

**A Handbook on Finance  
at Local and Regional Level**

**A set of Council of Europe  
legal instruments,  
with an introduction  
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# A Handbook on Finance at Local and Regional Level

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**Introduction**  
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An effective system of local government is important for both political and economic reasons. It shares power and promotes the accountability of local public services. It also helps to fit those services to local needs and preferences.

The financial framework within which local government operates is crucial to meeting both these objectives. This booklet reproduces the relevant articles of the European Charter of Local Self Government and recommendations made by the Council of Ministers which define the practical ways in which these aims can be met. How much power and responsibility regional and local governments actually exercise depend substantially on

- (1) what range of public services they finance;
- (2) whether their revenues are commensurate with these responsibilities;
- (3) how much real choice they have in allocating their budget to individual services;
- (4) whether they can determine the rates of their taxes and charges (both allowing them to vary their level of spending and making them answerable to the payers).

The term "local government" will be used to describe both upper (regional, county, district) and lower (city, municipal, settlement) tiers of self-government.

## **Spending Responsibilities**

There is wide diversity between individual states in the scale of the tasks devolved to local government. In most countries local government is responsible for what are often called "communal services": local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries, social housing. What varies greatly is the extent of local responsibility for the social sector, chiefly comprising education, health and social assistance. In some cases the whole service is funded by the State Budget, in some costs are split between levels of government, in some local budgets meet all costs except central supervision.

This varying degree of local budget responsibility for the social sector makes a major difference to the nature and scale of decentralisation. Without such responsibility local government expenditure is unlikely to exceed 5-6% of GDP. Responsibilities for education, health care or social assistance are likely to double or treble this proportion. This in turn has a major impact on financial self sufficiency. Major social sector responsibilities are usually combined with a substantial dependence on State grants or tax shares, both because of the limited capacity of revenues which can be assigned to local levy and because of the degree of geographical equality expected in access to these services and, in consequence, the need to equalise financial resources.

## Local Taxation

The Charter lays considerable emphasis on the power of local governments to levy their own taxes. By local taxation the Charter means taxes which

- (1) accrue to the budgets of the local government in whose area they are collected, and
- (2) are subject to some degree of variation by the recipient local government; i.e. the local government has some discretion in deciding how much each person pays, by setting the rate, determining the basis of assessment, granting exemptions etc.

Local taxation is important for two main reasons. Firstly power to vary tax rates allows local governments to fit their levels of expenditure to local needs and preferences. Secondly, fixing the amount of tax which citizens have to pay makes local leaders more answerable for the way they spend their income.

To meet these objectives local taxes need certain characteristics. Firstly the geographical origin needs to be clear so that the revenues truly come out of local pockets and the burden cannot be passed on to people or organisations in other jurisdictions. Secondly, it should be possible for rates to vary between jurisdictions without significant administrative cost or distortion to trade. Thirdly, tax bases should be reasonably buoyant so that natural expansion arises from the same pressures such as inflation, population and economic growth which demand increases in local expenditure.

Taxes on *property* are the most common local taxes, though not necessarily the most important. They have two major advantages for local government. Firstly, their base is obviously localised; there is no room for argument where the revenue should accrue; there are clear connections between the value of real estate and the municipal expenditure on local infrastructure. Secondly, real estate is the one tax base which cannot be hidden by a "black economy".

There are also significant weaknesses which, in practice, keep the yields of property taxes far below those of major taxes on income and consumption. The tax has to be collected directly from the taxpayer, making it more politically sensitive than other levies paid indirectly or deducted from salaries. The lack of direct correlation between the assessment of property tax and the income from which it has to be paid adds to this sensitivity. Assessing market or rental values of the tax is complex and slow; as a result cruder and less discriminating bases of assessment are often used limiting incidence and potential yields; in either case it is hard to keep valuations up to date so that the tax base responds very slowly to changes in prices or economic growth which increase demands on municipal expenditure.

As a result property taxes rarely raise more than 1-2% of GDP, enough to fund much municipal infrastructure, but not major social sector responsibilities. It is critical to their contribution that local governments have power to raise rates regularly to keep pace with prices and are encouraged to do so.

*Personal income taxation* meets the requirements for a local tax. In some western European states (notably Switzerland and the Scandinavian countries) local governments add their own rates as surcharges on the national rates of personal income tax; the national rates are kept low enough to allow room for the local levies. It is no coincidence that these are the countries where local government has the highest measure of fiscal independence. This is because personal income tax has far greater potential capacity than any other tax capable of levy at local level. It also has clear linkages to expenditure on personal services such as health and education.



Shares of personal income tax are the largest tax revenue for local government in most CEE countries, but only in Croatia and Montenegro do local governments have any control over their rates. Sharing elsewhere does not meet the Charter's definition of local taxation, although most CEE countries treat it as such because it is generally distributed by origin.

Taxation of *corporate profits, business turnover* etc has provided substantial revenue to several European systems of local government, but is generally in decline as a local government revenue throughout Europe. There are severe technical difficulties in assigning such receipts to the local government from which the business incomes truly derive. Corporate profits are highly volatile and the base lacks the stability to support services with such a large component of regular committed expenses as those of local government. National governments are anxious to restrict taxes on this base to attract inward investment.

Taxation of *sales of goods and services* has also provided substantial revenues to some local governments, notably in the former Yugoslavia. However, it is being widely eliminated from local government revenue, largely because of its competition with value added tax, which is obligatory in the European Union and under adoption in states aspiring to EU membership.

### **User Charging**

At municipal level user charging is often as significant as local taxation in its yields and impact on household incomes. It is less discussed, partly because it tends to be undertaken by subsidiary enterprises rather than the parent municipality. However, deregulation of prices and withdrawal of state subsidies are generally increasing both the burden of charges such as housing rents, water and heating charges and public transport fares, and the responsibility of municipal governments for determining tariffs.

National policy generally discourages the general subsidies which often restrained utility charges in the past and favours full cost pricing accompanied by the introduction of subsidies to low income households, probably more equitable and efficient but more administratively demanding.

### **Intergovernmental Transfers**

Intergovernmental transfers take a number of forms:

Shares of national taxes distributed *either*

(1) by formula (e.g. per capita), *or*

(2) by origin (i.e. to the local government where they are collected).

Grants which are *either*

(1) specific, ie targeted to support specific expenditures (e.g. social benefits, education), *or*

(2) general, ie untargeted and used at the discretion of local government (often known as block grants).

Targeted grants are usually intended to stimulate a specific type of expenditure which is favoured or mandated by national government.

Tax sharing and block grants usually have two main purposes, vertical and horizontal equalisation. *Vertical* equalisation means closing the gap between the cost of the services devolved on local governments and the yield of their direct revenue sources. *Horizontal* equalisation adjusts differences between individual local governments in their per capita revenues or spending needs. In some cases such as Sweden and Poland equalisation is partially financed through horizontal redistribution, i.e. by transferring revenue between local governments with above and below average incomes.

Transfers have a critical role in most countries in ensuring that local government resources are commensurate with responsibilities, and that people in poorer areas do not experience unacceptably low standards of service. But dependence upon transfers poses obvious threats to local autonomy as well as risks of political partiality in their distribution. The Charter and the Council of Ministers' recommendations define a number of principles and practices to reduce these risks.

Firstly, transfers should so far as possible comprise block grants or tax shares whose use is not prescribed by Government. Earmarked grants may be justified for certain types of capital but their availability and the criteria should not restrict local choice over expenditure priorities.

Secondly, the volume and distribution of transfers should be governed by permanent legislation and not subject to arbitrary changes in annual national budgets. So far as possible the volume should be indexed to factors such as national revenue growth or GDP so that local government's share of resources remains stable and buoyant.

Thirdly, the distribution of transfers should be determined by objective formulae which preclude bargaining and negotiation with individual recipients, although local authority associations should be consulted on their design. Eligibility for equalisation funds should not be influenced by local decisions, being based on measurements of revenue potential and spending needs which ignore actual budgets and performance. Calculations of revenue capacity, for example, should assume that all local governments levy the same rate of tax, and should not change because a particular authority chooses to increase or reduce it. Spending need should be determined by objective factors such as the number of school age children in the case of education.

Capital investment grants are more difficult to subject to transparent formulae because of their one-off nature, but their availability and the criteria for their award should be publicised so that all eligible recipients can apply.

## **Capital Finance**

Local governments are often able to devote operating surplus to capital expenditure and any revenue from sale of assets should be spent on investment, not on current costs. Even so, the cost of large capital projects such as road construction, water treatment plants or new school building often exceed the capacity of annual budgets and can only be financed by long term credit.

National laws and policy should permit local governments to borrow money for investment (though not for operating budget deficits), although it may be necessary to impose limits to prevent excessive debt. A ceiling on the proportion of annual revenue devoted to debt service is the usual control.

National governments or local authority associations are also advised to establish suitable sources of loan finance for local governments. These may consist of banks specialising in municipal credit, or national funds acting as an intermediary between the capital markets and individual municipal borrowers. Such specialised and pooled institutions generally lower transaction costs and spread risks. Another vital piece of the institutional framework for capital finance is legislation governing cases of municipal insolvency.

Much physical and social infrastructure is now funded by private enterprises carrying out property development which creates the demand for extra roads, sewage capacity, school places etc; this is usually demanded as a price for planning permission.

## **Financial Management**

The recommendations over local government financial resources are all designed to maximise local choice – discretion over both raising revenue and spending it. The key instrument is the annual budget but local governments are encouraged to frame this within the context of longer term forecasts, so that both capital investment and the improvement of service operations can be effectively planned and programmed. Forecasting future ability to operate a new capital asset and to service associated debt is a vital part of an investment decision.

The Charter emphasises the role of the whole elected council in approving budgets and in monitoring their implementation, a role which should not be delegated. This does not preclude delegating some detailed discretion over the use of funds to subsidiary institutions like schools, so long as the representative bodies retain overall control of the purposes for which money is used. Budget proposals should also be sufficiently public for wider consultation with interest groups, neighbourhood organisations, service users and other non-governmental bodies, but public participation should not usurp the ultimate responsibility of elected members for the hard budgetary choices.

Monitoring budget execution requires reliable information. Professionally competent and up to date accounts are essential to this; so also is internal audit reporting directly to the Council or its chief executive. Valuable also are national statistics showing relative standards of services and their costs against which performance can be judged.

## **External Control**

Any form of external control is often seen by local government as a threat to its autonomy; in practice it can, properly designed and exercised, improve its accountability and safeguard public confidence.

External audit is crucial to the maintenance of integrity and efficiency. Systems vary; in many countries responsibility lies with the national audit organisation responsible to Parliament for auditing all public bodies. In other cases there are other state bodies particularly responsible for local government or a special audit service established by the local authority associations. In some states there is no state imposed system, but a legal obligation on each local government to appoint independent auditors from the commercial system. What matters are the independence and professionalism of the auditors, their affordability by all sizes of local government, submission of their reports to the elected council, and disclosure to the general public.

Audit has traditionally focussed on the legality and honesty of local government financial transactions. However, there has been an increasing tendency for external audit to devote attention to issues of efficiency and to compare local government practices in terms of productivity and “value for money”. Similar principles apply to the inspections of local government services such as schools, which can have very positive impacts providing they focus on helping to improve performance rather than casting blame.

Another area highlighted by this booklet for national organisation is the training and qualification of local governments’ financial staff. This may be the concern of national government, of local authority associations or of the finance profession itself. However organised, it is important that financial managers are appropriately trained, appointed on merit and protected from political interference when seeking to maintain standards of legality, integrity and efficiency.

Central governments often subject local government financial decisions to the approval of ministries or regional administrators. These provisions may arise from macroeconomic policy, as in the case of borrowing or tax levels. Alternatively, such controls may arise from a paternalistic desire to protect local citizens from abuse of power. The danger is that such controls may be exercised irrationally, incompetently or for political advantage and, therefore, counterproductive. Where such controls are justified, they are better exercised through the imposition of normative rules and standards than by case-by-case decisions.

## **Conclusion**

These paragraphs have sketched the general philosophy of fiscal decentralisation behind the Charter and the detailed recommendations which accompany it.

Local government finance is a matter of common principle rather than practice since the basic structure of local government and the assignment of both expenditure responsibilities and revenue sources differ widely between European countries, as do the economic circumstances within which it operates. Both principles and practices should be designed to afford local representative bodies much freedom of action, but also incentives to use it accountably.

## **European Charter on Local Self Government**

### **Preamble**

The member States of the Council of Europe, signatory hereto,

Considering that the aim of the Council of Europe is to achieve a greater unity between its members for the purpose of safeguarding and realising the ideals and principles which are their common heritage;

Considering that one of the methods by which this aim is to be achieved is through agreements in the administrative field;

Considering that the local authorities are one of the main foundations of any democratic regime;

Considering that the right of citizens to participate in the conduct of public affairs is one of the democratic principles that are shared by all member States of the Council of Europe;

Considering that it is at local level that this right can be most directly exercised;

Convinced that the existence of local authorities with real responsibilities can provide an administration which is both effective and close to the citizen;

Aware that the safeguarding and reinforcement of local self-government in the different European countries is an important contribution to the construction of a Europe based on the principles of democracy and the decentralisation of power;



Asserting that this entails the existence of local authorities endowed with democratically constituted decision-making bodies and possessing a wide degree of autonomy with regard to their responsibilities, the ways and means by which those responsibilities are exercised and the resources required for their fulfilment,

Have agreed as follows:

## **Article 1**

The Parties undertake to consider themselves bound by the following articles in the manner and to the extent prescribed in Article 12 of this Charter.

### ***Part I***

## **Article 2 – Constitutional and legal foundation for local self-government**

The principle of local self-government shall be recognised in domestic legislation, and where practicable in the constitution.

## **Article 3 – Concept of local self-government**

1 Local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

2 This right shall be exercised by councils or assemblies composed of members freely elected by secret ballot on the basis of direct, equal, universal suffrage, and which may possess executive organs responsible to them. This provision shall in no way affect recourse to assemblies of citizens, referendums or any other form of direct citizen participation where it is permitted by statute.

## **Article 4 – Scope of local self-government**

1 The basic powers and responsibilities of local authorities shall be prescribed by the constitution or by statute. However, this provision shall not prevent the attribution to local authorities of powers and responsibilities for specific purposes in accordance with the law.

2 Local authorities shall, within the limits of the law, have full discretion to exercise their initiative with regard to any matter which is not excluded from their competence nor assigned to any other authority.

3 Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen. Allocation of responsibility to another authority should weigh up the extent and nature of the task and requirements of efficiency and economy.

4 Powers given to local authorities shall normally be full and exclusive. They may not be undermined or limited by another, central or regional, authority except as provided for by the law.

5 Where powers are delegated to them by a central or regional authority, local authorities shall, insofar as possible, be allowed discretion in adapting their exercise to local conditions.

6 Local authorities shall be consulted, insofar as possible, in due time and in an appropriate way in the planning and decision-making processes for all matters which concern them directly.

#### **Article 5 – Protection of local authority boundaries**

Changes in local authority boundaries shall not be made without prior consultation of the local communities concerned, possibly by means of a referendum where this is permitted by statute.

#### **Article 6 – Appropriate administrative structures and resources for the tasks of local authorities**

1 Without prejudice to more general statutory provisions, local authorities shall be able to determine their own internal administrative structures in order to adapt them to local needs and ensure effective management.

2 The conditions of service of local government employees shall be such as to permit the recruitment of high quality staff on the basis of merit and competence; to this end adequate training opportunities, remuneration and career prospects shall be provided.

**Article 7 – Conditions under which responsibilities at local level are exercised**

1 The conditions of office of local elected representatives shall provide for free exercise of their functions.

2 They shall allow for appropriate financial compensation for expenses incurred in the exercise of the office in question as well as, where appropriate, compensation for loss of earnings or remuneration for work done and corresponding social welfare protection.

3 Any functions and activities which are deemed incompatible with the holding of local elective office shall be determined by statute or fundamental legal principles.

**Article 8 – Administrative supervision of local authorities' activities**

1 Any administrative supervision of local authorities may only be exercised according to such procedures and in such cases as are provided for by the constitution or by statute.

2 Any administrative supervision of the activities of the local authorities shall normally aim only at ensuring compliance with the law and with constitutional principles. Administrative supervision may however be exercised with regard to expediency by higher level authorities in respect of tasks the execution of which is delegated to local authorities.

3 Administrative supervision of local authorities shall be exercised in such a way as to ensure that the intervention of the controlling authority is kept in proportion to the importance of the interests which it is intended to protect.

**Article 9 – Financial resources of local authorities**

1 Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.

2 Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.

3 Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.

4 The financial systems on which resources available to local authorities are based shall be of a sufficiently diversified and buoyant nature to enable them to keep pace as far as practically possible with the real evolution of the cost of carrying out their tasks.

