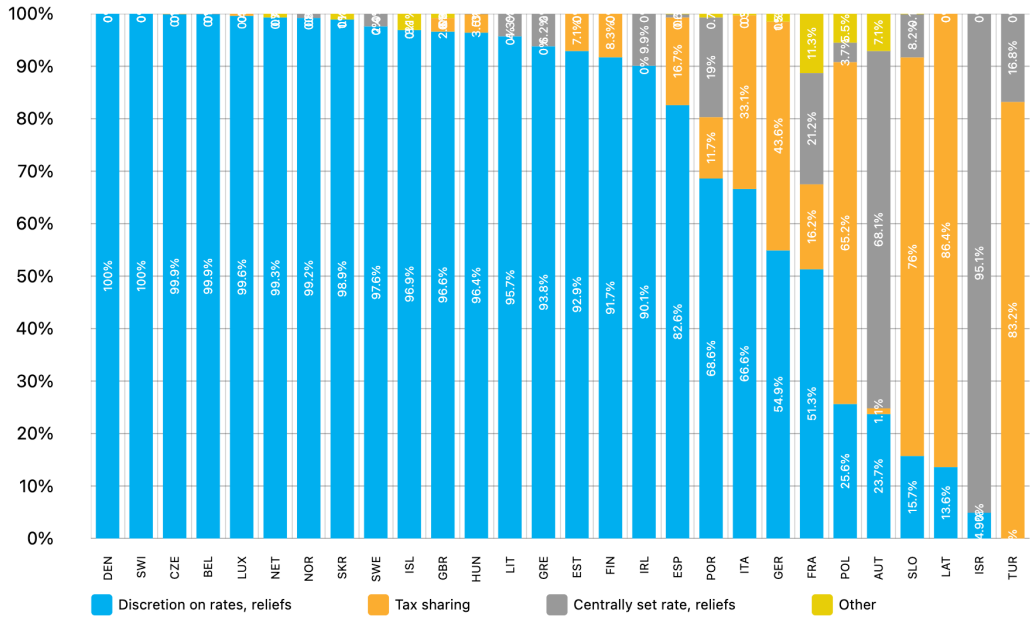
Tarification incitative parmi les modes de financement du service public déchets | Optigede - Ademe

Local tax autonomy

Subnational tax autonomy is measured not only by the ratio of tax revenue in the local budget, but by the local government's power to levy and collect them. The OECD has developed an indicator, which classifies all local tax revenue according to a six-unit-typology (OECD, 2020). Each tax is categorised using a scale ranging from high autonomy, such as being able to set tax rates, reliefs and tax sharing methods, to low tax autonomy, whereby the central government sets the tax rates and allowances. These 12 forms of local tax autonomy have been further distilled into four categories for the purposes of studying this matter in the CEMR countries that are covered by the OECD revenue statistics (Figure 19).

Most of the countries have high local tax autonomy. Local governments enjoy discretionary authority in setting tax rates and reliefs for almost all the local tax revenue. (Regional (state) governments' taxing powers have been measured separately.) However, there is another distinct group of countries that typically employ tax sharing schemes. The method of revenue split will determine how stable and certain this source is, in light of whether the sharing arrangement can be changed by the central government only with the consent of local governments (high autonomy) or unilaterally through budget legislation (limited autonomy). The remaining countries fall somewhere in the middle, with local governments only responsible for tax collection while the tax base, rate and reliefs are set at the central level (e.g. Austria, Israel).

FIGURE 19 AUTONOMY IN SETTING THE MAJORITY OF LOCAL GOVERNMENT TAXES, 2018



During the past decade, the level of tax autonomy has remained stable. There were only three countries in the OECD report where tax autonomy increased significantly by 2018. The share of taxes with local discretion on rates and reliefs was higher in Slovakia, Greece and Italy than at the beginning of the period. Reforms were responsible for major changes in these countries even though they started with a relatively low base at the beginning of the decade. In France, the locally significant municipal housing tax is gradually being replaced with revenue-sharing schemes (see Box 19).

Box 19 – Shift from a local tax towards revenue sharing in France

Up until 2020, a municipal housing tax (TH) was paid by owners or users of housing premises. It was based on the cadastral rental value of the dwellings, as assessed in 1980, revalued using an annual coefficient close to inflation. This tax brought in around EUR 24 billion or 15.5% in local tax revenue (in 2020). It was deemed to be unequal revenue, mainly on account of the timeworn tax base.

The gradual abolition of this housing tax is scheduled for the period of 2018-2023. Since 2021, local governments have been receiving compensation as part of local tax reforms; instead of the housing tax, municipalities collect the departmental share of the property tax on built properties, while the departments and intermunicipal groupings with tax powers (GFP) collect a share of the national VAT.

Some consequences of this new tax basket entail the following:

- on tax strategies: municipalities have the power to set the property tax (TFPB) rates. The owners of premises have to pay taxes to the municipality, making them taxpayers; but as there is no residency requirement, they are not necessarily local residents and therefore not voters. Thus, the link between the citizen and the municipality is weakened.
- on territorial inequalities: the housing tax remains in force for second homes, which have an uneven distribution across the country.
- on departments' adaptability to budgetary shocks: the replacement of the TFPB with a share of VAT is not an adverse development in terms of revenue dynamics over time. However, the elimination of the power to set the TFPB rate further restricts any budgetary adaptation to the economic crisis.

For additional information, see:

Accès Territoires n°7 : la suppression de la taxe d'habitation (modalités et conséquences) - La Banque Postale

Réforme de la fiscalité locale - La Banque Postale

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