Fiscal devolution

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COVID-19 has brought into sharp relief the financial challenges facing English local government. It has also underlined the transformative role councils can play in supporting their communities and economies if they are given the freedom to get on and deliver.

The Local Government Association (LGA) has long called for genuine devolution to local areas. We believe that greater fiscal freedom, the power to raise more money locally and have greater control over how this money is spent in local areas is a crucial part of this process.

As this report sets out, the UK is an international outlier, one of the most fiscally centralised countries in the developed world. Local authorities in Germany, Switzerland and Holland can access a diverse range of revenue sources. They are also able to adjust and introduce local levies in consultation with their residents and businesses, innovating and diversifying their tax base in response to new public priorities, such as responding to climate change, and new forms of economic activity.

By contrast councils in England are only able to levy two taxes: council tax and business rates. Both are subject to significant intervention and control by Whitehall and both stand increasingly exposed in the light of long-term changes in home ownership and business composition, such as the rise of e-commerce and the growth in micro-businesses.

Over the last decade councils in England have increasingly found themselves having to argue in favour of protecting vital statutory services while driving inclusive growth and reform with one hand tied behind their back.

By contrast our international competitors have been able to demonstrate the positive impact fiscal devolution has had on accountability, financial efficiency and growth. As we look ahead towards the long process of economic and social recovery, this gap in local power and autonomy across England risks seeing our communities fall ever further behind.

I am therefore extremely grateful to Localis for having written such a timely and insightful report, which the LGA's People and Places Board were pleased to commission during a period of renewed interest in the prospect of further devolution to non-metropolitan areas.

While our local government neighbours in Europe enjoy significantly greater levels of fiscal and financial freedom it is also evident that many of these freedoms have their roots in local trust, collaboration and democratic accountability – qualities I know councils in England have in abundance.

Similarly, while the report's recommendations appear modest I believe they clearly and concisely speak to the opportunity of the forthcoming Devolution and Recovery White Paper to reset the often top-down relationship between national and local government and to press ahead with forging a new chapter in this country's history together as equals.

I look forward to picking up these conversations in earnest with government and I would strongly recommend this report to anyone with an interest and enthusiasm for putting an empowered local government at the heart of our national recovery.

Councillor Kevin Bentley
Chairman of the LGA People and Places Board
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Introduction

It is well known that local government in England doesn't have the powers or resources it needs. This has serious consequences for the services councils deliver to their communities, local democratic engagement and the opportunities for prosperity in towns and cities across the country. The goal of this report is to bring forward a discussion of increased local fiscal powers, in England’s unique context, based on:

- the acknowledgement that England’s economy is one of the most centralised in the world and that this imbalance needs to be addressed
- the need for councils to have more financial and decision-making powers with which to act, recognising that equalisation between places will always be important
- the desire to build stronger relationships between councils and their communities
- the desire to improve and expand cooperation between different councils, particularly across the metropolitan and non-metropolitan divide.

Over the last decade the value of central government grants to local government has significantly fallen. In order to support their communities, the idea of increasing councils’ capacity to raise money through tax is being taken increasingly seriously. Yet there remains concerns that different tax rates across local areas could create a ‘race to the bottom’ or a ‘postcode lottery’.

This concern is particularly pronounced in non-metropolitan England, where councils are increasingly having to charge much higher rates than in urban areas. A key aim of this report is to explore how other countries manage fiscal devolution.

The COVID-19 crisis has increased the scale and urgency of the financial problems facing councils. In early June, the metro mayors of England’s city-region combined authorities issued a warning that councils may be forced to issue Section 114 notices, effectively declaring them bankrupt. The District Councils’ Network, representing the 187 local government districts in non-metropolitan England, has called for greater access to finance ‘with restrictions lifted and flexibilities granted’ to help chart the course to recovery. The County Councils Network, representing the counties beyond the city regions, has called for an ‘income guarantee’ given the uncertainty resulting from much of the economy remaining at standstill, of recouping the council tax receipts that make up on average 56 per cent of their members’ income.

The concerns raised and solutions put forward by local government over the course of this crisis are made in the context of what could be described as an exceptionally centralised national system.