5 The protection of financially weaker local authorities calls for the institution of financial equalisation procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures shall not diminish the discretion local authorities may exercise within their own sphere of responsibility.

6 Local authorities shall be consulted, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.

7 As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.

8 For the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law.

#### **Article 10 – Local authorities' right to associate**

1 Local authorities shall be entitled, in exercising their powers, to co-operate and, within the framework of the law, to form consortia with other local authorities in order to carry out tasks of common interest.

2 The entitlement of local authorities to belong to an association for the protection and promotion of their common interests and to belong to an international association of local authorities shall be recognised in each State.

3 Local authorities shall be entitled, under such conditions as may be provided for by the law, to co-operate with their counterparts in other States.

### **Article 11 – Legal protection of local self-government**

Local authorities shall have the right of recourse to a judicial remedy in order to secure free exercise of their powers and respect for such principles of local self-government as are enshrined in the constitution or domestic legislation.

### ***Part II – Miscellaneous provisions***

#### **Article 12 – Undertakings**

1 Each Party undertakes to consider itself bound by at least twenty paragraphs of Part I of the Charter, at least ten of which shall be selected from among the following paragraphs:

- Article 2,
- Article 3, paragraphs 1 and 2,
- Article 4, paragraphs 1, 2 and 4,
- Article 5,
- Article 7, paragraph 1,
- Article 8, paragraph 2,
- Article 9, paragraphs 1, 2 and 3,
- Article 10, paragraph 1,
- Article 11.

2 Each Contracting State, when depositing its instrument of ratification, acceptance or approval, shall notify to the Secretary General of the Council of Europe of the paragraphs selected in accordance with the provisions of paragraph 1 of this article.

3 Any Party may, at any later time, notify the Secretary General that it considers itself bound by any paragraphs of this Charter which it has not already accepted under the terms of paragraph 1 of this article. Such undertakings subsequently given shall be deemed to be an integral part of the ratification, acceptance or approval of the Party so notifying, and shall have the same effect as from the first day of the month following the expiration of a period of three months after the date of the receipt of the notification by the Secretary General.

### **Article 13 – Authorities to which the Charter applies**

The principles of local self-government contained in the present Charter apply to all the categories of local authorities existing within the territory of the Party. However, each Party may, when depositing its instrument of ratification, acceptance or approval, specify the categories of local or regional authorities to which it intends to confine the scope of the Charter or which it intends to exclude from its scope. It may also include further categories of local or regional authorities within the scope of the Charter by subsequent notification to the Secretary General of the Council of Europe.

### **Article 14 – Provision of information**

Each Party shall forward to the Secretary General of the Council of Europe all relevant information concerning legislative provisions and other measures taken by it for the purposes of complying with the terms of this Charter.

## ***Part III***

### **Article 15 – Signature, ratification and entry into force**

1 This Charter shall be open for signature by the member States of the Council of Europe. It is subject to ratification, acceptance or approval. Instruments of ratification, acceptance or approval shall be deposited with the Secretary General of the Council of Europe.

2 This Charter shall enter into force on the first day of the month following the expiration of a period of three months after the date on which four member States of the Council of Europe have expressed their consent to be bound by the Charter in accordance with the provisions of the preceding paragraph.

3 In respect of any member State which subsequently expresses its consent to be bound by it, the Charter shall enter into force on the first day of the month following the expiration of a period of three months after the date of the deposit of the instrument of ratification, acceptance or approval.

#### **Article 16 – Territorial clause**

1 Any State may, at the time of signature or when depositing its instrument of ratification, acceptance, approval or accession, specify the territory or territories to which this Charter shall apply.

2 Any State may at any later date, by a declaration addressed to the Secretary General of the Council of Europe, extend the application of this Charter to any other territory specified in the declaration. In respect of such territory the Charter shall enter into force on the first day of the month following the expiration of a period of three months after the date of receipt of such declaration by the Secretary General.

3 Any declaration made under the two preceding paragraphs may, in respect of any territory specified in such declaration, be withdrawn by a notification addressed to the Secretary General. The withdrawal shall become effective on the first day of the month following the expiration of a period of six months after the date of receipt of such notification by the Secretary General.

#### **Article 17 – Denunciation**

1 Any Party may denounce this Charter at any time after the expiration of a period of five years from the date on which the Charter entered into force for it. Six months' notice shall be given to the Secretary General of the Council of Europe. Such denunciation shall not affect the validity of the Charter in respect of the other Parties provided that at all times there are not less than four such Parties.

2 Any Party may, in accordance with the provisions set out in the preceding paragraph, denounce any paragraph of Part I of the Charter accepted by it provided that the Party remains bound by the number and type of paragraphs stipulated in Article 12, paragraph 1. Any Party which, upon denouncing a paragraph, no longer meets the requirements of Article 12, paragraph 1, shall be considered as also having denounced the Charter itself.

### **Article 18 – Notifications**

The Secretary General of the Council of Europe shall notify the member States of the Council of Europe of:

- a any signature;
- b the deposit of any instrument of ratification, acceptance or approval;
- c any date of entry into force of this Charter in accordance with Article 15;
- d any notification received in application of the provisions of Article 12, paragraphs 2 and 3;
- e any notification received in application of the provisions of Article 13;
- f any other act, notification or communication relating to this Charter.

In witness whereof the undersigned, being duly authorised thereto, have signed this Charter.

Done at Strasbourg, this 15th day of October 1985, in English and French, both texts being equally authentic, in a single copy which shall be deposited in the archives of the Council of Europe. The Secretary General of the Council of Europe shall transmit certified copies to each member State of the Council of Europe.



## **Recommendation Rec(2004)1 of the Committee of Ministers to member states on financial and budgetary management at local and regional levels**

*(Adopted by the Committee of Ministers on 8 January 2004 at the 867th meeting of the Ministers' Deputies)*

The Committee of Ministers, under the terms of Article 15.b of the Statute of the Council of Europe,

Considering that the aim of the Council of Europe is to achieve a greater unity between its members for the purpose of safeguarding and realising the ideals and principles that are their common heritage and facilitating their economic and social progress;

Considering that this aim may be pursued *inter alia* through the adoption of common action in economic, social, legal and administrative matters;

Having regard to the provisions of the European Charter of Local Self-Government, which it adopted in the form of an international treaty on 15 October 1985 and which to date has been ratified by a large majority of Council of Europe member states;

Having regard to the following reports of the Steering Committee on Local and Regional Democracy (CDLR):

- Effects on the financial autonomy of local and regional authorities resulting from the limits set at European level on national public debt (2000);
- Methods for estimating local authorities' spending needs and methods for estimating revenue (2001);
- Risks arising from local authorities' financial obligations (2002);
- Recovery of local and regional authorities in financial difficulty (2002);
- Budgetary procedures and budget management at local authority level (2002);

Taking into account CLRAE Opinion 20 (2003) on the Committee of Ministers' preliminary draft recommendation to member states on financial and budgetary management at local and regional level;

Aware that local and, where it exists, regional self-government implies a degree of autonomy in financial and budgetary management, without which local and regional authorities cannot be accountable for, and control and manage the share of public affairs falling within their remit;

Believing it important that public spending is managed openly and in accordance with the law and that financial and budgetary management procedures play a vital role in this respect;

Considering that financial and budgetary management procedures must be tailored to the needs of local and regional communities for greater effectiveness,

Recommends that the governments of member states:

1. take inspiration for their policy on financial and budgetary management at local and regional levels from the following principles of:
  - a.* securing consistency with the macro-economic targets of the national economic policy;
  - b.* establishing and ensuring financial stability of local and regional authorities;
  - c.* looking for cost-effectiveness of services provided to the community;
  - d.* ensuring openness and accountability of decisions;
2. ensure that these principles are respected through the appropriate means, including the use of domestic law by changing, where necessary, the regulatory framework of financial and budgetary management at local and regional levels, and by drawing on the guidelines appended to the present recommendation;

3. involve local and regional authorities or their representatives in debate and in any reforms that might prove necessary in the area of financial and budgetary management at local and regional levels, and in the area of financial relations between levels of government, particularly as a follow-up to the present recommendation;

4. translate the present recommendation into their official language(s) and circulate it to their local and regional authorities and associations thereof, inviting them to take note of the guidelines intended for them set out in Part II of the appendix.

## **Appendix to Recommendation Rec(2004)1**

### ***Part I - Guidelines for central authorities***

*These guidelines are addressed to central authorities insofar as they are responsible for defining the legal framework and supervising the activity of local or regional authorities.*

*In certain federal states, these competences belong to the federated entities. In such cases, these guidelines are addressed to them. Central authorities are invited to bring these guidelines to their attention.*

### **General principles**

1. The local or regional authority should be entitled, within the framework of national economic policy, to foreseeable resources commensurate with its competences and responsibilities that would allow it to implement these competences effectively and of which it may dispose freely.

2. The overall system of local and regional finance should aim at striking a suitable balance between financial transfers, including grants and shares of nationally determined taxes on the one hand, and locally determined taxes and charges on the other. Such balance should provide discretion to adjust revenue and expenditure levels to local priorities, and also ensure that local services nevertheless reach minimum standards, whatever the local or regional fiscal capacities may be.

3. Higher-level authorities whose decisions impose additional costs on local and regional authorities should ensure that these costs are covered by new financial resources such as additional fiscal resources, evolving financial transfers or other financial means.

4. Legislation should establish rules for drawing up, approving and implementing local and regional budgets and for the supervision of their implementation, as well as for their healthy, balanced management in the long term.

5. It should not be possible to delegate the adoption of the budget and the approval of the accounts to a committee or a body other than the elected deliberative body of the local or regional authority.

6. Within the limits of the legislation, the local or regional authority should be able to independently adopt its budget and to adapt the operational rules applicable to its budget and to apply them to its specific situation.

7. The local or regional authority should be able to allocate credit balances carried over from a budget year to non-recurrent expenditure (for example, self-financing from investments, the reduction of public borrowing, setting up provisions or reserves, etc.) and carry over debit balances in order to rectify the situation by allocating funds from subsequent budgets to write them off.

### **Limitations on the financial autonomy of local and regional authorities**

8. The state or legally established supervisory authority may take measures to restrict the financial autonomy of a local or regional authority or to limit or reduce the amount of funding transferred to it. Such measures should be taken within the framework defined by statute and should not be excessive or threaten the principle of local autonomy.

9. Such restrictive measures may be general (applied to all authorities) or specific (applied to a limited number of authorities, having regard to their particular situation). Their aim should be to:

- ensure a healthy macro-economic policy at state level, on the one hand, and
- ensure sound and safe management, while observing the rules laid down by statute and administrative law, and overcome financial difficulties or deal with exceptional situations encountered within those local and regional authorities subject to the restrictions, on the other hand.

10. The limitations which may be imposed by the state on the financial autonomy of local and regional authorities should be established by law. Limitations should be based on objective, transparent and verifiable criteria, applied fairly and in such a way as to avoid accounting devices that obscure the truth.

11. The local or regional authority should be consulted, following appropriate procedures, prior to any measure to restrict its financial and budgetary autonomy, and it should be notified of the application and consequences of any such measure. Institutional mechanisms of regular dialogue, consultation and co-operation between the different levels of government could be created.

12. Regular checks should be made by the central authority to gauge whether the limitations are necessary and effective.

13. Specific measures restricting the financial and budgetary freedom of certain local or regional authorities should be short-term and lifted once they have achieved their aim.
14. The limitations imposed on each authority should be clear, objective and quantifiable.
15. The limitations should be proportionate to the desired aim and be free of any punitive nature.
16. Measures having a substantial impact on the financial autonomy of a local or regional authority, such as the general and rigid capping of spending and taxation rates, should be avoided if other, softer, measures such as incentives and flexible limitations (which vary in time and take account of the situation and of the average spending and taxation rates for a certain type of community) could be used.

### **Methods of financial estimation**

17. Evaluations of the evolution, at the national level, of local and regional authority spending needs and provisional receipts, of financial transfers and of criteria for sharing these transfers should be prepared and published. These are to be considered as provisional evaluations; they should be subject to adjustment at regular intervals. They should be based on calculation formulae that are transparent, stable, fair and objective.
18. The purpose of these evaluations should be to provide information on changes in the macro-economic situation and the foreseeable amount of transfer funding that could be granted by the central authority to local and regional authorities, and they should allow, where applicable, for transfers to be shared fairly between authorities.
19. Where appropriate, the state should promote the setting up of standards for essential local and regional services and should develop outline procedures for financial estimations relating to spending needs at local and regional levels.

### **Assessment and management of financial risk**

20. The assessment of financial risk should comprise prior monitoring and warning mechanisms (such as tables presenting the evolution of revenue and expenditure, of indebtedness and interest rates, of the main tax bases, etc.) as well as intervention and supervisory procedures. An approach of overall regulation should be preferred to that of control of individual activities.

21. Speculative investment by local and regional authorities should be prohibited. If the local or regional authority wishes to invest on the equity market, such investment should be managed professionally.

22. Any financing techniques which have the object or the effect of concealing the level of debt of the local or regional authority should be prohibited. All financing techniques should be subject to conditions that ensure or restore the transparency of the financial situation or limit the risks involved.

23. Legislation should exclude or limit the possibility of using buildings and assets indispensable to the fulfillment of the local or regional authority's mandatory or related tasks as collateral for guaranteeing borrowing.

24. In general, local and regional authorities should have the right to incur debts only for the funding of investment expenditure and not for current expenditure. The level of debt could be established in relation to the volume of the authority's own resources, their extent, stability and foreseeable development.

### **Local elected representatives and employees**

25. The quality and accuracy of the financial and budgetary information issued by the local or regional authority should be guaranteed by the mayor, the chief executive or any other elected representative or executive body designated by law, who assumes responsibility.

26. Officials responsible for collecting local or regional tax revenue and/or committing local or regional expenditure and enjoying a degree of independence in the exercise of their duties should be personally accountable for their acts of management, in accordance with the law.

27. The central authority should ensure that local or regional officers and elected representatives receive appropriate professional training. If such training is not provided by the local or regional authority itself or its association, the central authority could, for example, set up standards in this respect, organise such training and help the local or regional authority and its association to organise training for their elected representatives and officers.

### **Control**

28. The external supervisory procedure should be laid down by law and should be balanced and fair. The procedure should be limited to an examination of the legality of decisions. In the case of a disagreement, the procedure should provide the supervising authority with the possibility of recourse to the competent jurisdiction.

29. In general, control after the event should be preferred to prior approval or authorisation.

30. Failing this, where prior approval is required, particularly for the exercise of delegated powers, a reasonable time limit should be set by law for the supervisory authority to give its approval, which shall be deemed granted if no reply is forthcoming within the time limit set.



31. There should be a legal deadline for the adoption of local and regional budgets and mechanisms to ensure the continuity of public services if the budget is not adopted in due time, or if the local or regional authority fails to fulfill its obligations (such as omission from the budget of expenses that are legally or contractually binding, inaccuracy of budgetary entries, gross violation of budgetary procedures, etc). Such mechanisms may provide for the intervention of the central authority, of the controlling body or of an independent administrative body in order to redress the situation, while at the same time guaranteeing that the intervention is proportional to the cause, is neither political nor excessive, does not endanger local or regional self-government and is not prolonged beyond what is needed to redress the situation or to tackle the deficiencies observed.

32. There should be statistical and comparative analysis of budget implementation, spending and the rate of spending in order to detect any anomalies and trigger the relevant warning procedures, rather than a series of successive authorisations that provide no dynamic overview.

33. The central authority should ensure that arrangements are made for drawing up comparisons of budgets and performance for local or regional authorities of comparable size and socio-economic characteristics that are widely accessible (through publications or Internet site postings) and accompanied by explanatory texts (such as the meaning of indicators used, etc.).

### **Recovery of local and regional authorities in financial difficulty**

34. As a general principle, the central authority should not guarantee the borrowings of a local or regional authority.

35. Current expenditure of the local and regional authority should be financed out of current revenue and non-earmarked reserves, except in exceptional cases of cash advances and short-term loans.

36. The state or supervisory authority should establish procedures for monitoring the financial situation of local and regional authorities by gathering financial information and making it public. This information should enable citizens, the local and regional authority and the government to be aware of the financial situation of a given authority, to compare it with that of other authorities with similar characteristics and to take appropriate measures, where necessary and according to law, to avoid any financial difficulties arising.

37. Procedures should exist enabling the local or regional authority to handle a localised and short-term financial crisis without requesting assistance from the next highest level of authority or the state. Such procedures could be established, for example, under a bankruptcy and insolvency code for local and regional authorities.

38. The state or supervisory authority should establish and observe clear rules for intervention to assist a local or regional authority in financial difficulty.

39. These rules of intervention should pursue the aim of financial recovery of the local or regional authority concerned while making elected representatives and officers responsible for their acts. There should be provisions aimed at discouraging and avoiding perverse effects such as local or regional authorities becoming accustomed to assistance or becoming careless in their financial management or competing for state aid.

40. In cases where the financial difficulty arises from a structural income deficit, the central authority should not only provide financial assistance but should also intervene to eliminate the causes of that structural deficit.

41. The central authority should make provision for special financial resources in order to help local and regional authorities that are in an emergency situation, or victims of natural disasters or affected by sharp economic decline.

42. Financial assistance should be granted following dialogue with the given local or regional authority and on the basis of an economic recovery plan that includes financial contributions and undertakings from the authority itself.

43. Financial assistance should be adjusted according to the local or regional authority's wealth and medium-term economic and fiscal potential.

## ***Part II - Guidelines for local and regional authorities***

Local and regional authorities are invited to take into account the following measures when designing their policies in the field of financial and budgetary management, insofar as they fall within their competence.

### **General principles**

44. It would be desirable for newly elected local or regional executives to present a programme at the beginning of their term in office setting out aims, priorities and measures with an indication of the time-table of implementation and of the relevant budget resources.

45. The local or regional authority should draw up pluri-annual budget plans (covering the two to four years following the current year) setting out the overall budget objectives, an indication of the cost of pursuing the policies and undertakings subscribed to, and future budgetary consequences of decisions taken or to be taken.

46. Budget projections and proposals should be prepared with the involvement of in-house experts (for example, receiver, treasurer, internal auditor) and outside opinions (such as economists, independent auditors, etc.), particularly in the event of public debate (hearings before the relevant committees, the local or regional council, etc.).

47. Whenever a decision is taken by the executive or the local or regional council, the budgetary expenditure for the current year and the following financial years should be clearly explained.

48. As a general rule, the proceedings of committees dealing with budget matters should be open to the public and their documents should be published and accessible to the public.

49. The elected representatives and officers of local and regional authorities should be offered and benefit from appropriate training in budgeting, both basic and advanced, that enables them to understand the documents submitted to them and to take appropriate, informed decisions. Incentives for training such as a closer link with promotion criteria should be implemented for officers.

50. Any activity of a local or regional authority that may result in public debts or entail significant financial risk should be primarily agreed upon and authorised by the elected deliberative body concerned.

### **Information and openness**

51. Budget and accounting documents should be easily readable, providing both a clear and comprehensible overview of the budget (including main balances, issues and priorities, key data, etc.) and sufficient detail to analyse the content of the budget and make relevant comparisons (with other financial years, other authorities, etc.).

52. Published documents, for example via the Internet, should be accompanied by a suitable explanation making them more easily comprehensible to a lay public.

53. Expenditure and receipts should be presented by type and by function in budget documents, identifying as far as possible the different sectors of local and regional government involved so that the sharing of resources between fields of activity may be gauged.

54. Information on the performance of the local or regional service management (financial indicators, output and impact indicators, comparisons with the performances of other local or regional authorities and the interpretation of such information) should, where appropriate, be appended to budgetary documents.

55. The local or regional authority should stimulate participation by citizens and social partners in public affairs by regularly consulting them and should ensure that objective information is provided on the financial aspects of the issues under consultation.

56. The local or regional authority should make it possible for citizens to be informed of draft budgets as soon as these are forwarded to local or regional councillors for final approval. When a budget has been adopted, its outlines and consequences for the community should be made public; for example by explaining changes in taxation or priority allocation of the authority's funding, and mentioning services ready to provide the public with further details.

### **Preparation of the budget**

57. Preparation of the budget should be the responsibility of a specialised unit of the local or regional authority with a good knowledge of the authority's operational departmental costs and budget consumption so that it can propose different options to the executive and prepare internal arbitration before arbitration at a later stage.

58. Budget proposals should be discussed by the authorities and persons responsible for the domain concerned and then by those responsible for finance, who should consider overall balances, overall income, borrowings and any problems raised.

59. Choices between different investment projects should be made more objective, for example by using a “scoring” system based on several criteria. When the size of the proposed investment justifies it, a participatory process involving the local community should be envisaged; if this occurs, procedures should be set up in order to guarantee that the exercise is properly run.

60. The budgetary consequences of a local or regional authority’s links with the commercial sector (for example, income and expenditure linked to shareholding, execution of guarantees given, etc.) should be carefully assessed in accordance with the rules and procedures for assessment used in the private sector.

### **Assessment and management of financial risk**

61. The presentation of the budget and accounts must give as complete and objective a picture as possible of the local or regional authority’s financial situation. The local or regional authority should work towards drawing up consolidated accounts, integrating the results and showing the risks and obligations of the different satellite agencies.

62. Where the consolidation of the accounts is not possible, the local or regional authority should present an overview of its participation or involvement in any external organisation and possible risks to which the organisation may be exposed in which the local or regional authority is a financial stakeholder.

63. The presentation of the budget should be accompanied by an analysis of the financial risks to which the local or regional authority is exposed: the quantifiable risks should give rise to setting up reserves, while the degree of exposure to non-quantifiable risks should be estimated.

64. In those countries where the local or regional authorities are at liberty to deposit their funds at the banks that they deem appropriate, a system of insurance or re-insurance is needed to protect the local or regional authorities against the loss of some of their assets in the event of bankruptcy of their bank.

65. Guarantee or guarantee deposit obligations should be published, with a distinction being made between the obligations during the financial year, the loans outstanding and the costs arising from these guarantees; the use of risk-assessment ratios to limit these risks is to be recommended.

66. Establishing or managing commercial enterprises and participation in such enterprises should be limited, in principle, to public service activities or to activities in which there is no competitive market or activities that are aimed at economic promotion (such as housing developments, creation of business parks and start-up activities, promotion of employment, etc.).

67. If the local or regional authority has the right to invest on the financial market, it should, in principle, limit such investment to the bond market. Any other financial product should be the subject of specific ratios for assessing their volatility and risk and in every case be subject to professional management.

68. Follow-up systems and ratios should be set up, the most important of which must be made public so as to enable the financial situations to be compared and the divergences to be analysed and to prevent risks.

69. Local and regional authorities should acquire, individually or collectively, the expertise necessary to manage risks arising from their financial obligations; that expertise may imply training financial executives of local administrative bodies or involving the state services or independent public consultancy bodies, the associations of local authorities and the private sector on a commercial basis. Consultancy and supervisory functions should not be exercised by the same body.

70. Horizontal and vertical co-operation between authorities should be encouraged to facilitate the completion of major projects, in such a way as to share the expenses and the risks.

71. Estimates of investment-project costs should not overlook recurrent subsequent costs (such as staffing, operation, maintenance, etc.), which should logically be incorporated into pluri-annual budget programming.

72. In public-private partnerships, the risks should be shared out realistically and the local or regional authority should avoid, by its intervention, taking on the role of guarantor of risky private investment. In particular, an explicit public guarantee is preferable when the nature of the structure or service is such that the authority may find it difficult, to put its future in the hands of the user.

### **Approval of the budget**

73. A budget strategy debate should be organised at the beginning of the budgetary procedure, permitting initial discussion of the overall objectives to be adopted for the year and possibly the years to come.

74. The local or regional authority should set sufficient time limits in which councillors may read and analyse the budget documents issued.

75. If the elected representatives consider the information received to be inadequate or unclear, they - individually or collectively (for example in the competent committees) - should be able to request further information, question the relevant officers and, where necessary, hear the experts of their choice.

### **Implementation of the budget**

76. Where appropriate, a debate on the implementation of the budget should be held mid-year, in order to put budget changes into perspective and to review the changes in the economic, budgetary and social context, and after the end of the financial year.



77. The council should receive regular updates (for example, every three or four months) on the monitoring of the budget. If budget adjustments prove necessary, it would be advisable to group them in one or two “sets” per annum, accompanied by an overview or even a debate on the state of budget spending.

78. Budget adjustments should be limited in number and in scope in order to avoid diverting the aims of initial budgetary objective. Adjustments should be organised in such a way as to give a clear view of the changes suggested and on their importance, and they should be given the same level of transparency, publicity and conditions of democratic control as the initial budgets.

### **Budget accounts**

79. The accounts (for financial year  $n$ ) should be submitted to the council within a reasonable time, and certainly before the holding of the debate on budget implementation for the following year ( $n + 1$ ) and before the budget for the year after that ( $n + 2$ ) is drawn up.

80. Approval of the accounts should be properly debated, in committee and then in the council, in the light of an outside opinion (for example an external audit).

81. The executive of the local or regional authority should ensure that the reports of committees and the council concerning the budget are published (allowing public access or on-line consultation).

### **Control**

82. The local or regional authority should establish and put into general practice a framework for internal auditing (for example a code of ethics, independence measures, a right of initiative, conditions of intervention, notification of the council, follow-up, publishing of reports, etc.) and organise support for such internal auditing (recommended methodology, outside technical back-up).

83. Without prejudice to any existing legal obligations, the local or regional authority should make systematic use of annual external auditing (in

whatever form) to certify accounts and check their compliance with the law (including measures combating fraud and corruption).

84. The local or regional authority should assess the efficiency of its management at regular intervals, for example by making use of external audit.

### **Financial difficulty**

85. The local or regional authority should not request financial aid from the state or supervisory authority if it is able to redress its financial situation through other means.

86. As soon as it finds itself in financial difficulty, the local or regional authority should devise and set up a financial recovery plan, if necessary with assistance from the state or supervisory authority, independent administrative authorities or private auditing firms.

87. The recovery plans should be debated and adopted by the council or assembly in public sittings. The plan should set out the necessary data and the undertakings on which the following budgets are to be based. The plan may be contractual, depending on legislation, vis-à-vis the body providing financial support to the local or regional authority concerned.

## **Explanatory report**

### **I. Origins of the recommendation**

The present Recommendation<sup>1</sup> on the financial and budgetary management of local authorities represents the final outcome of the CDLR's proceedings. These have already resulted in the publication of several reports on financial-management subjects.

One of the first important policy and regulatory instruments in this field was Recommendation No R (92)5 of the Committee of Ministers to the member states on borrowing by local and regional authorities. The second legal instrument on a financial-management subject was Recommendation No R (96) 3 on local authorities' budgetary deficits and excessive indebtedness.

In 1996 the European conference of ministers responsible for territorial authorities, meeting in Lisbon, adopted an important report and a resolution on local finance.

In 2000 the Committee of Ministers adopted Recommendation No. R (2000) 14 on local taxation, financial equalisation and grants to local authorities. This recommendation had been prepared by the CDLR from a report based on national practices in this area.

Since 2000 the CDLR has issued the following series of sectoral reports on matters relating to the financial and budgetary management of local and regional authorities:

- Effects on the financial autonomy of local and regional authorities resulting from the limits set at European level on national public debt (2000);
- Methods for estimating local authorities' spending needs and methods for estimating revenue (2001);
- Risks arising from local authorities' financial obligations (2002);

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<sup>1</sup> See document CM(2003)159 Addendum 1.

- Recovery of regional and local authorities in financial difficulty (2002);
- Budgetary procedures and budget management at local authority level (2002).

These reports have resulted in guidelines on good practice in the fields concerned. The CDLR has decided to consolidate these guidelines in a draft recommendation from the Committee of Ministers to the member states and has drawn up the draft recommendation on the financial and budgetary management of local and regional authorities.

## **II. Grounds for the recommendation**

One of the Council of Europe's aims is to strengthen and consolidate local and regional democracy in the member states. It seeks to assist states when framing and implementing their regulatory framework for the functioning of the state, its institutions and intermediate structures, such as communes, provinces and regions. The Council of Europe also seeks to encourage the sharing of experience and best practice relating to important trends at the local and regional levels.

Local and regional authorities must be able, "within the limits of the law, to regulate and manage an important share of public affairs under their own responsibility, in the interest of their population...". This is the definition of local self-government given by the European Charter of Local Self-Government. Local and regional self-government is inconceivable without a degree of independent financial and budgetary management. Local and regional authorities take financial decisions or decisions with a financial impact: they run public services; invest in projects of local utility; levy income tax and other taxes, impose charges, receive grants and subsidies and decide on the use of public money. For the discharge of their responsibilities, they require a certain financial autonomy and even the power to adapt the general financial and budgetary management procedures laid down by the state to the needs of local and regional communities in order to make their operations more effective.

The budgetary process in the case of local authorities is both highly technical and highly political. However, technique and subjective assessment cannot be separated and the different parties have differing interests. This makes procedures important. By devising procedures, politicians are able to influence the emphasis placed on the various budgetary needs.

Moreover, it is extremely important for public spending to be managed both by local or regional authorities and by central government according to the law and with complete openness. In this, financial and budgetary management procedures play a fundamental role.

Budget procedures must therefore empower citizens to demand an accounting of the way in which elected representatives have managed affairs and respected commitments. They can also elucidate the various issues and options. They can play an important role in making the information process less one-sided and the services provided by the municipality more effective. They must also enable the executive to be supervised either through the work of the councillors or through other channels of public participation.

However, financial management is a much broader field than just budgetary management. The CDLR has noted that numerous subjects of great importance for proper financial management, such as the analysis and management of financial risks, financial estimation, financial auditing and choice of investment, are poorly known and practised in many Council of Europe member states. Other subjects, like the recovery of local and regional authorities in financial difficulty, are rarely regulated by clear and efficacious procedures.

It should be mentioned, finally, that certain subjects closely bound up with the financial management of local and regional authorities are covered by other Council of Europe legal instruments and are not discussed in this recommendation:

- the budgetary sources of local and regional authorities were dealt with in Committee of Ministers Recommendation No R (2000)14 on local taxation, financial equalisation and grants to local authorities;

- the procedures for general supervision of the activity of local and regional authorities were dealt with in Recommendation No R(98)12 on supervision of local authorities' action.

### **III. Scope of the recommendation**

The recommendation was drawn up after a thorough examination of best practice in the member states and in local and regional authorities.

It therefore applies to:

- Council of Europe member states;
- local authorities;
- regional authorities enjoying administrative self-government.

The application of the recommendation to regional authorities takes account of the conclusions of the CDLR's proceedings and of the definition adopted by the 13th Conference of European Ministers responsible for Local and Regional Government meeting in Helsinki in 2002. That conference defined regional authorities as "territorial authorities between the central government and local authorities. This does not necessarily imply a hierarchical relationship between regional and local authorities". In addition, the Helsinki conference stated that "Regional self-government denotes the legal competence and the ability of regional authorities, within the limits of the constitution and the law, to regulate and manage a share of public affairs under their own responsibility, in the interests of the regional population and in accordance with the principle of subsidiarity."

However, given the diversity of models, regions and competences, it was not considered worth while to draw up more specific provisions for the regions.

### **IV. Consultations on the draft recommendation**

Before forwarding the draft recommendation to the Committee of Ministers, the CDLR requested and obtained the opinion of the Congress of Local and Regional Authorities in Europe (CLRAE).

The CDLR also consulted the World Bank, the International Monetary Fund, the Organisation for Economic Co-operation and Development and the Local Government Initiative (LGI). Consultation was an opportunity for the organisations mentioned to make substantial improvements to the text and to assess its consistency, relevance and utility in the light of their theoretical knowledge and practical experience.

The draft recommendation has also been published on the CDLR website ([www.coe.int/local](http://www.coe.int/local)) and in the LOREG database ([www.loreg.org](http://www.loreg.org)) and circulated to participants at a number of international seminars and conferences. Several national governments have likewise consulted interested parties (in particular, associations of territorial authorities).

## **V. Explanations concerning the content of the recommendation**

The recommendation consists of a preamble stating the main grounds on which the Committee of Ministers based the recommendation, an operative part containing formal recommendations to Council of Europe member states and a two-part appendix comprising guidelines for the central authorities (Part I) and for local and regional authorities (Part II).

The preamble is self-explanatory.

### **A. Explanations concerning the operative part of the recommendation**

*Recommends that the governments of member states:*

In certain federal countries, the competencies which might prove to be necessary for the implementation of the recommendations to follow might not belong to the central governments. In this case, the suggestions made at the beginning of the appendix might guide these governments: they should therefore bring these recommendations to the attention of the competent authorities.

1. *take inspiration in their policy on financial and budgetary management at local and regional level from the following principles:*

- a. *securing consistency with the macro-economic targets of the national economic policy;*
- b. *establishing and ensuring financial stability of local and regional authorities;*
- c. *looking for cost-effectiveness of services provided to the community;*
- d. *ensuring openness and accountability of decisions.*

This first recommendation lists the principles which should underlie all national policies in this area and is self-explanatory.

2. *ensure through appropriate means that these principles are pursued including by the domestic law, where necessary by changing the regulatory framework of financial and budgetary management at local and regional level, drawing on the guidelines appended to the present recommendation;*

The principles set out in the first recommendation may be pursued by states by means of legislative and regulatory measures and different national policies and initiatives. If necessary, the relevant national legislation should be amended accordingly.