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2 The Guardian (2014) – The more power is devolved, the faster tax revenues race to the bottom www.theguardian.com/society/2014/sep/21/tax-revenues-britain-devolved-race-bottom
4 John Fuller MBE (2020) – The crisis has proved again that local action works www.themj.co.uk/The-crisis-has-proved-again-that-local-action-works/217821
5 County Councils Network (2020) – Councils call for ‘income guarantee’ to see them through Coronavirus pandemic www.countycouncilsnetwork.org.uk/councils-call-for-income-guarantee-to-see-them-through-coronavirus-pandemic
Across Europe, local government has been able to react to this crisis with greater power and autonomy than in the UK. This report, although completed before the pandemic, is relevant to the response as it looks for inspiration in less centralised systems. Investigating lessons learned from the devolution of growth funding and fiscal devolution, particularly to non-metropolitan areas, in nations where power is not so densely concentrated with central government, is one important way of evidencing how devolution could work in England. Since the UK is the most centralised country in the western world, this allows us to present case studies from a broad spectrum of national and local arrangements, all of which are more substantive than those enjoyed in England. We have focused on three countries, aiming to cover a range of different theories and practices in the devolution of fiscal powers and growth funding.

The case studies investigated are the Netherlands, Germany, and Switzerland. These examples were chosen in-part based on the different ways fiscal devolution has been observed to be practised: in the Netherlands, broad cooperation and bottom-up organisation is practised; in Germany, ‘yardstick competition’ of slight local differentiation takes place, whereas Switzerland is closer to the stereotypical view of tax competition between local government. The Netherlands has a system closer to the UK in terms of its funding and organisation, whereas Germany and Switzerland are federal. In none of these systems is a race to the bottom evident, nor is there a postcode lottery which in any way rivals that currently found in the UK. They all in different ways demonstrate that fiscal devolution, like decentralisation in general, is not a binary choice between two extreme poles.

Another aspect of this research is a comparison of economic development funding and its distribution in our case studies. In the context of Britain’s exit from the European Union, which gave impetus for the announcement of the Shared Prosperity Fund, how other countries divide up large ‘single-pot’ funds across local government is of great relevance. The Shared Prosperity Fund is intended to ‘reduce regional inequality’, an end to which there are many potential means. Among our case studies, we found that each nation conceptualised the task differently: from broad, large-scale infrastructure development in Germany to very precise, targeted measures to curb inequality in Switzerland. As we move in earnest from the rescue to the recovery of the national economy, with the current focus on ‘levelling up’ through major expenditure across broad regional geographies, our case study analysis provides an insight into the importance of looking at the other side of the issue, the provision of social infrastructure to support prosperity.

Comparing the case studies

Political differences aside, there are broad economic similarities across our case studies. All three case studies, as well as the UK, are highly developed, Western European states. All four nations tax above the average for Organisation for Economic Co-operation and Development (OECD) nations, ranging from Germany at the higher-end and Switzerland at just above the OECD average. Across our case studies, the average Tax: GDP ratio is 41 per cent.

6 The Telegraph (2015) – Council tax rises for social care risk ‘postcode lottery’
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Figure 1: Tax to GDP ratio in case study countries
This graph breaks that down into levels of government. These are for 2018 so business rates are only factored in for the amount that was actually retained by councils under the retention scheme, not that which was redistributed by central government. We can see the difference in the set-up of the case studies. It is important to note that, even in federal systems, the bulk of tax revenue is at the central tier and the actual municipal level of government doesn’t exceed 7 per cent of GDP in any of the case studies.

Figure 2 breaks down tax revenues into tiers of government, illustrating clearly the difference in the institutional layout across the case studies. It is important to bear in mind, however, that even in federal systems the bulk of tax revenue is generated by central government. Even in the highly-devolved and decentralised Swiss system, the actual tax revenues of municipal governments do not exceed seven per cent of GDP.

Figure 2: Tax to GDP ratio in case study countries with breakdown
This underlines the point that the argument for fiscal autonomy of local government is not necessarily about the ability to raise large amounts of revenue or fundamentally realign and reorganise the roles and responsibilities of the public sector. The argument put forward in this report is more concerned with the levers available to local government and the flexibility and nuance that a broader suite of powers could provide. This is illustrated in figure 3, which

7 Note: figures are for 2018 and therefore business rates are only factored in for the amount that was retained by councils under the retention scheme, not those which were redistributed by central government.
shows local government revenue as a percentage of total government revenue, taking out all central transfers. The difference between the unitary states in the Netherlands and the UK and the federal systems in Germany and Switzerland is pronounced. For the UK though, local government revenue is almost entirely a combination of council tax, commercial activity and (for a small proportion of councils) retention of half or more of their business rates.

Figure 3: Local government revenue, not including fiscal transfer, in case study countries
Fiscal powers for local government

Dispersed as they are across the scale of political and fiscal centralisation, our case study nations show three types of local taxation arrangement, ranging from those relatively close to the UK’s to others on the opposite end of the spectrum. Beginning with the most politically practical in the English context, these are:

- **Fiscal freedom**: a broader suite of local taxes and restoration of certain grant funds.
- **Fiscal devolution**: same local taxes but devolution of some central taxes.
- **Fiscal federalism**: locally-determined tax regimes.