This recommendation refers to the guidelines in the appendix. These represent good practices in the area of financial and budgetary management at local and regional level which have been identified during Council of Europe intergovernmental proceedings and which are useful for pursuing the principles already listed.

It is therefore recommended that member states take these guidelines as a basis when pursuing the principles listed in the first recommendation. The guidelines should therefore not be adopted or implemented en bloc. The appendix containing them should simply be used as a compendium of good European practice on which the laws and procedures to be applied in the member states should be aligned as necessary.



3. *involve local and regional authorities or their representatives in debate and any reforms that might prove necessary in the area of financial and budgetary management at local and regional level and of financial relations between levels of government, particularly as follow-up to the present recommendation;*

Article 4.6 of the European Charter of Local Self-Government states: "Local authorities shall be consulted, insofar as possible, in due time and in an appropriate way, in the planning and decision-making processes for all matters which concern them directly."

The third recommendation goes further than the charter provision and recommends that local and regional authorities should be not only consulted (an obligation on states that have ratified the Charter) but also involved in debates and any reforms carried out. Involvement means more than just formal consultation; it should be reflected in a process of direct participation by local and regional authorities.

4. *translate the present recommendation into their official language(s) and circulate it to local and regional authorities and associations thereof, inviting them to take note of the guidelines intended for them set out in part II of the appendix.*

Translation of the recommendation is a necessary stage if it is to be circulated and applied. Part II of the appendix to the recommendation contains guidelines for local and regional authorities designed to help them improve their financial and budgetary management. States are therefore requested to forward the recommendation to the authorities concerned and their associations and to invite them to note the examples of good practice in the guidelines intended for them.

## **B. Explanations concerning the appendix to the recommendation**

### **Part I**

#### **Guidelines for central authorities**

The opening paragraphs in Part I of the Appendix specify the authorities for which these guidelines are intended.

In the Appendix, the term "state" is used either to refer to the executive authority (government) or in accepted expressions such as "state budget". The term "central authority" refers to the government, Parliament, the supervisory authority established at central level or even a specialised agency set up under the law, depending on each country's system and the competences of the respective bodies.

## General principles

*1. The local or regional authority should be entitled, within the framework of national economic policy, to foreseeable resources commensurate with its competences and responsibilities that would allow it to implement these competences effectively and of which it may dispose freely.*

This guideline embodies one of the essential principles of regional self-government identified by the Conference of European Ministers responsible for Local and Regional Government held in Helsinki on 27 and 28 June 2002.

Foreseeable resources enable local and regional authorities to conduct long-range budgetary planning, without which it would be difficult, if not impossible, to ensure effective budgetary and financial management.

Providing local and regional authorities with resources commensurate with their competences and of which they may dispose freely is one of the essential principles of local and regional self-government deriving directly from Article 9 of the European Charter of Local Self-Government (ECLSG).

*2. The overall system of local and regional finance should aim at striking a suitable balance between financial transfers, including grants and shares of nationally determined taxes on the one hand, and locally determined taxes and charges on the other. Such balance should provide discretion to adjust revenue and expenditure levels to local priorities, and also ensure that local services nevertheless reach minimum standards, whatever the local or regional fiscal capacities may be.*

In its report entitled "Methods for estimating local authorities' spending needs and methods for estimating revenue", the CDLR considered that local services should be funded in an adequate and reasonable proportion from those authorities' own resources, such as local taxes and charges. Local authorities would otherwise be unable to adjust the level of services to the public's needs; elected representatives could spend the money from governmental transfers inefficiently and blame the poor quality and/or quantity of services on the level of these transfers; the government could try to control the way in which transferred resources were spent.

At the same time, setting minimum standards for essential local and regional services is a common and recommended practice in Council of Europe member states. While it is normal to provide partial funding for services by means of financial transfers so as to enable local and regional authorities to adopt those standards, these authorities must also be left the power to adjust the quantity and quality of services to the public's needs: one of the vital elements in local and regional democracy. It is therefore important to strike a balance between authorities' own resources and transferred resources.

For other recommendations concerning local authorities' own resources, see also Recommendation No. R (2002) 14 on local taxation, financial equalisation and grants to local authorities.

3. *Higher-level authorities whose decisions impose additional costs on local and regional authorities should ensure that these costs are covered by new financial resources such as additional fiscal resources, evolving financial transfers or other financial means.*

This paragraph is designed to discourage "unfunded tasks" whereby higher level authorities, usually the state, transfer additional responsibilities to local or regional authorities or impose new and expensive obligations on them without seeing that local and regional authorities' revenues are adequate with their obligations. Such action may compel authorities to raise local taxes, charges or dues with no choice in the matter, may not improve existing services and may render them unable to discharge their responsibilities properly. In all cases, such situations constitute undue pressure on local and regional authorities' freedom.

4. *Legislation should establish rules for drawing up, approving and implementing local and regional budgets and for the supervision of their implementation, as well as for their healthy, balanced management in the long term.*

The state has a duty to establish rules for supervising the procedures governing the use of public funds; the establishment of rules on budgetary procedure at national level should include sufficient incentives for ensuring the efficiency in public spending, as well as guarantee at least a minimum of openness and public ethics and allow the collection of comparative statistics and data.

5. *It should not be possible to delegate the adoption of the budget and the approval of the accounts to a committee or a body other than the elected deliberative body of the local or regional authority.*

This paragraph refers to two essential competences of local and regional authorities, which have major political implications. The local or regional deliberative assembly is therefore the only body that can legitimately adopt the budget and approve the financial accounts. General delegation of this competence to another body, such as the financial committee, should be prohibited.

In order to make the text more readable, the elected deliberative body, which may be either a council or an assembly, will be referred to as a "council" in the rest of the Appendix. The expression "elected deliberative body", which is more comprehensive and totally unequivocal, is used in this paragraph to avoid any legal ambiguity and to reinforce the idea that it is this body, irrespective of whether it is called a council or an assembly, that must approve the budget and the accounts.

6. *Within the limits of the legislation, the local or regional authority should be able to independently adopt its budget and to adapt the operational rules applicable to its budget and to apply them to its specific situation.*

As stressed in the report on "Methods for estimating local authorities' spending needs and methods for estimating revenue", the budgetary process is not just a technical but also a political process. Independent adoption of the budget is thus a prerequisite for local and regional self-government. In addition, adjusting services to local needs without being able, to some extent, to adjust procedures would be extremely difficult. It must therefore be possible to adapt the rules to at least the size of the authority and of the project.

7. *The local or regional authority should be able to allocate credit balances carried over from a budget year to non-recurrent expenditure (for example, self-financing of investments, the reduction of public borrowing, setting up provisions or reserves, etc.) and carry over debit balances in order to rectify the situation by allocating funds from subsequent budgets to write them off.*

The confiscation of positive balances that occurs in many European countries encourages local and regional authorities to spend at the end of a budget year without bothering about efficiency. The possibility of carrying over positive balances is an incentive to improve financial management even if that possibility is made conditional on the expenditure concerned being allocated to non-recurrent expenditure. The carrying over of negative balances generally takes the form of being able to contract short or very short-term loans.

### **Limitations on the financial autonomy of local authorities**

8. *The state or legally established supervisory authority may take measures to restrict the financial autonomy of a local or regional authority or to limit or reduce the amount of funding transferred to it. Such measures should be taken within the framework defined by statute and should not be excessive or threaten the principle of local autonomy.*

The law should specify the possible restrictions and the circumstances in which a decision may be taken to impose a restriction. The obligation to discuss limitations imposed on local authorities with the authorities concerned flows directly from Articles 4.6 and 9.6 of the European Charter of Local Self-Government.

9. *Such restrictive measures may be general (applied to all authorities) or specific (applied to a limited number of authorities, having regard to their particular situation). Their aim should be to:*

- *ensure a healthy macro-economic policy at state level, on the one hand, and*
- *ensure sound and safe management, while observing the rules laid down by statute and administrative law, and overcome financial difficulties or deal with exceptional situations encountered within those local and regional authorities subject to the restrictions, on the other.*

This paragraph classifies the restrictions on the financial autonomy of local and regional authorities, and lists the most adequate reasons for introducing and applying them.

10. *The limitations which may be imposed by the state on the financial autonomy of local and regional authorities should be established by law. Limitations should be based on objective, transparent and verifiable criteria, applied fairly and in such a way as to avoid accounting devices that obscure the truth.*

The obligation to establish limitations by law also flows, although less directly, from Articles 4.1, 4.2, 4.4, 8.1 and 9.1 of the charter. The listed conditions to which limitations should be subject are such as to rule out any threat to local and regional self-government and the application of inefficient or arbitrary limitations or of limitations based on unjust or inequitable political criteria.

*11. The local or regional authority should be consulted, following appropriate procedures, prior to any measure to restrict its financial and budgetary autonomy, and it should be notified of the application and consequences of any such measure. Institutional mechanisms of regular dialogue, consultation and co-operation between the different levels of government could be created.*

This paragraph returns to and develops the principle of consulting local and regional authorities before any measures are taken to restrict their financial autonomy. It also recommends appropriate procedures for dialogue, consultation and co-operation. As pointed out in the report on "Effects on the financial autonomy of local and regional authorities resulting from the limits set at European level on national public debt", the creation of institutional forms of dialogue may both increase the effectiveness of limitations and enable local and regional authorities to offset the loss of financial autonomy by a gain in political influence.

*12. Regular checks should be made by the central authority to gauge whether the limitations are necessary and effective.*

Obsolete historical limitations should not persist through inertia or because of resistance to change by some of the parties involved. Limitations may also have to be strengthened or modified in order to take account of changes in a situation. As suggested by this guideline, existing limitations should therefore be regularly assessed so that they can be adapted to requirements.

*13. Specific measures restricting the financial and budgetary freedom of certain local or regional authorities should be short-term and lifted once they have achieved their aim.*

Limitations affecting only one authority or a small number of authorities should not be permanent. This is a precondition for the equal treatment of local and regional authorities.

*14. The limitations imposed on each authority should be clear, objective and quantifiable.*

The aim of this guideline is to make sure that limitations are clear and fair.

*15. The limitations should be proportionate to the desired aim and be free of any punitive nature.*

A limitation should be introduced for the purpose given in paragraph 9 and comply with the conditions listed in paragraphs 8 and 13. Limitations should accordingly not be excessive or punitive in nature. Even if it follows logically from the previous paragraphs, this principle is vital for the safeguarding of local and regional democracy and it is therefore affirmed in this recommendation.

*16. Measures having a substantial impact on the financial autonomy of a local or regional authority, such as the general and rigid capping of spending and taxation rates, should be avoided if other, softer, measures such as incentives and flexible limitations (which vary in time and take account of the situation and of the average spending and taxation rates for a certain type of community) could be used.*



In its report on "Effects on the financial autonomy of local and regional authorities resulting from the limits set at European level on national public debt", the CDLR reviews the different types of limitations applied by European states and concludes that preference should be given to flexible limitations when such limitations are at least as effective as rigid limitation according to the aims followed (paragraph 9). For example, limitations may be linked to the public deficit (as in Poland where, under the constitution, a deficit on the part of local and regional authorities must be progressively reduced when the national debt increases) or to the indebtedness of the authority concerned, or which may be fixed according to national averages. Rigid limitations, on the other hand, should be avoided as far as possible.

### **Methods of financial estimation**

*17. Evaluations of the evolution, at the national level, of local and regional authority spending needs and provisional receipts, of financial transfers and of criteria for sharing these transfers should be prepared and published. These are to be considered as provisional evaluations; they should be subject to adjustment at regular intervals. They should be based on calculation formulae that are transparent, stable, fair and objective.*

This paragraph recommends to the central authorities that they prepare or have prepared a series of provisional financial evaluations and sets out a number of conditions with which evaluations should comply if they are to be effective and objective.

It is based on one of the conclusions of the CDLR report on "Methods for estimating local authorities' spending needs and methods for estimating revenue".

*18. The purpose of these evaluations should be to provide information on changes in the macro-economic situation and the foreseeable amount of transfer funding that could be granted by the central authority to local and regional authorities, and they should allow, where applicable, for transfers to be shared fairly between authorities.*

This paragraph mentions the three essential reasons for the central authorities to draw up financial estimates of the needs and revenue of local and regional authorities: to collect information leading to a sound macro-economic policy; to make forecasts of the total amount of financial transfers to other authorities; and to plan the sharing of that amount among the authorities so that the latter may estimate their future revenue.

19. *Where appropriate, the state should promote the setting up of standards for essential local and regional services and should develop outline procedures for financial estimations relating to spending needs at local and regional levels.*

The setting of minimum standards for services should be one of the state's important roles in ensuring that citizens can enjoy essential services wherever they live or work. Setting outline financial estimation procedures for the use of local and regional authorities helps the latter to foresee their revenue and spending effectively.

### **Assessment and management of financial risks**

20. *The assessment of financial risk should comprise prior monitoring and warning mechanisms (such as tables presenting the evolution of revenue and expenditure, of indebtedness and interest rates, of the main tax bases, etc.) as well as intervention and supervisory procedures. An approach of overall regulation should be preferred to that of control of individual activities.*

The central authorities should introduce both warning mechanisms (the examples given are drawn from the CDLR report on "Risks arising from local authorities' financial obligations") and conventional supervision and intervention procedures in order to assist local and regional authorities with risk assessment and management. The benchmarking of financial indicators, which is extremely useful for risk assessment, would in fact be difficult without central authority intervention.

The individual supervision of operations does not simply entail considerable cost and time; it may also make local and regional authorities less concerned about risk assessment. For these reasons the emphasis should be on defining, on the basis of well-chosen information, general rules that prevent excessive risk-taking by those authorities.

*21. Speculative investment by local and regional authorities should be prohibited. If the local or regional authority wishes to invest on the equity market, such investment should be managed professionally.*

There is no unanimously accepted definition of "speculative investment". Nevertheless, financial products exist (eg options and warrants) which are regarded as presenting a significant risk by the whole financial community. Recourse to such products should therefore be prohibited. Use of the share market could be either limited (taking account of indicators such as historical volatility in order to define an investment as speculative) or prohibited. In any case, the use of shares as an investment product should be managed professionally.

*22. Any financing techniques which have the object or the effect of concealing the level of debt of the local or regional authority should be prohibited. All financing techniques should be subject to conditions that ensure or restore the transparency of the financial situation or limit the risks involved.*

The use of techniques like that commonly known as "creative accounting" in order to conceal, *inter alia*, the level of debt is a temptation for many bodies, both public and private. Central authorities should take the necessary steps to prevent local and regional authorities from resorting to such methods by basing themselves, for example, on the rules which companies listed on the stock exchange are required to observe in their financial dealings.

23. *Legislation should exclude or limit the possibility of using buildings and assets indispensable to the fulfillment of the local or regional authority's mandatory or related tasks as collateral for guaranteeing borrowing.*

In many European countries these goods are classed as public assets of the commune or region. Public assets are exempt from seizure and thus cannot normally be used as collateral. This paragraph therefore applies mainly to countries that make no distinction between public and private assets. In other countries it is likewise possible for certain goods which are indispensable to the fulfillment of local or regional authority's tasks to be part of the private assets of the local or regional authority.

Central authorities are therefore invited to adopt legislation to forbid or limit (eg by demanding a council vote, or even a qualified majority) the use of assets indispensable to the fulfillment of local authorities' mandatory tasks as collateral.

24. *In general, local and regional authorities should have the right to incur debts only for the funding of investment expenditure and not for current expenditure. The level of debt could be established in relation to the volume of the authority's own resources, their extent, stability and foreseeable development.*

The financing of current expenditure by borrowing is unsustainable in the long term and should therefore be prohibited. Exceptions to this principle could include short-term borrowing in order to bridge the gap between cash inflows and outflows, and borrowings by local or regional authorities undergoing restructuring following a financial recovery plan. For example, a deficit may be carried over a limited number of years.

### **Local elected representatives and employees**

25. *The quality and accuracy of the financial and budgetary information issued by the local or regional authority should be guaranteed by the mayor, the chief executive or any other elected representative or executive body designated by law, who assumes responsibility.*

This paragraph embodies an essential principle of responsibility and transparency. In the event of serious or deliberate misconduct, the executive should be held accountable politically (to the council), administratively (penalised or dismissed, normally after court proceedings) and personally (in the civil or criminal courts).

On this point see also Committee of Ministers Recommendation to the member states No R (98)12 on the supervision of local authorities' action.

*26. Officials responsible for collecting local or regional tax revenue and/or committing local or regional expenditure and enjoying a degree of independence in the exercise of their duties should be personally accountable for their acts of management, in accordance with the law.*

The personal accountability of public treasurers and other officials enjoying a degree of independence is an established fact in certain countries and is regarded as good practice by the CDLR in its report on "Risks arising from local authorities' financial obligations". It could be subject to a ceiling and be limited to cases of serious or deliberate misconduct. The officials concerned might take out insurance limiting the risks in the case of unintentional negligence.

*27. The central authority should ensure that local or regional officers and elected representatives receive appropriate professional training. If such training is not provided by the local or regional authority itself or its association, the central authority could, for example set up standards in this respect, organise such training itself and help the local or regional authority and its association to organise training for their elected representatives and officers.*

Financial management is a technical and generally poorly known subject. However, it is very important for efficient management. The state should therefore see that the training of local and regional representatives (both elected and appointed) is not left entirely to the discretion of the local and regional authorities, which might not possess the necessary resources. A mix of obligatory standards to be obeyed by these authorities, direct intervention, technical assistance (handbooks and course guides), logistical assistance (structures and teachers) and financial assistance to authorities (and their associations) is therefore recommended.

## **Controls**

28. *The external supervisory procedure should be laid down by law and should be balanced and fair. The procedure should be limited to an examination of the legality of decisions. In the case of a disagreement, the procedure should provide the supervising authority with the possibility of recourse to the competent jurisdiction.*

The recommendation that the supervisory procedure be set by law (or the constitution) results directly from Article 8.1 of the Charter. Supervision is balanced where the extent of the supervisory authority's intervention is proportional to the magnitude of the interests which the authority wishes to preserve. Balanced supervision therefore arises out of Article 8.3 of the Charter. The adjective "fair" describes supervision which is neither political nor punitive and which is applied to local and regional authorities, subject to differences based solely on objective factors connected with the situation of the authorities concerned.

Limiting supervision to an examination of the legality of decisions taken in the exercise of authorities' own competences is a vital principle of local and regional self-government, deriving from Article 8.2 of the ECLSG.

In the event of a disagreement, the last sentence advocates judicial proceedings brought by the central authority. The reverse procedure (whereby the decision is set aside by the central authority, with the possibility of appeal by the local or regional authority) has often been criticised as leaving the way open to abuses and delays in cases where the relevant jurisdiction eventually rules that a decision was illegally set aside, slowing down the work of local and regional authorities and hampering their efficiency.

29. *In general, control after the event should be preferred to prior approval or authorisation.*

Prior controls cause further delays and therefore threaten local and regional authorities' speed of action. They may also encourage the supervisory authority to question the desirability of decisions and may unduly limit local autonomy. Limiting prior administrative controls (those where the governmental authority's intervention is a condition for the effectiveness or validity of the local measure) has already been recommended by the Committee of Ministers in its Recommendation No R (98)12 on the supervision of local authorities' action.

30. *Failing this, where prior approval is required, particularly for the exercise of delegated powers, a reasonable time limit should be set by law for the supervisory authority to give its approval, which shall be deemed granted if no reply is forthcoming within the time limit set.*

A failure to react by the supervisory authority in the case of prior control results in excessive delays for local and regional authorities and can become a formidable weapon against local and regional self-government. Local and regional authorities must therefore be permitted to do their work even when the supervisory authority fails to play its part. This guideline also appears in Recommendation No R (98)12 on the supervision of local authorities' action.

31. *There should be a legal deadline for the adoption of local and regional budgets and mechanisms to ensure the continuity of public services if the budget is not adopted in due time, or if the local or regional authority fails to fulfill its obligations (such as omission from the budget of expenses that are legally or contractually binding, inaccuracy of budgetary entries, gross violation of budgetary procedures, etc.. Such mechanisms may provide for the intervention of the central authority, of the controlling body or of an independent administrative body in order to redress the situation, while at the same time guaranteeing that the intervention is proportional to the cause, is neither political nor excessive, does not endanger local or regional self-government and is not prolonged beyond what is needed to redress the situation or to tackle the deficiencies observed.*

Blockage of a local or regional authority's activity, whether for political reasons (eg lack of an adequate majority), functional reasons (eg difficulty in collecting or processing the information needed to prepare the budget) or temporary reasons (eg inability to assemble a quorum) is not a particularly exceptional situation. In such a case, the central authority must take the intervention powers necessary for public local and regional services to continue. This paragraph establishes that principle and gives examples of possible measures. It also sets limits on intervention by the central authority in order to cut the potential risks of such intervention for local or regional autonomy.

32. *There should be statistical and comparative analysis of budget implementation, spending and the rate of spending in order to detect any anomalies and trigger the relevant warning procedures, rather than a series of successive authorisations that provide no dynamic overview.*

Monitoring of the implementation of local and regional budgets by the central authority would not simply enable the latter to derive information of use for its macroeconomic analyses. A warning system could also help the central authority to take measures to prevent or limit possible difficulties for one or more local or regional authorities.



33. *The central authority should ensure that arrangements are made for drawing up comparisons of budgets and performance for local or regional authorities of comparable size and socio-economic characteristics that are widely accessible (through publications or Internet site postings) and accompanied by explanatory texts (such as the meaning of indicators used etc.).*

Comparisons of budgets and performance can be extremely valuable, can supply the information needed for decision making both by the central authority and by the local and regional authorities and can make those authorities' activities more open. Such comparisons would be difficult to organise on the initiative of local or regional authorities without central authority involvement.

### **Recovery of local and regional authorities in financial difficulty**

34. *As a general principle, the central authority should not guarantee the borrowings of a local or regional authority.*

Central authorities are often asked by credit institutions, particularly international ones, to provide guarantees. This is a bad practice which is of greater comfort to banks than to central or local/regional authorities. It encourages local authorities not to assess financial risks and to get into debt and often means that the central authorities have to pay the bill. Local autonomy does not emerge strengthened.

A genuinely joint project implemented by the central authority and the local or regional authority could constitute an exception to this rule. In such a case, it would nevertheless be worth while for the central authority to associate the local or regional authority with the three types of risk involved in any project (investment risk, industrial risk or risks with respect to costs and commercial risk or risks with respect to revenue) and monitor the development of the project and financial risks.

35. *Current expenditure of the local and regional authority should be financed out of current revenue and non-earmarked reserves, except in exceptional cases of cash advances and short-term loans.*

Financing current expenditure from non-permanent resources such as borrowings (already dealt with in paragraph 23), exceptional transfers, the proceeds of assignments, civil damages, gifts and legacies etc, is unsustainable in the long term. As the relatively short electoral cycle could encourage certain elected representatives to go on a spending spree, the state should introduce safeguards against such practices.

36. *The state or supervisory authority should establish procedures for monitoring the financial situation of local and regional authorities by gathering financial information and making it public. This information should enable citizens, the local and regional authority and the government to be aware of the financial situation of a given authority, to compare it with that of other authorities with similar characteristics and to take appropriate measures, where necessary and according to law, to avoid any financial difficulties arising.*

Together with paragraphs 32 and 33, this paragraph defines the role that the state should play in collecting and processing the financial information used by local authorities in order both to allow effective management tools to be prepared and to increase transparency and access by members of the public to financial information.

Monitoring is expensive but it makes the information process between the state, the public and the local or regional authority less one-sided. It could be done by independent public or private bodies.

37. *Procedures should exist enabling the local or regional authority to handle a localised and short-term financial crisis without requesting assistance from the next highest level of authority or the state. Such procedures could be established, for example, under a bankruptcy and insolvency code for local and regional authorities.*

Local authorities can encounter financial difficulties impossible to solve by local means, even if they enjoy complete freedom in respect of local taxation. If the legal framework does not specify the way to settle the situation, the local authority may plausibly argue that central government has implicitly agreed to intervene. It may then be hard for the latter not to do so even if the crisis is due to errors in local financial management.

Furthermore, in the majority of countries, the recovery of local and regional authorities in financial difficulty is effected case by case, following different procedures and taking measures that vary greatly from one situation to another. The preparation of a set of recovery rules would be useful for the public, which would be confident that essential local and regional services would continue, for the local or regional authorities, which would find themselves with a code of conduct for rapid recovery, and for the financial lending institutions (thus possibly with an improvement in the credit terms offered to local and regional authorities).

38. *The state or supervisory authority should establish and observe clear rules for intervention to assist a local or regional authority in financial difficulty.*

Defining intervention procedures on a case-by-case basis is time-consuming and in most cases inefficient. In addition, "tailored" interventions may lead to accusations of favouritism or corruption and can tie the hands of the authorities in difficulty. However, the rules must obviously leave the central authorities some latitude both for the sake of flexibility and so that action may be matched to the prevailing circumstances and to the situation of the authority in difficulty.

39. *These rules of intervention should pursue the aim of financial recovery of the local or regional authority concerned while making elected representatives and officers responsible for their acts. There should be provisions aimed at discouraging and avoiding perverse effects such as local or regional authorities becoming accustomed to assistance or becoming careless in their financial management or competing for state aid.*

Financial assistance can be addictive (authorities receiving it begin to feel dependent on state financial assistance, which stops them trying to mobilise their resources and improve their management), can lead to carelessness (authorities become over reliant on the state safety net and reckless in risk assessment and management) and can lead to competition (authorities start to fight among themselves over state assistance) and so on. An assessment should be made, both upon implementation of the general assistance rules and in each specific case, of the possibility of perverse effects and steps taken to prevent them arising. Such assessment should include an evaluation of the local or regional authority's financial and fiscal capacity in the short, medium and long term.

*40. In cases where the financial difficulty arises from a structural income deficit the central authority should not only provide financial assistance but should also intervene to eliminate the causes of that structural deficit.*

Treating grants and other state transfers designed to relieve the structural lack of resources of one or more authorities as discretionary state assistance is a serious threat to local and regional democracy.

*41. The central authority should make provision for special financial resources in order to help local and regional authorities that are in an emergency situation, or victims of natural disasters or affected by sharp economic decline.*

Making provision for special financial resources in order to help local and regional authorities in difficulty should make the process of assisting with recovery more transparent and prevent situations where the state does not have the necessary resources to help these authorities. Such resources may take the form of specific annual budgetary headings or of a special pluri-annual fund. The advantage of a fund is that it can be built up, inter alia, during periods of economic growth and abundant resources. Unsurprisingly, the number of authorities in financial difficulty increases with a deteriorating economic situation, when the state itself is least able to help them.

42. *Financial assistance should be granted following dialogue with the given local or regional authority and on the basis of an economic recovery plan that includes financial contributions and undertakings from the authority itself.*

Given the almost invariably skewed nature of the information flow between central authority and local/regional authority, dialogue and consultation are essential conditions for effective assistance to an authority in financial difficulty. In order that local or regional resources may be mobilised, assistance should also be conditional on the existence of a clear and formal recovery plan that includes substantial commitments (a financial contribution) and contractual undertakings (the acceptance of obligations) by the authority in difficulty.

43. *Financial assistance should be adjusted according to the local or regional authority's wealth and medium-term economic and fiscal potential.*

According to the conclusions of the CDLR in its report on the recovery of local authorities in financial difficulty, assistance should be conditional on financial effort and not on a large financial contribution by the authority in difficulty. A wealthy authority with untouched tax resources, could easily meet the obligation to contribute to the recovery plan by means of, for example, a sum equal to the central government contribution. A poor authority would find it hard to meet that condition. Accordingly, granting assistance in proportion to the authority's contribution could encourage wealthy authorities not to use their resources and to await state intervention and could exclude the poorer authorities that need it most.

## Part II

### Guidelines for local and regional authorities

Local and regional authorities are invited to take into account the following measures when designing their policies in the field of financial and budgetary management, insofar as they fall within their competence.

#### General principles

44. *It would be desirable for newly elected local or regional executives to present a programme at the beginning of their term in office setting out aims, priorities and measures with an indication of the time-table of implementation and of the relevant budget resources.*

The existence of a serious and detailed policy programme on the part of the local or regional authority is an essential condition for good financial planning.

45. *The local or regional authority should draw up pluri-annual budget plans (covering the two to four years following the current year) setting out the overall budget objectives, an indication of the cost of pursuing the policies and undertakings subscribed to, and future budgetary consequences of decisions taken or to be taken.*

According to the conclusions of the CDLR in its report "Budgetary procedures and budget management at local authority level", the preparation of pluri-annual budget plans is an essential tool of good financial and budgetary management. Plans should set out the budget objectives, the decisions to be taken and detailed financial estimates.

46. *Budget projections and proposals should be prepared with the involvement of in-house experts (for example, receiver, treasurer, internal auditor) and outside opinions (such as economists, independent auditors etc.), particularly in the event of public debate (hearings before the relevant committees, the local or regional council etc.).*

Even large and medium sized authorities able to recruit in-house experts in financial auditing should make use of outside advice and arrange public debates on the various budget projections and proposals. This remark applies particularly to small authorities, which have greater difficulty in finding the necessary skills among the local labour force and therefore have to place more reliance on outside advice.

*47. Whenever a decision is taken by the executive or the local or regional council, the budgetary expenditure for the current year and the following financial years should be clearly explained.*

Failure to assess the financial implications of decisions taken or to make them known constitutes probably the greatest danger to the financial autonomy of local and regional authorities. Many of the authorities experiencing financial difficulties can blame decision makers who have either been unable or have not wished to assess the financial impact of their decisions.

*48. As a general rule, the proceedings of committees dealing with budget matters should be open to the public and their documents should be published and accessible to the public.*

The proceedings and documents of these committees are probably the most sensitive, but it is essential to make their proceedings open and publish their documents in order to ensure genuine transparency in the activities of local and regional authorities.

*49. The elected representatives and officers of local and regional authorities should be offered and benefit from appropriate training in budgeting, both basic and advanced, that enables them to understand the documents submitted to them and to take appropriate, informed decisions. Incentives for training such as a closer link with promotion criteria should be implemented for officers.*

The skills most important for the management of public affairs, ie financial skills, are probably those least developed in elected representatives, especially new ones, but they are also often lacking among local and regional officials. Training in budgetary matters is therefore essential for improving the financial management of local and regional authorities.

*50. Any activity of a local or regional authority that may result in public debts or entail significant financial risk should be primarily agreed upon and authorised by the elected deliberative body concerned.*

Authorisation by the local or regional council of activities that may generate debt or entail significant financial risk is an essential principle in order to ensure careful, open and responsible management. In terms of debt, the guideline is clearly not aimed at short-term borrowing to bridge the gap between cash inflows and outflows; rather, it is a question of establishing obligations for future revenue. The degree of risk that might be considered "significant" cannot be defined for Europe as a whole, since it depends on a range of factors such as the authority's total resources, its level of debt, its ability to increase its resources and the proportion of optional expenditure in relation to compulsory expenditure.

### **Information and openness**

*51. Budget and accounting documents should be easily readable, providing both a clear and comprehensible overview of the budget (including main balances, issues and priorities, key data, etc.) and sufficient detail to analyse the content of the budget and make relevant comparisons (with other financial years, other authorities etc.).*

This paragraph sets out essential conditions that budget documents must satisfy in order to be open (ie understandable and capable of being democratically monitored).



52. *Published documents; for example via the Internet, should be accompanied by a suitable explanation making them more easily comprehensible to a lay public.*

This paragraph is self-explanatory.

53. *Expenditure and receipts should be presented by type and by function in budget documents, identifying as far as possible the different sectors of local and regional government involved so that the sharing of resources between fields of activity may be gauged.*

Classification by type and function provides a clear picture of the authority's activities. Identifying the administrative departments responsible for the different budget chapters should increase the openness of budgetary documents.

54. *Information on the performance of the local or regional service management (financial indicators, output and impact indicators, comparisons with the performances of other local or regional authorities and the interpretation of such information) should, where appropriate, be appended to budgetary documents.*

There are many indicators that can be used to assess the performance of services. These indicators can be formed into analytical systems of the "tell—tale" type (table showing a set of indicators as they have evolved over the past few years and including information on the interpretation of their level and trend, together with the warning thresholds to be watched) or of the benchmarking type (comparative analysis of the different indicators for several authorities). In a simplified form, these management tools can also help to increase openness and the public's understanding of local and regional services.

55. *The local or regional authority should stimulate participation by citizens and social partners in public affairs by regularly consulting them and should ensure that objective information is provided on the financial aspects of the issues under consultation.*

A drop in the level of public involvement in local and regional public life is noted in many countries. The authorities should adopt a proactive approach, go out to meet the people, stimulate their participation and make sure that the information, including financial information, necessary for a proper understanding of local or regional public activity reaches them. The Committee of Ministers has already adopted an important recommendation in this area (Rec(2001)19) on the participation of citizens in local public life.

56. *The local or regional authority should make it possible for citizens to be informed of draft budgets as soon as these are forwarded to local or regional councillors for final approval. When a budget has been adopted, its outlines and consequences for the community should be made public; for example by explaining changes in taxation or priority allocation of the authority's funding, and mentioning services ready to provide the public with further details.*

The timely communication of financial documents to members of the public should enable the latter to analyse them and make their comments known. Budgetary documents should be made public as soon as possible (see also paragraph 47, which recommends that budget committee documents be made public) but in any case as soon as they are forwarded to the council for adoption. Informing the public about the budget as adopted and explaining its main features and consequences is an essential element of transparency.