### Fiscal freedom in the Netherlands

The Netherlands is a decentralised unitary state, with two-tiers of local government comprising 12 provinces and 355 municipalities. Dutch local government has seen continual mergers of municipalities resulting in a drop from 913 in 1970 to 355 as of 2019. A key feature of the Netherlands is how tasks are often shared between central and local government, a process which was furthered by a decentralisation programme in 2007. In 2015 new responsibilities were transferred to the municipalities including youth healthcare and long-term employment support of disabled people. These are on top of existing responsibilities like urban development, employment policy and social welfare amongst others.

Devolution of fiscal responsibilities is limited in the Netherlands, with decentralised taxes accounting for 5.2 per cent of total tax revenues. Most of the money coming to local government is given by central government through grants, most notably the Municipal Fund. However, while the taxation field is small, local government has a lot of freedom in the way municipalities want to levy taxes in percentage rates. Additionally, depending on the type of collaboration, there is freedom to decide how the tax burden will be distributed between private citizens and corporations within the municipalities.

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9 Ibid
Inter-Municipal Cooperations [IMC] play a huge role in local government and are regulated under public law through the Joint Provisions Act [WGR] of 1984. IMCs are formed to carry out the coordinated execution of municipal tasks, with multiple municipalities constituting them. There are approximately 2,000 such arrangements covering cooperation in a number of different policy areas and shared services. Municipalities can enter multiple partnerships depending on the area of service provision they are collaborating on, with the type of partnership depending on this too. Municipalities can enter into tax collaborations with one another to levy their taxes. Currently there are approximately 46 such tax-collaborations, with all 21 water authorities participating in them.

The number of municipalities belonging to each tax collaboration differs and depends on a multitude of factors. For example, the collaboration in Limburg comprises of 30 municipalities and two water boards, whereas the collaboration of de Kompanjie in northern Netherlands consists of only two municipalities. Collaborations function as a separate body to the constituent municipalities and act solely as an executive arm of levying for them. They have no say in the setting of fiscal policy, meaning that municipalities in each collaboration are free to choose what taxes, and the percentage rates of those taxes, the collaboration will levy on their behalf.

Types of taxes levied

The municipalities have the power to set their own tax rates, but only to the extent that has been established by prior agreement with central government. The main tasks of the collaborations might differ slightly depending on their respective individual contexts, but in general they would include levying all local taxes, and managing the valuation of immovable property [WOZ], which is the valuation of a property as deemed by the municipality. In addition to this, other tasks might include providing assistance and support to clients in tax-related matters and preparing relevant bylaws.

The local taxes that a collaboration might choose to levy, much like the tasks, differ slightly based on demographic factors and municipal needs. For municipalities, these would include the real estate tax, refuse tax, sewer tax, pollution levy, and taxes for the use of municipal land amongst others. Another increasingly important tax is the tourist tax. The significance of this tax for local revenue might differ across the country, and some municipalities might choose to levy this on their own instead of their tax collaboration.

The water boards levy taxes based on the work they put into providing sufficient water to their area. This includes a water system levy that covers the costs of providing the correct amount of water and flood protection as well as a water treatment levy, which covers costs for purifying water.
Tourist tax in Amsterdam

If your business offers paid accommodation to tourists and other visitors from outside your municipality, you are obliged to pay a tourist tax. There are two types, land tourist tax and water tourist tax. This is a municipal tax; therefore, the rates will differ from one area to the next. The tax is charged to the guest as a part of their final bill, or charged separately alongside the nightly rate.

Regardless of whether you operate as a business or an individual, you will need to register with the local tax department and file the taxes yourself. Once you have registered, you will be sent yearly reminders to pay the tax, which you can do through the municipal online portal or in writing. It is billed separately from the rest of municipal taxes and is not included in the municipal tax assessment. However, they do contribute towards the overall amount of tax that municipalities levy across the country.

From the beginning of 2020, new regulations were introduced in Amsterdam, meaning that in addition to the current rate of 7 per cent of the price of the room already charged by the city, a fixed rate has been introduced of €3 per person per night for hotels and €1 for campsites. For house rentals, the tax accounts for 10 per cent of turnover of the stay. This means that Amsterdam’s tourist tax is one of the highest in Europe. While the city experiences increasingly high levels of tourism each year, the introduction of a flat rate tax is allegedly not meant to deter tourists from coming to the city, but rather to ensure that tourists play their part in the upkeep of Amsterdam, according to a city representative.