### **Preparation of the budget**

57. *Preparation of the budget should be the responsibility of a specialised unit of the local or regional authority with a good knowledge of the authority's operational departmental costs and budget consumption so that it can propose different options to the executive and prepare internal arbitration before arbitration at a later stage.*

Preparation of the draft budget is a highly technical operation and should therefore be the responsibility of a specialised person or unit. Besides preparing the draft budget, this unit should also prepare the executive's decisions from the financial viewpoint and arrange the arbitration to which draft budgets should be subject.

58. *Budget proposals should be discussed by the authorities and persons responsible for the domain concerned and then by those responsible for finance, who should consider overall balances, overall income, borrowings and any problems raised.*

This paragraph is self-explanatory.

59. *Choices between different investment projects should be made more objective, for example by using a "scoring" system based on several criteria. When the size of the proposed investment justifies it, a participatory process involving the local community should be envisaged; if this occurs, procedures should be set up in order to guarantee that the exercise is properly run.*

In order to improve the decision-making process concerning projects to be financed, this paragraph proposes the introduction of an analysis of the "choice of investment" type taken from the private sector (weighted multi-criteria analysis). For major projects the organisation of a participatory process is recommended (eg involvement of NGOs in decision making, ad hoc forms of consultation, surveys or even referenda). In the case of a participatory process, rules, capable of ensuring that the various interests at stake are represented and that the over representation of certain groups is avoided, should be drawn up and followed.

60. *The budgetary consequences of a local or regional authority' links with the commercial sector (for example, income and expenditure linked to shareholding, execution of guarantees given etc.) should be carefully assessed in accordance with the rules and procedures for assessment used in the private sector.*

The CDLR report on "Methods for estimating local authorities' spending needs and methods for estimating revenue" notes that local and regional authorities often seem ill-equipped to assess the trend of their income and expenditure linked to the commercial sector (contracts, participation in capital, issue of guarantees). This paragraph recommends the use of tools which have already been tried and tested in the private sector (establishment of reserves and provisions, use of financial tables etc).

### **Assessment and management of risks**

*61. The presentation of the budget and accounts must give as complete and objective a picture as possible of the local or regional authority's financial situation. The local or regional authority should work towards drawing up consolidated accounts, integrating the results and showing the risks and obligations of the different satellite agencies.*

The budgets of local and regional authorities do not generally reveal the risks arising from their involvement in other organisations. In order to give a clearer picture of authorities' financial situations and the financial risks to which they are exposed, such information should nevertheless be included in the financial documents, either by consolidating the accounts (paragraph 61) or, if this is impossible (paragraph 62), by appending as complete a description as possible of the financial interests and risks arising from such involvement.

*62. Where the consolidation of the accounts is not possible, the local or regional authority should present an overview of its participation or involvement in any external organisation and possible risks to which the organisation may be exposed in which the local or regional authority is a financial stakeholder.*

See the explanation given to paragraph 61.

63. *The presentation of the budget should be accompanied by an analysis of the financial risks to which the local or regional authority is exposed: the quantifiable risks should give rise to setting up reserves, while the degree of exposure to non-quantifiable risks should be estimated.*

Preparing an analysis of the financial risks to accompany the financial documents is a very rare practice among European local and regional authorities. Such an analysis would be very useful, however, both for elected representatives and for members of the public who do not always have the skills with which to analyse the information presented in budget documents.

64. *In those countries where the local or regional authorities are at liberty to deposit their funds at the banks that they deem appropriate, a system of insurance or re-insurance is needed to protect the local or regional authorities against the loss of some of their assets in the event of bankruptcy of their bank.*

Local authorities have already experienced very severe difficulties because of the failure of banks where they had deposited their funds. Even if this situation is not widespread (authorities in many countries are not free to deposit funds as they wish, and, where they are, they generally choose the most solid banks. Banks are usually well supervised and monitored and cases of bankruptcy in consolidated economies are exceptional), reminding them of the need to protect themselves against the eventuality of bank failure is an important principle which local and regional authorities should bear in mind.

65. *Guarantee or guarantee deposit obligations should be published, with a distinction being made between the obligations during the financial year, the loans outstanding and the costs arising from these guarantees; the use of risk-assessment ratios to limit these risks is to be recommended.*

The granting of guarantees and guarantee deposits is one of the greatest risks run by local and regional authorities in many European countries. This risk should therefore be made as obvious as possible by following the recommendations in this paragraph and should be limited by use of the prudential principle (eg by fixing grant ceilings and setting aside reserves).

66. *Establishing or managing commercial enterprises and participation in such enterprises should be limited, in principle, to public service activities or to activities in which there is no competitive market or activities that are aimed at economic promotion (such as housing developments, creation of business parks and start-up activities, promotion of employment, etc.).*

The involvement of local and regional authorities in commercial activity should be limited to the setting of certain rules and to direct participation in the activities mentioned in this paragraph (provision of public services or of other services which, while not formally public, are, by reason of their importance and the absence of private providers, akin to public services and to activities for promoting the economy and employment).

Participation in competitive economic enterprises could constitute a threat to free competition (the authority would simultaneously be player and referee, laying down rules in an area where it has a direct interest) and a danger to the authority's financial health (because of their more cumbersome rules of procedure and their limited economic skills, local and regional authorities are generally ill-equipped to take economic decisions and assess the financial risks of economic activities).

67. *If the local or regional authority has the right to invest on the financial market, it should, in principle, limit such investment to the bond market. Any other financial product should be the subject of specific ratios for assessing their volatility and risk and in every case be subject to professional management.*

In some European countries, local and regional authorities are free to make deposits and to invest in the financial market. The authorities have an obligation to see that the public services enjoy a degree of stability and generally need readily available resources. The volatility of most of these products should compel authorities to confine themselves to bonds. In the contrary case - not recommended - professional management could reduce, though not eliminate, investment risks.

68. *Follow-up systems and ratios should be set up, the most important of which must be made public so as to enable the financial situations to be compared and the divergences to be analysed and to prevent risks.*

The setting up of systems of financial ratios has already been recommended for specific activities in paragraph 52 (for analysis of the performance of public services) and paragraph 57 (for choosing an investment). The CDLR has noted that the use of financial indicators is rare among local and regional authorities. It is recommended in this paragraph that the overall financial situation of authorities be subject to a system of monitoring by financial ratios. Such ratios, if properly explained, could enable the authority's situation to be compared with that of previous years, with the estimates on the basis of which the budget was prepared and with the situation of other comparable authorities.

69. *Local and regional authorities should acquire, individually or collectively, the expertise necessary to manage risks arising from their financial obligations; that expertise may imply training financial executives of local administrative bodies or involving the state services or independent public consultancy bodies, the associations of local authorities and the private sector on a commercial basis. Consultancy and supervisory functions should not be exercised by the same body.*

The CDLR has noted that the management of financial risks is poorly known and practised by the local and regional authorities of most European countries. This paragraph makes self-explanatory recommendations for alleviating this situation. Separating the supervision and consultancy functions establishes confidence between adviser and advised and prevents undue interference by the supervisory body, which could exploit the consultancy function by introducing disguised checks on the advisability of certain activities.

70. *Horizontal and vertical co-operation between authorities should be encouraged to facilitate the completion of major projects, in such a way as to share the expenses and the risks.*

Inter-authority co-operation can help to spread the financial risks and therefore limit their effects for a particular authority.

*71. Estimates of investment-project costs should not overlook recurrent subsequent costs (such as staffing, operation, maintenance etc.), which should logically be incorporated into pluri-annual budget programming.*

This paragraph states an obvious principle. Nevertheless, the CDLR has noted that making allowance for the recurrent costs of new projects is often neglected by local and regional authorities (either deliberately in order to avoid opposition to the new projects, or involuntarily because of a lack of adequate professional skills) and that this can cause the authority concerned considerable financial difficulties.

*72. In public-private partnerships, the risks should be shared out realistically and the local or regional authority should avoid, by its intervention, taking on the role of guarantor of risky private investment. In particular, an explicit public guarantee is preferable when the nature of the structure or service is such that the authority may find it difficult, to put its future in the hands of the user.*

In accordance with the CDLR's conclusions, local and regional authorities should clearly define the sharing of risks *ex ante* and on a contractual basis in partnerships with the private sector. Private partners should be obliged to assume, at least in part, all categories of risk: investment risk, industrial risk (with respect to costs) and commercial risk (with respect to revenue).

Even if, generally speaking, the granting of financial guarantees to the private sector is not a recommended practice, this paragraph describes a situation where it is acceptable or even to be recommended but where, in order to be visible and taken into account in any monitoring system, it should be explicit. There are numerous examples of authorities which, while not granting an explicit financial guarantee, have had to intervene financially in order to safeguard a service abandoned by a failing private operator and have thereby come up against completely unexpected financial difficulties.



## **Approval of the budget**

73. *A budget strategy debate should be organised at the beginning of the budgetary procedure, permitting initial discussion of the overall objectives to be adopted for the year and possibly the years to come.*

The budget strategy debate should enable both elected representatives and the public to hold a discussion on the main thrusts of the budget, and the budget preparation staff to obtain useful information on the major projects to be launched, the level of services, the local or regional authority's priorities and other assumptions to be adopted for preparation of the budget. The still persisting practice of presenting only a finalised draft budget to the council and public should be avoided.

74. *The local or regional authority should set sufficient time limits in which councillors may read and analyse the budget documents issued.*

These time limits cannot be defined at European level. What may be an adequate time limit for one authority may not be so for another with a more complex budget, a more sensitive financial situation, less clear explanatory information appended to the budget, a different size or less efficient data processing facilities. In its report on "Budgetary procedures and budget management at local authority level", the CDLR nevertheless considers that, generally speaking, while a period of a few days before a committee debate may appear reasonable, a minimum of 15 to 20 days seems to be required before a vote in the council.

75. *If the elected representatives consider the information received to be inadequate or unclear, they - individually or collectively (for example in the competent committees) - should be able to request further information, question the relevant officers and, where necessary, hear the experts of their choice.*

Rules should be made at local and regional authority level so that elected representatives can have access to information, especially financial, but also in order to ensure that certain elected representatives do not convert their right to information into a weapon for harassing the executive or local or regional officials.

### **Implementation of the budget**

76. *Where appropriate, a debate on the implementation of the budget should be held mid-year, in order to put budget changes into perspective and to review the changes in the economic, budgetary and social context, and after the end of the financial year.*

In all local and regional authorities enjoying some degree of financial autonomy, there may be discrepancies between budget estimates and the budget as implemented. In general, therefore, it is worth examining the implementation of the budget mid-year so that any necessary corrective measures can be taken. A debate on budget implementation at the end of the financial year is also a highly advisable practice.

77. *The council should receive regular updates (for example, every three or four months) on the monitoring of the budget. If budget adjustments prove necessary, it would be advisable to group them in one or two "sets" per annum, accompanied by an overview or even a debate on the state of budget spending.*

This paragraph establishes a principle of importance for the stability of budget implementation: inform often, correct rarely. The necessity of clarity for monitoring the budget is obvious. The reasons why the number of budget adjustments must be limited are explained in the following paragraph.

78. *Budget adjustments should be limited in number and in scope in order to avoid diverting the aims of initial budgetary objective. Adjustments should be organised in such a way as to give a clear view of the changes suggested and on their importance, and they should be given the same level of transparency, publicity and conditions of democratic control as the initial budgets.*

Budget adjustments generally get less attention from the media and public. Their more technical nature, the lack of accompanying explanatory documents and of discussions about the main aspects and the smaller sums of money involved usually make them harder to understand than the original budget. Nevertheless, they should be made comprehensible and the same level of involvement should be enlisted from the public as for preparation and approval of the initial budget.

### **Budget accounts**

79. *The accounts (for financial year  $n$ ) should be submitted to the council within a reasonable time, and certainly before the holding of the debate on budget implementation for the following year ( $n + 1$ ) and before the budget for the year after that ( $n + 2$ ) is drawn up.*

This paragraph establishes a rule concerning the maximum time limit for closing the accounts for the financial year and forwarding them to the council. However, there is a risk of unpleasant surprises which it might not be possible to take into account in the discussions on budget implementation for the following year and in the preparation, on the correct basis, of the budget for the following year.

80. *Approval of the accounts should be properly debated, in committee and then in the council, in the light of an outside opinion (for example an external audit).*

Budgetary accounts have a technical aspect and approving them is often less interesting to elected representatives than adoption of the budget. Both an outside technical opinion and the involvement of elected representatives in discussing and adopting them should therefore be obtained.

81. *The executive of the local or regional authority should ensure that the reports of committees and the council concerning the budget are published (allowing public access or on-line consultation).*

This paragraph is aimed at ensuring the transparency and supervision of budgetary accounts, which are generally less interesting to the public. However, it is essential for those who so wish to have easy access to those documents.

**Control**

82. *The local or regional authority should establish and put into general practice a framework for internal auditing (for example a code of ethics, independence measures, a right of initiative, conditions of intervention, notification of the council, follow-up, publishing of reports, etc.) and organise support for such internal auditing (recommended methodology, outside technical back-up).*

The existence of an efficient internal auditing mechanism is a prerequisite for the proper exercise of local and regional self-government and for improving the performance of financial management at local and regional level. This paragraph gives examples of instruments useful both for improving the general framework of internal auditing activity and for securing the support which such auditing may require.

83. *Without prejudice to any existing legal obligations, the local or regional authority should make systematic use of annual external auditing (in whatever form) to certify accounts and check their compliance with the law (including measures combating fraud and corruption).*

The use of external auditing in addition to the different existing forms of internal and external administrative supervision is a means of ensuring the competence and independence needed to assess management efficiency. Certification of the accounts and review of the legality of the budgetary procedures may also be performed better by an independent auditing body; use of external auditing in these areas may either replace or complement the similar supervision mechanisms established by the local or regional authority or by the central supervisory authority.

84. *The local or regional authority should assess the efficiency of its management at regular intervals, for example by making use of external audit.*

Assessing performance and efficiency is a sine-qua-non condition for improving local authorities' financial management.

**Financial difficulty**

85. *The local or regional authority should not request financial aid from the state or supervisory authority if it is able to redress its financial situation through other means.*

In its report on "Recovery of local and regional authorities in financial difficulty", the CDLR notes that many local and regional authorities are tempted to obtain exceptional financial assistance from the state even where this is not in their overall interest. Such assistance seldom comes without strings. Furthermore, the larger the number of authorities receiving assistance, the more such assistance may adversely affect local financial resources either directly (through a decrease in general grants from the state) or indirectly, because the rise in central taxation required to cover the additional transfers always has a negative impact on the local or regional tax base or on the authorities' room for manoeuvre in tax matters. Such assistance therefore threatens the financial autonomy of local and regional authorities, who should avoid it as far as possible.

86. *As soon as it finds itself in financial difficulty, the local or regional authority should devise and set up a financial recovery plan, if necessary with assistance from the state or supervisory authority, independent administrative authorities or private auditing firms.*

For electoral timetable reasons or other reasons, local and regional authorities in financial difficulty often indulge in a spending spree. This can only worsen their position even if it postpones the moment when recovery measures have to be taken. Furthermore, such measures are often ill prepared, incoherent and inconsistent, and thus ineffective. This paragraph recommends to local and regional authorities that they set up without delay, in partnership with competent authorities or external experts, coherent programmes of measures to put right their financial situation.

87. *The recovery plans should be debated and adopted by the council or assembly in public sittings. The plan should set out the necessary data and the undertakings on which the following budgets are to be based. The plan may be contractual, depending on legislation, vis-à-vis the body providing financial support to the local or regional authority concerned.*

This paragraph contains recommendations concerning the content and adoption of recovery plans and is self-explanatory.