This has not eased reservations towards the tax, with some calling additional levies targeting tourists a form of localised economic self-mutilation that will only serve to hurt those that cities like Amsterdam are trying to attract. Other voices from the tourism industry have praised the move, seeing the tourist tax as a way for visitors to meet their obligation to preserve the environment of where they are visiting. Ultimately, how the tax is managed is one of the most important aspects of its success. If it is implemented properly, it can be seen as a key tool to support innovation and sustainable destination management. If mismanaged, it can give the impression that while visitors’ money is welcome, they are not.

Role of central bodies

The Association of Dutch Municipalities acts as a platform that connects all municipalities in the Netherlands and its overseas territories, with the aim of strengthening the representation of local government on the national and international stage. It was founded in 1912, and since then has been involved in a wide range of policy fields where local government would be affected.

The VNG also works closely with the tax collaborations. They play an active support role, both for the municipalities and collaborations. This entails a functioning website, a service centre, ongoing publications, regularly-held workshops, conferences and regional sessions. The Association supports the directors of the collaborations in convening three times a year.

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19 City of Amsterdam – Tourist Tax www.amsterdam.nl/en/municipal-taxes/tourist-tax-(toeristenbelasting)/
20 Ibid
22 The Telegraph (2020) – Welcome to 2020, the year of the tourist tax www.telegraph.co.uk/travel/news/tourist-tax-amsterdam-venice
24 Hotel Management (2020) – Amsterdam increases tourist tax www.hotelmanagement.net/legal/amsterdam-increases-tourist-tax
25 VNG (2020) – Association https://vng.nl/rubrieken/vereniging
This presents directors with the opportunity to share best practice with one another, raise concerns, and hear the perspective of The Hague.

Factors affecting success

Academic work looking into the effectiveness of IMC’s has pointed to a number of factors affecting their success. Chief amongst these are trust, the variety of cooperative partners, and the uniformity of the rules governing cooperation. Trust is seen as the most important factor for success or perceptions of success and encompasses the other factors. This is because ‘high levels of trust show a strong association with low levels of perceived transaction costs’. The number of seats each municipality has on the board of their collaboration depends on the contribution of the municipalities in terms of how extensively they use the services. This requires municipalities placing a vast amount of trust in one another to ensure that they all, regardless of size, get a full voice.

There is an argument that local taxation allows for further local democratic participation and accountability. If people can vote on local matters such as building a new swimming pool, it is better democratically and economically if they feel the burden themselves. This would increase participation, as residents would have a lot more stake in local issues, as opposed to the current system where money is paid into a system far removed from the community and their immediate concerns. It would also lead to increased accountability through transparency, given that citizens are so close to the financial decisions being made on community matters. On the other hand, the small size of many local tax bases can be an obstacle, as it impedes the municipalities’ ability to show citizens the direct benefits of their taxpaying.

The metropolitan/non-metropolitan divide

A key benefit of IMCs is how they allow municipalities across the metropolitan and non-metropolitan divide to come together in a way that brings shared benefits to all. The IMC model recognises the individual strengths of each municipality and allows them to be shown collectively through the cooperation.

However, Dutch law ensures that all municipalities have the same possibilities with regard to taxation and how it is devolved. Therefore, all municipalities, regardless of which side of the divide they are on, are equal with regards to their responsibilities and income streams. The instruments of taxation available to a municipality are the same for an urban city like Amsterdam and a rural village like Bunnik. On this topic, there have been ongoing discussions about whether larger urban municipalities should be afforded extra instruments to cater to their needs. The size of a municipality and its population might have an effect on taxation choices it makes in practice. For example, a rural municipality might not find it in their benefit to levy a parking tax, whereas a larger one might - in which case the benefits for them might be bigger.

One of the main reasons cited for the decrease in the number of municipalities, and the increase of their scale of operation, has been the continual decentralisation of tasks to the municipal level. The latter has also led to the high levels of cooperation in the administration of these tasks under the form of IMCs. Municipalities also work closely together in raising awareness of their shared concerns, with the avenues available through the VNG, but also forums created on the basis of shared characteristics. To this end, there is an informal joint initiative for the largest four cities of Amsterdam, Rotterdam, The Hague, and Utrecht where shared urban issues and desired solutions can be discussed on the national level. Similar arrangements exist for medium sized and small municipalities, with regular discussions taking place between initiatives on all three levels.

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27 Ibid

Fiscal freedom in the British context

The Dutch approach to fiscal autonomy bears a lot of similarities with the current British context. Devolution of fiscal responsibilities is very limited in The Netherlands. Out of the 5.4 per cent of total tax revenue that the local state levies, 3.5 per cent comes from municipalities, 1.1 per cent from water boards, and 0.6 per cent from provinces, while central government levies the rest.

Adjusted for population; Dutch local tax take is about the same as in the UK. In the Netherlands it is 1.3 per cent of GDP and in the UK, it is 1.6 per cent. While there is an ongoing debate to increase the amount of revenue coming from local taxation, currently national government funding, through grants such as the municipality fund, plays a necessary role in municipal revenue. For the city council of Utrecht this means that out of total revenues of €1.46 billion in 2019, €235 million came from local taxes and fees while €869 million came from national government grants, and €353 million came from other revenue sources - including rents and land developments.

The majority of municipal revenue comes from central government grants because, much like the UK, most policies are set at the national level but executed at the municipal level. National policies executed by municipalities include areas such as education, urban regeneration and aspects of healthcare services. While there is a small taxation field, there is quite a lot of freedom in the way you want to levy taxes and what you choose to levy. Additionally, there is a lot of freedom in the way the tax burden is distributed between the citizens and companies within the municipality.

Municipalities execute tasks such as education through central government grants, while waste collection and parks maintenance are funded by local taxation. This is relatable to how our system of local government works. The fiscal freedom afforded to Dutch municipalities lies in their ability to tailor the levying of taxes based on their needs. The instruments of taxation being the same for all municipalities allows them complete freedom to decide which taxes are best for them, and whether to levy them individually or through a tax collaboration.

There are generally three different categories of local taxes: general tax, earmarked tax, and fees. The first are taxes that are compulsory contributions of citizens to the government without identifiable compensation. Here citizens contribute to the general treasury of the municipality. The second are compulsory contributions that citizens make, which can only be used to pay towards specific government services. The third is the price for individual use of government services, with the fees going towards the cost of running the service. In both the second and third categories, the revenue derived from them may never exceed the cost. For the city of Utrecht, within the first category, the property tax affects most citizens and is completely levied by the tax collaboration. This is in addition to the tourist tax and a dog tax.

There is another tax for when there is an encroachment on municipal land by private property known as a ‘precario tax’ – for example on cafe and restaurant terraces. For practical reasons, this tax is levied in part by Utrecht and in part by the collaborations, as the latter has the best resources to maintain a tax register for the more permanent tax base (for example the terraces that are year round), while Utrecht has the best information on the ad-hoc use of grounds. Earmarked taxes like waste and sewage are levied exclusively by the collaboration. Fees are levied by Utrecht because the citizens requesting the services already have direct contact with the city council. It is therefore practical to use these moments of direct contact to levy charges.

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29 For the UK figure this does not currently include business rates, which it will do once business rates retention is fully rolled out.
Fiscal devolution

The collaboration carries out the litigation, in court, and collection in last resort, through bailiffs, of all local taxes.

This broad suite of local taxes that are available to Dutch municipalities, as well as their tendency to cooperate through tax collaborations shows the extent to which local government has greater placemaking levers, while providing citizens with greater transparency on the revenues and finances of their councils. Local government in the Netherlands has less autonomy than England in their ability to raise revenue through taxation, as the percentage of overall tax revenue is 5.2 per cent. However, the point is that Dutch municipalities have far wider amounts of freedom and choice in how they raise their percentage.

Currently, the fiscal relationship between central and local government in the UK is asymmetrical, with the amount of revenue needed to be raised by councils set by central government through council tax requirements. This gives them only one option through which to raise this revenue. On the other hand, the Dutch context offers greater control and freedom on the local level for municipalities to decide how to and what to tax in the best interest of their locality. Applying this to the English context would require councils having similar levels of fiscal freedom as their Dutch counterparts. The potential of local taxation would need to be realised through figuring out, on a community level, what matters most to citizens of different localities across the country, and where they would like to see their money going to the most. This is something Localis explored in its 2018 report ‘Monetising Goodwill: Empowering places for civic renewal’ which identified the gap between what people are willing to contribute towards funding local services and what they provide now and surveyed on a regional basis what services people living in England are willing to contribute more to fund when they know what it is spent on.31

Fiscal devolution in Germany

Each layer of German government has different responsibilities regarding tax powers. The administrative levels of government consist of 16 States, 402 districts and over 11,000 municipalities. The districts can be further broken down into 295 rural districts and 107 independent cities.32 Within sub-national government, the state lies at the top, the districts in the middle and the municipalities at the bottom. Most important for our analysis are the municipalities. They have the power to set rates for the local business tax; the ‘Gewerbesteuer’.