## **Recommendation Rec(2005)1 of the Committee of Ministers to member states on the financial resources of local and regional authorities**

*(Adopted by the Committee of Ministers on 19 January 2005 at the 912th meeting of the Ministers' Deputies)*

The Committee of Ministers, under Article 15.b of the Statute of the Council of Europe,

Considering that the aim of the Council of Europe is to achieve a greater unity between its members for the purpose of safeguarding and realising the ideals and principles which are their common heritage and facilitating their economic and social progress, and that this aim may be pursued, *inter alia*, by common action in economic, social, legal and administrative matters;

Considering that local self-government implies a degree of financial autonomy;

Considering the provisions of Article 9 of the European Charter of Local Self-Government, which it adopted as an international treaty on 15 October 1985 and which has now been ratified by a large majority of member states of the Council of Europe;

Having regard to the Resolution on local government finance adopted at the Conference of European Ministers responsible for Local Government in Lisbon in 1996;

Having regard to Recommendation Rec(2004)1 of the Committee of Ministers on financial and budgetary management at local and regional levels;

Having regard to the following reports of the Steering Committee on Local and Regional Democracy (CDLR):

- Local finance in Europe (1997);
- Limitations of local taxation, financial equalisation and methods for calculating general grants (1998);
- Effects on the financial autonomy of local and regional authorities resulting from the limits on national public debt set at European level (2000);
- Methods for estimating local authorities' spending needs and methods for estimating revenue (2001);
- Risks arising from local authorities' financial obligations (2002);
- Recovery of local and regional authorities in financial difficulty (2002);
- Budgetary procedures and budget management at local authority level (2002);

Having regard to Recommendation 79 (2000) of the Congress of Local and Regional Authorities of the Council of Europe, adopted in connection with the monitoring of the implementation of the European Charter of Local Self-Government and concerning the financial resources of local authorities in relation to their responsibilities;

Considering that local taxation, state grants and financial equalisation mechanisms should be adapted to the needs of local communities so that their authorities can operate as effectively as possible, with due regard for the rules and codes of conduct applicable at national level;

Considering that the solutions to local authorities' financial problems should be adapted to the specific features of each state, as resulting, *inter alia*, from its structure, territorial organisation, distribution of powers between the different tiers of government and traditions;

Considering that this Recommendation, which was specifically developed for local authorities, may also apply, *mutatis mutandis*, to self-governing regional authorities and recalling in this respect the Helsinki Final Declaration on regional self-government adopted by the Conference of European Ministers responsible for Local and Regional Government in 2002;



Considering that the changes that have taken place since its adoption justify replacing Recommendation Rec(2000)14 of the Committee of Ministers to member states on local taxation, financial equalisation and grants to local authorities by this Recommendation,

Recommends that the governments of member states:

1. ensure a fair distribution of public financial resources between the different tiers of government, taking account of the responsibilities assigned to each of these tiers and changes in those responsibilities, as well as economic circumstances;
2. guarantee local authorities a system of financing their expenditure that is based on the following principles:
  - local authorities' resources and their allocation must be consistent with the requirement that they discharge their responsibilities effectively;
  - local authorities are entitled, within the framework of national economic policy, to raise adequate resources of their own;
  - a substantial proportion of transfers, and, generally, of their own resources, must not be earmarked for specific purposes;
  - the amount of state grants must be fair, transparent and foreseeable; fairness demands that allocation rules be universal, non-discriminatory, stable, and neither arbitrary nor negotiable on an ad hoc basis;
  - the financial equalisation system should allow local authorities to provide their citizens, if they so wish, with broadly comparable levels of services in return for comparable levels of taxation and charges; this system should take account both of disparities in the financial capacity of local authorities and disparities in their spending needs;
  - where the demands of national economic policy so require, measures should be taken to ensure that the system of financing local authorities is consistent, overall, with those demands; such measures should:

- a. not be disproportionate to the demands in question;
  - b. should be negotiated with these authorities or their representatives;
- and
- c. should be introduced by law;
- specific limitations which apply to a limited number of local authorities should be lifted as soon as the situation permits.
3. review – if necessary – the legal and administrative framework for local taxation and grants to local authorities so as to encourage the improvement of services and their efficient provision, and the legal and administrative framework for financial equalisation, so as to ensure fairness and solidarity between authorities, with due regard in particular for the guidelines appended to this Recommendation;
4. involve local councillors in the debate on reforms needed in this area, particularly those undertaken pursuant to this Recommendation, and on arrangements for implementing such reforms;
5. translate this Recommendation into their official language(s) and circulate it to local authorities and associations of such authorities, inviting them to take note of the guidelines addressed to them, as set out in Part II of the Appendix.

## **Appendix to Recommendation Rec(2005)1**

### ***Part I – Guidelines for central authorities***

*These guidelines are addressed to central authorities, in so far as they are responsible for defining the legal framework and supervising the activities of local authorities. In certain federal states, these responsibilities rest with the federated entities. In such cases, these guidelines are addressed to them. Central authorities are invited to bring the guidelines to their attention.*

## 1. Definitions

Within the meaning of this Recommendation:

*a.* From the point of view of the authority's capacity to alter their level, resources may be classified as either own or transferred resources.

An authority's "own resources" are resources of which it can vary the level, possibly within a predetermined range. These resources may, for example, be fiscal or non-fiscal, exclusive or shared, etc.

An authority's "transferred resources" are resources whose level the authority may not vary. They may be, for example, fiscal or non-fiscal, exclusive or additional, proportional or non-proportional (grants), etc.

*b.* From the point of view of the authority's capacity to use their proceeds freely, resources may be classified as either earmarked or non-earmarked.

A local authority's "earmarked resources" are resources which must be used for a purpose (goods, property, a service, a programme) decided on by an authority other than the authority in question.

"Non-earmarked resources" are resources which may be used freely, with due regard for the legislation concerning the use of public funds, by the local authority.

*c.* From the point of view of the relation between the sum that constitutes revenue of the local authority and the total sum levied locally, resources may be proportional or non-proportional.

An authority's "proportional resources" are resources that depend directly on the amount raised locally. They may be, for example, fiscal or non-fiscal, exclusive or non-exclusive (shared), etc. Own resources are normally proportional.

"Grants" are non proportional financial transfers.

*d.* From the point of view of the number of authorities which share their proceeds, resources may be exclusive or shared.

An authority's "exclusive resources" are the resources whose proceeds, as a whole, constitute the revenue of the authority in question. They may, for example, be financial or non-financial, own resources or financial transfers, etc.

An authority's "shared resources" are resources that are raised by the authority in addition to resources raised by another authority on the same basis.

*e.* Other definitions

"Additional resources" are shared own resources.

"Surcharges" are fiscal additional resources.

"General grants" are non-earmarked, non-proportional financial transfers.

"Specific grants" are earmarked non-proportional financial transfers.

The "financial capacity" is the maximum revenue an authority can raise in standard conditions which are set at the national level. As a rule, financial capacity largely depends on the tax (fiscal) capacity. There are, however, authorities that can raise very substantial non-fiscal resources (revenue from property, in particular land and buildings, economic activities or financial investments); their financial capacity takes account of this.

An authority's "tax (fiscal) capacity" is its ability to raise taxes in standard conditions which are set at the national level. Tax capacity is therefore proportional to the tax base, and differences in tax base lead to differences in tax capacity.

An authority's "spending need" is the amount theoretically necessary for the authority to produce or provide goods or services or a predetermined set of goods and services at standard level. The differences between authorities' spending needs stem either from differences in the unit costs of the goods and services produced or provided by the authorities in order to meet the quantity and quality minima imposed on them, or from the number of services needed (economies of scale) to attain these minima, or from differences in the number of residents entitled to the services.

"Delegated tasks" are competencies for which the ultimate responsibility falls on a higher level authority but the implementation of which has been transferred to a local authority.

"Exceptional revenue" is revenue which does not occur on a regular basis.

"Fiscal pressure" is the ratio between the total compulsory contributions and the added value (for companies) or income (for families) on the considered territory.

## **2. General principles**

1. States are invited to take note of and put into practice the fundamental principles to be observed in respect of local and (*mutatis mutandis*) regional authorities' financial resources, as set out in Article 9 of the European Charter of Local Self-Government.

2. The main objectives in developing intergovernmental financial relations should be to the following:

- to secure revenue for each tier of government according to the assignment of their responsibilities and standard financial needs (vertical fiscal balance);
- to achieve an equitable distribution among local authorities (horizontal fiscal balance);
- to enhance the efficiency of the public sector.

3. Local authorities should, within the framework of the national economic policy, be entitled to their own resources, which should be adequate, and of which they may freely dispose, in the exercise of their powers and responsibilities, within the limits of the law (financial autonomy).

4. Taxes (right to levy, proceeds and capacity to set the rate, if necessary inside a pre-established bracket) should be assigned to local authorities unless these taxes would exhibit significant horizontal spillovers, entail an inequitable pattern of revenue among local authorities, or discrimination or distortions among authorities, which warrants these taxes being administered at higher levels of government (subsidiarity principle). Where taxes are assigned to local authorities, they should also be given some power to intervene in their administration in order to improve their efficiency and to appropriate their proceeds (fiscal autonomy). Fiscal autonomy includes some tax policy discretion on behalf of local authorities, especially in the setting of tax rates.

5. To the greatest extent possible, each local authority should finance, from its own resources, the expenditure it decides on (fiscal equivalence at the local authority level).

6. Fiscal equivalence at individual level requires local authorities to charge, within a common regulatory framework, for local public services, and to tax citizens and local businesses in accordance with their use of local infrastructure (tax-benefit principle).

7. Local authorities should balance the financing of public services through taxation and charges, according to the public-private benefit they provide. When an authority deems it necessary to help a category of citizens to have access to a public service, it should not subsidise the service, but grant financial help to the users in question, in a targeted and, as far as possible, personalised way.

8. For regulatory purposes of local interest, local authorities should be able to levy fees, fines and emoluments and to grant permits and user rights to local businesses.

9. Where taxes are shared with local tiers of government, the local share should be commensurate with the local tax effort in order to encourage local officials to strengthen and develop the local tax base (derivation or origin principle).

10. Where there are large inter-jurisdictional disparities between local financial capacity and spending needs, central authorities should ensure the compensation of the financially weaker local authorities. These transfers should be unconditional and secure financing of a reasonable standard level of public service provision for all local authorities.

11. For local services of national interest (vertical spillovers) or for which some degree of national harmonisation is desirable, central authorities should guide local authorities through standard setting, and support these programmes through specific grants or service-related elements calculated for the general grants.

12. Where local authorities act as agents of a higher administrative level, the principal government must share the costs of these programmes (connectivity principle). Full funding is appropriate where the mandating government can control the administration of the programme; where this is not true, local authorities could be required to share some costs in order to contain their volume and to support the targeting and the effective administration of the programme.

### **3. Local taxation guidelines**

#### *a. Fiscal decentralisation*

13. Financial autonomy of local authorities implies that local authorities have sufficient own resources to fund a significant proportion of the costs incurred in the discharge of their responsibilities, as defined in the Constitution or by law. This proportion should be sufficiently large to allow for and encourage substantial room for manoeuvre and accountability on the part of local authorities when they determine the expenditure to be incurred in the discharge of these responsibilities.

14. Shared resources of local authorities should primarily consist of non-earmarked additional resources and/or non-earmarked shared proportional resources decided by a permanent law.

15. A degree of tax decentralisation is therefore required. The following parameters may be used to determine this degree:

- the ratio of local authorities' tax revenues to total state tax revenues;
- the ratio of local tax revenues to total local resources;
- the ratio of tax revenues to the grants from the state and other public authorities;
- the ratio of local authorities' own tax revenues to the country's gross domestic product;
- the ratio of the maximum resources to the minimum resources that the authorities can raise by varying local taxation rates within the statutorily permitted range.

16. When the degree of fiscal decentralisation is considered low on the basis of the above parameters, the central authorities should consider, in conjunction with the local authorities, means of increasing the proportion of local authorities' own tax revenues and tax revenues transferred under a permanent law, without necessarily increasing overall tax pressure.



17. Local authorities should be able to establish the level of their (exclusive or additional) taxation, if appropriate within predetermined limits, so that they can vary the quantity and quality of their services according to local needs and preferences and so that elected representatives are more accountable.

18. When they can decide on the level of their revenues derived from taxes established at national level, local authorities should, in general, be able to vary the rate rather than the tax base. The rates fixed should reflect a local political choice, whereas the tax base should be assessed objectively and uniformly based on the law.

19. Local authorities' freedom in tax matters should be restricted only for reasons relating to fairness or national economic policy constraints.

20. Limitations on the financial autonomy of local authorities should not be disproportionate to the objectives pursued, and should be discussed with local authorities or associations of such authorities, provided for by law and lifted as soon as possible.

21. In general, when higher authorities take decisions that reduce the local authorities' tax base, compensation should be provided.

22. In order to send out a clear message to the public and ensure that local authorities are accountable, local taxation rates should vary essentially in accordance with their respective communities' choices as regards level of services. For this reason, differences in financial capacity, and in particular in the local tax base and spending needs, should be subject to an equalisation system.

23. Minimum conditions regarding the openness of decisions concerning local taxation should be laid down by law, both for central authorities (publication of information on which decisions are based, national debates, consultation of local authorities or their associations) and for local authorities (public meetings, public votes or votes by roll call, publication of key documents before meetings at which decisions are taken, etc.).

*b. Structure of local taxation*

24. The tax revenues of a local authority should come from resident individuals or property or businesses on the territory of the local authority in question.<sup>2</sup>

25. The structure of local taxation should be such as to ensure a fair, open breakdown of the burden of local taxation according to the taxpayers' ability to pay.

26. The structure of local taxation should be such as to ensure that the overall tax burden and its relation to the level of services provided for the individuals and businesses that bear it is clearly visible (as this is a prerequisite for the efficient allocation of resources according to local preferences).

27. Local authorities should be able to vary the rates of taxes that account for a substantial proportion of their revenues, so as to prevent slightly different levels of services from being matched by large differences in local taxation rates.

28. Local taxes should have a sufficiently high yield and low administrative and inspection costs.

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<sup>2</sup> The CDLR studies show that local and regional authorities have greater financial autonomy in countries where they receive a share of revenues from income tax and all revenues raised in tax on land and buildings.

29. Local taxation should be reasonably stable so as to make for continuity and foreseeability in public services, and have a certain degree of flexibility, so that tax revenue can be adjusted to changing budget costs.

30. Local taxes should be neutral and create little negative economic distortion (minimum impact on growth and the economic structure of the municipality), demographic distortion (so as not to prompt people to migrate) and social distortion (so as not to cause further problems for social groups in difficulty).

31. The central authorities should be able to help local authorities draw up local tax regulations. The establishment of a single database (or a single access point) for all local taxation can make for greater openness.

32. Care should be taken to avoid: unduly large or unduly rapid changes in the tax base or taxation rate introduced by the higher authority; the risk of incentives that are contrary to local interests; measures that undermine the incentive to collect the tax intended for local authorities and carry out the inspections necessary to this end; unduly long delays in paying the sums collected; and a lack of information about the amount collected.

*c. Tax collection and litigation*

33. Consideration should be given to the possibility of the central authority's registering and collecting the taxes. The main advantage of such a system is that the regulations are drawn up by the central authority, registration costs are reduced and collection and litigation costs are lower, because there are economies of scale, and are borne by the higher authority.

34. If the taxes are collected by the local authorities, the central authority should provide them with logistic support (training, access to information, integrated, interoperable software, etc.) and set up special databases at national level.

35. When the tax is collected by a higher authority before being transferred to the local authorities, it is important that the sums concerned should be transferred within a reasonable time set by the law. A system permitting regular payments is of key importance to the municipality's cash management. The local authorities should be provided with transparent information about the calendar of transfers and the amounts paid.

36. It is desirable to have a single litigation procedure for local taxes, established at national level (or regional level in federal states). Failing that, it is recommended that the various procedures have as much in common as possible.

#### **4. Financial equalisation guidelines**

##### *a. Equalisation systems*

37. The purpose of financial equalisation should be to allow local authorities to provide their citizens, if they so wish, with services of generally similar levels for similar taxation levels.

38. When designing their equalisation systems, central authorities should take account of the fact that the differences in the tax burden that authorities have to impose on their residents to achieve the same level of services are generally the result of differences in their financial capacity, their spending needs or their managerial efficiency.

39. The equalisation system should compensate, at least in part, for differences in authorities' financial capacity (so as to provide more resources to financial weaker authorities) and spending needs (so as to provide more resources for authorities that either have additional responsibilities or, by virtue of their geographical location, demographic situation or other factors, are obliged to spend more in order to discharge their responsibilities). It should not compensate for differences in managerial efficiency or differences in cost stemming from the adaptation of service levels to local preferences.

40. A substantial degree of financial equalisation is a prerequisite for the success of fiscal decentralisation and sound local self-government. At the same time, financial equalisation is a prerequisite for the success of policies geared to economic stability and balanced, sustainable regional development. The decision concerning the desirable degree of equalisation is an eminently political one. There is no optimum level of equalisation at European level. It is important, however, that, once the decision has been taken, an efficient equalisation system is set up to implement it.

41. Local authorities should be provided with appropriate information about the way in which equalisation systems work, for they cannot accept a system with which they are unfamiliar or which they do not understand.