The local government functions of the districts and municipalities (similar to upper-tier authorities in the English system) are defined by the state. They include both mandatory and optional functions, and for the districts include secondary education, hospitals, and fire protection amongst others. For municipalities, responsibilities include town planning, local roads, and primary education. Optional responsibilities are tourism, public transport, and sport and leisure. Municipalities are funded from a mixture of grants through the municipal equalisation system, as well as shared and their own source taxes.

31 Localis (2018) – Monetising Goodwill: Empowering places for civic renewal

32 OECD (2016) – Regional Country Profile: Germany
Income tax is a shared tax that is distributed across the three different levels of government. The share of tax is not the same for every level of government, with municipal shares being the smallest.

The taxes within the competencies of municipalities include the local business tax and the immovable property tax. The distribution of tax revenue is closely linked to the fiscal equalisation mechanism. The local business tax plays a significant role in equalisation calculations. For example, in Baden Württemberg, to ascertain the correct horizontal distribution effect within the municipal fiscal equalisation system, the trade tax is taken into account with a set weighting factor percentage point. Then, after the deduction of the local business tax levy, parts of which are paid to federal and state government, the remaining amount is for the municipality.

There are two levels to the equalisation mechanism in Germany, one that operates exclusively between the federation and the states, and the second which operates between the states and their municipalities. There are differences between the 16 states with regards to how much money they put into the federal equalisation system, because of regional economic factors. On the federal level, shared taxes are a part of the formula-based equalisation system between the 16 states, as defined by German equalisation law.

City Tax in Berlin

A city tax was introduced in Berlin from 1 January 2014, which is charged on all visitors staying in hotels overnight. This includes any form of short-term paid accommodation, with the tax owed regardless of whether the guest has actually spent the night or not. Those who are visiting Berlin for business reasons are exempt from the tax, in which case they will have to provide the hotel with sufficient proof, including written proof from their employer. If the guest does not want to provide evidence at the time, they can pay the tax and apply to the relevant tax office for a reimbursement.

The tax itself is a flat rate of 5 per cent of the price of the hotel room, and is payable by the hotel to the city of Berlin. Allegedly, revenue raised from the tax is aimed at boosting the arts and culture sector of the city. But there is some debate over how each city can use the tax, with the German Hotel and Restaurant Association (DEHOGA) claiming that it cannot be used for any specific purpose and must go to government directly. While the hotel is obliged to pay the tax, theoretically there is no equal obligation on them to pass the fees onto their guests. Yet almost all still do in order not to lose out financially. How each hotel or place of accommodation might handle the tax differs from place to place. Some might choose to include it within the overall price from the beginning, while others might opt to add this on separately at the end.

The introduction of the tax caused a certain level of annoyance amongst hoteliers owing to the short notice given to hotels, meaning that many did not have enough time to adapt to the change adequately. Another point of contention was the tax having to be paid first and foremost by the hoteliers, and that it couldn’t simply be added on to the hotel bill for the guests. The tax has raised close to €270 million since its introduction in 2014, which has allegedly gone directly to the Berlin Senate. This has given rise to other complaints from DEHOGA that they are being treated like a cash cow and that there is not enough of a level playing field between them and the Senate.

Those in favour of the tax point to many of the

34 Senatsverwaltung fur Finanzen – Information for visitors on Berlin’s hotel occupancy tax
35 IP Hostel (2014) – Berlin’s City Tax
36 Berliner Morgenpost (2014) – Berlin kassiert nun von seinen Touristen eine Bettensteuer
37 Berliner Morgenpost (2014) – Freude über den Betten-Boom ist bei Hoteliers getrübt
www.morgenpost.de/berlin/article226733449/Freude-ueber-den-Betten-Boom-ist-bei-Hoteliers-getruebt.html

33 OECD (2016) – Regional Country Profile: Germany
same arguments expressed in the case of Amsterdam; that even tourists have an obligation to contribute to the ongoing upkeep of Berlin, something that would benefit both visitors and Berliners. What both examples of Amsterdam and Berlin show is that a tourist tax is not impossible. However, serious consideration needs to go into how it would be implemented. How it is perceived by each stakeholder involved including, government, business, and tourists will play a part in its success.

Types of taxes

The local business tax is the most important source of revenue for local municipalities and communities. Self-employed persons, including doctors and accountants, are exempt from it. The tax is calculated on company annual profits. Municipal involvement is in the tax multiplier, which they set and charge on the trade tax amount. The multiplier is usually set between 300 – 400 per cent, but no less than 200 per cent and tends to be higher in urban areas compared to rural areas.