42. Equalisation may be achieved by means of grants from a higher authority (vertical equalisation) or the redistribution of local tax revenues, particularly if they are collected by central government departments (horizontal equalisation) or a combination of both. Vertical equalisation generally lessens the risk of resentment among local authorities. Horizontal equalisation (provided for by law, in accordance with the principle of solidarity between authorities of the same level) has the advantage of strengthening inter-municipal solidarity and giving local authorities greater independence from the central authority; it should be envisaged, in particular, in cases where local taxation capacity varies too much for it to be possible to achieve the desired level of equalisation solely by means of financial transfers from the state. The extent to which local authorities with above average per capita revenues are expected to contribute to horizontal redistribution should not be so great, however, as to discourage them from the exploitation and development of their revenue base. The volume of resources contributed by the national budget to vertical equalisation should reflect the priority of the services for which local authorities are responsible within the overall framework of public expenditure; their stability should be guaranteed by a permanent law and some form of indexation to the growth of aggregate national budget revenues is highly desirable.

43. The desired degree of equalisation of disparities in spending needs and in financial capacity should be clearly and foreseeably specified.

44. Equalisation systems should specify openly and foreseeably which local parties are eligible for financial transfers to equalise financial capacity and spending needs. Eligibility criteria should be laid down by law.

45. Although equalisation systems normally operate at national level, it may be worth encouraging systems for pooling certain local taxes or redistributing certain local taxes among local authorities that make up an urban area and, in particular, between municipalities that constitute the industrial and commercial heart of the urban area and those which are residential areas. A local equalisation system of this kind makes it possible to compensate, at least in part, for externalities and may be set up by means of an agreement among the municipalities concerned. In some cases, if it is impossible to reach such an agreement, it may be necessary to legislate.

46. In all cases, the mechanisms adopted to equalise among jurisdictions should be based on standardised (not actual) levels of revenues and expenditures. The standardisation of costs and revenues acts as a safeguard against implicit financial bail-outs that would otherwise eliminate the local authorities' (and their officials') accountability and result in wasted public resources. It also avoids moral hazard by local authorities because it precludes the manipulation of distribution criteria by recipient governments.

47. Central authorities should regularly check how their equalisation systems are working and consider, with local authorities, improvements that can be made in order to ensure that the adverse effects of an unequal distribution of resources and spending needs are effectively remedied.

*b. Equalisation of spending needs*

48. The equalisation of (standardised) specific spending needs should be effected through grants based on appropriate and objective criteria. Even when these grants are programme-specific, they should allow some limited discretion as to their use within programmes, and should avoid onerous monitoring and reporting.

49. Spending needs should be estimated primarily on the basis of criteria which:

- are objective and which local authorities do not directly control;
- are unlikely to affect local authorities' freedom of choice, within the limits of the budgets available;
- do not penalise local authorities that endeavour to streamline the management of their services to make them more efficient, either by lowering unit costs or by trying, by means of co-operation arrangements or mergers, to increase the number of users and units produced in order to obtain economies of scale, and which do not involuntarily provide incentives to indulge in behaviour that is contrary to the objectives of local accountability and efficiency in the provision of public services;
- take account, as far as possible, of demographic, geographical, social and economic features leading to disparities in costs.

50. The calculation formulae used to estimate spending needs should fulfil the following conditions:

- the weight afforded to the various individual indicators should be determined on the basis of objective information about the impact of variations in those indicators on the actual cost of local services;
- insofar as the assessment of needs nevertheless entails value judgments as to the weight to be afforded to the various indicators, it is necessary to identify and assess the results of these judgments in conjunction with representatives of the local authorities concerned or their associations;

- formulae for evaluating needs (models) should be as simple as possible, so that they are easy to understand and make for openness and accountability, but comprehensive and detailed enough to be reliable;
- formulae for evaluating needs should remain as stable as possible, to allow local authorities to make long-term forecasts and so that changes in estimated needs reflect genuine changes in the situation of local authorities over which they have no control.

51. The equalisation of spending needs should take account of as many local authority activities as possible, and in particular those that are very important or compulsory. A different formula should be drawn up for each spending need in respect of which equalisation is to apply.

*c. Equalisation of financial capacity*

52. The equalisation of (standardised) financial capacity should aim at reinforcing a deficient revenue base of a local government measured against a national yardstick (benchmark); such transfers should be unconditional general grants at the discretion of local authorities.

53. The estimate of the financial capacity of local authorities should preferably include all sources of revenue. The aim should be to gauge overall financial capacity.

54. Care should be taken to ensure that the equalisation of financial capacity does not undermine local self-government by, in practice, inducing authorities to provide the same level of services or apply the same taxation rates.



55. Equalisation of financial capacity should not deter local authorities from improving the tax base and ensuring efficient tax collection. The measurement of financial capacity for equalisation purposes should be based on the assumption that all local authorities levy taxes at the same rates and are equally efficient in assessing and collecting taxes, so that authorities are not penalised for the efforts they make or rewarded for laxity. This assumption should be used solely to calculate equalisation funds and should not undermine the authorities' right to vary the actual rates of the taxes levied. Local authority decisions should not directly affect the amount of equalisation funds received or paid.

56. In contrast to the equalisation of spending needs, where there is more than one local tax, equalisation should not take place for each tax: a representative fiscal system should be devised that reflects the total local tax-raising potential. A resource equalisation fund should be set up and the money allocated according to discrepancies between the various authorities' tax capacity and the average tax capacity.

57. Actual fiscal pressure should not be used as indicator of the financial capacity.

## **5. Grants to local authorities**

58. Grants are provided by the central authorities for various reasons and may take various forms. In general, they should be provided for by law or decided on in the light of clear criteria laid down by law. The government's discretion in calculating and effecting transfers should be reduced in order to avoid objectivity and credibility problems.

### *a. General grants*

59. The higher authorities' contribution to local budgets should mainly take the form of general grants.

60. The sum total of such grants should:
- cover the standardised cost of discharging delegated tasks and the structural shortfall in local authorities' resources in relation to their statutory responsibilities;
  - take account of such factors as demographic changes and economic circumstances such as economic growth and rising costs, particularly when the level of local authorities' own resources and their ability to influence these resources do not make it possible to adjust them to meet expenditure increases caused by economic factors;
  - take account of variations in costs generated by decisions taken at national level, in particular variations in such general factors as salaries and social security costs, minimum standards for local services and environmental protection standards applicable to local authorities.
61. States should assure local authorities of a degree of stability in this sum total, possibly by law or by virtue of arrangements designed to ensure economic stability, with the cooperation of all tiers of government. The sum total of transfers should not be subject to frequent, arbitrary fluctuations when the state's annual budgets are drawn up.
62. Criteria for the allocation of general grants should be clearly defined by law, or at least in accordance with the legal framework, on a non-discretionary basis. This should enable local authorities to calculate in advance the amount of the grants they will receive and adopt their budgets accordingly.
63. Any major redistribution of resources between local authorities resulting from a substantial change in the criteria for calculating grants, sharing out taxes or equalisation formulae should take place gradually, over a sufficient number of years to allow local authorities to adapt their budgets to the new funding levels without any excessive transfer of services.

64. Local authorities should not be in a position to influence the amount of the general grants they receive, unless this is one of the explicit objectives of a particular grant.

*b. Specific grants*

65. Specific grants restrict local authorities' freedom of choice as regards policy, are less effective than general grants in making good shortfalls in resources in relation to responsibilities and are not very useful as equalisation tools. Recourse to specific grants should therefore generally be restricted to what is necessary to achieve the following objectives:

- (co-)financing capital expenditure as part of balanced, sustainable regional development policies;
- ensuring that certain local public services, for which minimum standards are laid down at national level, are provided at a standardised level throughout the country;
- offsetting any centrality costs affecting the provision of certain local public services, insofar as they are not compensated for by horizontal transfer mechanisms, following voluntary agreements or statutory obligations;
- financing certain public services that local authorities provide on behalf of the state or offsetting costs which local authorities incur when discharging responsibilities delegated by other authorities; while specific grants may be used for these purposes, particularly because they can serve as an incentive, general grants are often more effective; the central authorities should consider which solution is to be preferred, with due regard for local autonomy, in the particular situation in question.

66. Specific grants should generally be awarded on the basis of objective, transparent criteria related to spending needs. All the authorities eligible for such grants should be informed about the availability of funds and the relevant criteria and should be able to submit applications for such grants, which should be compared by means of transparent procedures.

67. Where specific grants are conditional upon financial contributions on the part of the authorities receiving them, the level of such contributions should be flexible so as to take account of the authorities' financial capacity. The central authorities should examine the possibilities of modulating the specific grants according to that capacity so that the financial effort, and not the financial input, of the authorities is comparable and the most disadvantaged authorities are not denied such grants.

## **6. Other financial resources**

### *a. Fees and charges*

68. Recourse to fees and charges can make a considerable contribution to local authority revenues. Their impact on the demand and on the access to services should, however, be examined.

69. Local authorities should be entitled to decide what to charge for the services they provide according to the situation and local preferences.

70. In the case of essential services, the central authorities may lay down minimum (quantitative and qualitative) standards and conditions of access for disadvantaged sections of the population (exemptions and subsidies).

71. If necessary, the central authorities may, in order to ensure equal access throughout the country, lay down maximum charges for essential services and minimum charges for convenience services.

### *b. Sundry resources*

72. With regard to the sundry resources of local authorities (revenues from economic activities, property, investments, donations and legacies), and also to loans, states are invited to take note of the guidelines addressed to them in Recommendation Rec(2004)1 on financial and budgetary management at local and regional levels.

## **7. Borrowing**

73. Local authorities should be able to borrow in order to finance their capital expenditure projects. Such projects are intended to benefit future generations, and recourse to borrowing may therefore make it possible to spread the burden fairly among generations. As future generations do not have a say in the choice of projects to be financed, however, financing through borrowing is mainly suitable for services for which the loan will be repaid by means of charges to users.

74. Except in the case of cash advances and in exceptional circumstances, local authorities should not be allowed to take out loans to finance current expenditure. Current expenditure benefits the current generations and financing it through loans would mean that the costs would be borne by future generations. In addition, financing current expenditure through borrowing would make elected representatives less accountable for the financial implications of their decisions.

75. Local authority access to borrowing may be restricted on account of national economic policy constraints, in order to limit the risk of non-repayment and to avoid decisions that would transfer an excessive financial burden to future generations. Any such restrictions should be fair, commensurate with the constraints in question, discussed in advance with the local authorities or their representatives and lifted as soon as the macro-economic situation permits.

76. In order to make decision-makers more accountable, local authorities should be held fully answerable for their decisions to resort to borrowing. The central authority should not offer guarantees for loans raised by local authorities, save in exceptional circumstances.

***Part II – Guidelines for local authorities*****1. General principles**

1. Major decisions such as the establishment of taxation rates, charges payable by users for services provided and recourse to loans should be taken by the elected deliberative body (council or assembly) at a plenary meeting, and not delegated to the executive or a committee or other body subordinate to the elected deliberative body.
2. Financial and budgetary discussions should take place and the relevant decisions should be taken at meetings of the elected deliberative body that are open to the public.
3. The consequences of local authority decisions concerning sources of revenue should be made public. Budgetary documents should include overviews that are easy to understand on this topic.
4. In areas in which local authorities enjoy discretionary powers, major financial decisions should be grouped together and taken at specific intervals. In general, decisions concerning revenues and those concerning expenditure should be taken together when the budget is adopted and revised.
5. Associations of local authorities can play an important role in finding solutions that strike a balance between the various tiers of authority when national economic policy is framed; the same is true with regard to helping local authorities to draw up local tax regulations, for example.
6. Local authorities should use information technologies to improve managerial efficiency (collection and processing of information, preparation of decisions, follow-up to decisions). Priority should be given to “real-time”, open, evolutive systems that are, where possible, interoperable with the authority’s other systems and with systems established centrally or as a result of horizontal co-operation. Opportunities for payment by electronic means at a distance should be increased.

7. Local authorities should make sure to provide their staff with the various forms of training they are likely to need (legal, financial, fiscal, organisational, etc.) and regularly update key technical skills.

8. Local authorities should set up systems to enhance the professionalism and ethics of staff dealing with financial and, in particular, fiscal matters. They are invited to take note of the best practices pinpointed by the CDLR in the Public Ethics at Local Level Handbook, adopted at the Conference on Ethical Standards in the Public Sector, Noordwijkerhout (31 March-1 April 2004).

## **2. Local taxation**

9. The basic principles for determining local taxation should be fairness (taxation should be commensurate with each taxpayer's ability to pay) and efficiency (a high yield and a low collection cost).

10. When they establish the level of local taxes, local authorities should do so as openly as possible, so that their decisions are clear to the public. Measures ensuring the transparency of fiscal decisions should include publishing (in paper and electronic version), posting up and possibly disseminating all draft fiscal decisions, the documents needed to understand them and the decisions actually taken.

11. Local authorities should vary the level of taxation only in order to adapt the level of services to local needs and preferences.

12. Local authorities should avoid introducing too many taxes, as this inevitably increases administration and is liable to increase the cost of collection, grounds for litigation, etc.

13. Although the incentive purpose of local taxation should not be overlooked, it should not render impossible activities that are otherwise lawful. Any incentive should respect the principle of the equality of citizens before the law. In such cases, the determination of the tax base, taxation rate and exemptions should be consistent with the objective pursued.

14. Untimely changes in the local tax framework that could cause excessive disruption to economic operators or households should be avoided.

15. The local authority should provide the public with information and explanations concerning any taxes in addition to tax levied by a higher authority. If they are exclusive taxes, it is up to the municipality to draw up its fiscal regulations and bring them to the attention of the public.

16. Local authorities should provide the public with comprehensive, readable information about the use made of tax revenues by the authority.

17. The means used to inform the public about local taxation should take account of specific local features: electronic publication, posters, direct mailing, telephone service, etc. Certain methods of prior consultation may also be useful, as may public meetings after the council has adopted regulations.

18. In the case of exclusive local taxes, the authorities should pay particular attention:

- to ensuring that tax bands are both simple and fair;
- to the quality of the drafting of tax regulations, particularly in small municipalities;
- to tax avoidance and evasion mechanisms that may be prompted by local regulations.

19. Information on the tax base should be regularly updated and founded on factors that do not lend themselves to contestation. Cooperation between local authority departments should be arranged in order to obtain the necessary information (police, registry of births, marriages and deaths, etc). Cooperation with the higher authorities may enable local authorities to obtain the information needed to establish the tax base.

20. The bulk of local taxation should rest on a relatively stable tax base.



21. Registration and collection of local taxes right at the start of the financial year enable the municipality to have financial resources at its disposal earlier in the year and therefore to improve its cash flow. Steps should be taken to avoid delays that could lead to subsequent adjustments obliging taxpayers to pay, in the course of the same year, tax due in respect of several years. A system for following up unpaid taxes should be set up, both to protect the interests of the community and to take account of social situations.

22. Local taxes should require the least possible effort and the fewest possible formalities on the part of taxpayers, so that they do not inadvertently evade tax. Local taxation should not be based on taxpayers' prior tax returns.

23. Payment demands should allow taxpayers to check the accuracy of the information on which the amount of tax payable is based: tax base, rate, any exemptions, etc. The procedure to be followed for lodging a complaint should also be clearly mentioned, as should the procedure for requesting easy payment terms in the case of a sizeable tax.

24. Given the delays involved in court proceedings and the uncertainty surrounding such proceedings, it is desirable that litigation be reduced to a minimum. It is therefore recommended that every effort be made to limit it: laws and regulations should be clear, with few exemptions and special cases; it should be easy to obtain information; social situations in which easy payment terms are desirable should be identified, etc. Tax documents should mention the deadline for lodging a complaint, the method of doing so and the time-limit within which a decision should be taken and the possibility of appeal. Budgetary reserves should, where appropriate, be set aside to take account of trends in litigation.

25. Local authorities should carry out audits at regular intervals for each tax directly levied by the authority. Such audits should:

- compare collection costs (and changes in such costs) with the proceeds from the tax;
- indicate whether, for example, all taxpayers have been identified and whether they all pay the tax;
- assess the incentive and discouraging role of any taxes that have such an objective.

### **3. Fees and charges**

26. As a rule, charges should not exceed the cost of services and the local authority should not seek to make a paper profit from the provision of public services.

27. The charges applied should not reduce demand excessively, particularly in the case of important public services.

28. The choice between financing through charges (in which case users pay) and financing through taxes (in which case taxpayers pay) should be explicit and taken by the authorities with due regard for the specific features and preferences of each authority. It should be taken, for each service, in the light of considerations of fairness and equality.

29. Local authorities should make sure that access to essential services is preserved for the most disadvantaged sections of the population.

### **4. Other resources**

30. Local authorities are invited to take account of the guidelines concerning other resources (borrowing, income from economic activities, property, investments, donations and legacies) addressed to them in Recommendation Rec(2004)1 of the Committee of Ministers on financial and budgetary management at local and regional levels.

31. Exceptional revenue should only be used to finance capital expenditure and the reimbursement of debt.