Taxes at the sub-national level are based on both shared and own-source taxes. Moreover, the state accounts for three-quarters of all tax revenue raised, which is derived from shared taxes, including the VAT. The local business taxes are an independent tax source for municipalities. It is, therefore, extremely valuable for them as they get to retain large portions of revenues raised and spend it on local issues.

Role of central bodies

There are three central bodies representing the interests of each level of sub-national government at the local, federal and EU levels. These are the German Association of Cities, the German County Association, and the German Association of Towns and Municipalities. The German Association of Cities was founded in Berlin in 1905. Its membership is constituted by over 200 cities, both autonomous and city states, and 16 state local government associations. This association serves as the mouthpiece of German cities, serving and advocating for further local government control. The German County Association is the union of 294 federal administrative districts. It takes an active role in decision-making through close collaboration with bodies on the federal and state level. Its main tasks range from municipal law and e-government to social affairs and environmental law to name a few.

The German Association of Towns and Municipalities represents the interests of 14,000 municipalities and towns on the lowest level of government. It works on a number of different issues that affect municipalities including urban design, procurement law, wind energy, and rural development to name but a few.

‘Yardstick competition’

Academic work has focused on the occurrence of ‘yardstick competition’ emerging when municipalities set their local business tax multiplier. Given that municipalities have control over the multiplier, one would assume that a form of horizontal tax competition would emerge as a way of attracting mobile tax bases to remain in a municipality.

43 Deutscher Landkreistag - Germany County Association – National Association of the 294 counties www.landkreistag.de/der-verband?id=544:verbandportrait&catid=16
44 Deutscher Stadte und Gemeinbund – Schwerpunkte www.dstgb.de/dstgb/Homepage/Schwerpunkte
However, an interesting trend has emerged whereby a large number of municipalities have chosen to set identical multiplier rates. Baden Württemberg is one such example, where 464 out of the 1,101 municipalities of the state have chosen the same tax multiplier of 340 per cent – something that does not emerge out of government regulations.

Yardstick competition ‘emphasises that comparative performance evaluation is important for voters who have the choice to vote for or against a government’.46 In the context of municipalities and the local business tax, potential investors would engage in comparative policy analysis of different municipalities and what their rates are. This drives municipalities to choose lower rates to remove worries of the risk of higher taxes.

Factors affecting success

The 2008 federal tax reforms and their effects on local tax policy considerations47 highlight certain successes. The aim of the reforms were to boost the image of Germany as a location for businesses, and included a range of tax cuts. The nature of these reforms has meant that municipalities have freedom to set a multiplier rate for local business tax without it having drastic consequences in the overall tax burden.

This tax acts as a tool which fosters a closer connection between business and place. If a local economic anchor48 sees that by paying the extra tax, they are funding local growth and regeneration for their employees and the community, they would be more willing to pay the tax. On the other hand, without the tax, municipalities might not be keen on having large enterprises operating in their areas, something especially true for more rural municipalities.

The need to foster closer connections with business also applies to medium-sized and smaller commercial enterprises. From the municipal perspective, doing this is equally important as making your place an attractive area to live and form a community.49 Striking the right balance between the two will be key in ensuring both wide-ranging business growth and prosperity in the community.

There remain certain business voices against the tax, especially from those enterprises which are not German, and do not understand why they have to pay it alongside the corporate income tax. A challenge arising from this is when enterprises start giving ultimatums to the municipality, saying, ‘If you do not reduce your tax multiplier, we will pull operations out of here’ risking thousands of jobs. This asymmetrical dynamic between business and place is something that requires attention, and a big part of doing this is to emphasise clearly what it is and why it is needed.

In recent decades, there have been municipal finance reform commissions looking at ways to replace the local business tax, with all results showing that the tax in its current structure would be the most preferable option.50 Municipalities will always advocate to retain this tax and fight against any erosion of their autonomy. There is an intrinsic link between localised taxation and democratic participation. At the same time, municipalities in Germany are increasingly charged with carrying out a large number of tasks while receiving less money. This leads to a problem of municipalities having to choose which services to cut. This often results in less freedom for municipalities doing what they want, as the tasks set by the federal and state level are prioritised as obligatory. If the local council does not have freedom to decide on a number of issues, their legitimacy is diminished in the eyes of the citizen. This is why it is extremely important that local government has power over their own money.

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46 Thiess Buettner and Axel von Schwerin (2016) – Yardstick competition and partial coordination: Exploring the empirical distribution of local business tax rates https://econpapers.repec.org/article/eeejeborg/v_3a124_3a3ay_3a2016_3a3ai_3ac_3agp_3a178-201.htm
49 Interview response
50 Interview response
The metropolitan/non-metropolitan divide

The local business tax differs depending on whether you are a rural municipality or an urban one, with the latter usually setting higher rates than the former. Only 10 per cent set a rate higher than 380 per cent. Any consideration on how the local business tax, and the 2008 reforms, plays out on the municipal level should be viewed through the lens of central/local relations as well as the metropolitan/non-metropolitan divide.

The factors involved in setting the tax multiplier depend heavily on the number of large corporations and partnerships in the municipality. This boils down to demographic and topographic characteristics, as cities and urban areas tend to have larger corporations. Municipal control over the rates at which they set the local business tax has not led to a race to the bottom. Putting the case of Baden-Württemberg into the perspective of the metropolitan/non-metropolitan divide, while urban areas usually serve as headquarters of big businesses, in more rural municipalities there tends not to be such a high commercial presence. Accordingly, they might opt to set the same rate as neighbouring municipalities with similar characteristics. For larger city municipalities faced with continual growth, questions need to be asked as to how this growth will be funded, and a key method would be by raising the percentage rate of the business tax.

Particularly within Baden-Württemberg, the municipal fiscal equalisation system has helped ensure that even weaker-taxed municipalities have the necessary financial strength to perform their tasks. The classification of urban and rich, and rural and poor does not necessarily stand true in the state as there are rural areas with extremely wealthy municipalities and financially weak urban centres. Accordingly, the picture is a lot more complex, highlighting the equal importance of other factors to a municipality’s wealth alongside the local business tax.

Fiscal devolution in the British context

Grants make up a smaller proportion of municipal funding in Germany owing to its federal structure of government. There are no direct federal grant transfers to municipalities. However, states with below average fiscal capacities are compensated through federal grants. On the municipal level, revenue through grants comes exclusively from the state, and, therefore, the amounts and structure will differ from state to state. For this reason, both the federal and state equalisation mechanisms play an important role in sub-national government revenue, with transfers occurring between the federal government and the 16 states to ensure an equal level of public services can be delivered across the country. Transfers also occur in particular cases, with mutual agreement between the state and federal government.

German local taxes, local business tax and property tax, are the same as in the UK and are comparable to business rates and council tax. A main difference in the German case of local government finance is how local government is allowed a share of the value added tax and the personal income tax. This share is regulated at the federal level, and to obtain a share in these taxes, a part of the revenue raised from the business tax is handed to the state and federal governments, with the majority remaining in municipal hands.

While the local business tax of Germany and business rates in the UK are comparable, a key difference between the two in terms of local control is German municipalities being able to set their own multiplier rate. In the UK, this multiplier is currently set by central government, which means that even with the introduction of a 75 per cent retention scheme, there is no freedom for local councils to set an overall business rate suited for their own requirements. The benefit of municipal control over the multiplier is in the ability to self-fund projects of local need. For example, if a municipality wants to introduce high

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51 Interview response
speed broadband in their area, they can consult with business and other stakeholders about raising the multiplier in order to use this revenue to fund it. This highlights the importance of business engagement, and how the German model of local business tax helps to establish a level relationship between place and business.

The fact that each layer of government is entitled to a share of personal income tax and value added tax means that local government could fund its own responsibilities, like social care, without being overly reliant on grants. Currently, the municipal fiscal equalisation system provides around €91 million to municipalities, with €100 million more coming from taxes. This makes it easier for each layer of government to fulfil their different tasks.

While money transferred through the equalisation systems helps sub-national government fulfil these tasks, retaining a percentage of shared taxes allows for greater local autonomy. Viewing the example of shared taxes in Germany on a broader level, local government receiving a share of income tax makes sense when considering how it can rebalance central/local relations. Particularly with regard to the way finances and resourcing are set against local government’s statutory responsibilities, it makes sense for percentages of revenue to be retained at the source of taxation. This would allow citizens to see how their tax bills are positively helping with the delivery of services and infrastructure on the local level, while also knowing that they are contributing to issues of national concern as well. Looking at it from the perspective of the relationship between place and business, this would give the former another avenue to have a stake in local productivity, and provide another way of establishing a level relationship between the two.

This model of fiscal devolution does not rely on the need for any ‘new’ taxes, but more on the reallocation of rewards and responsibilities around existing ones. One of the biggest takeaways for England from the German case is in the way that shared taxes operate and how they could possibly work in an English context. Currently, the business rates retention scheme is the closest thing England has to a shared tax. However, it is worth exploring how a system of shared tax of the biggest national taxes, like in Germany, could make something like a ‘local income tax’ more feasible. Doing something like this will not be an easy task and would require much deliberation as to what the roles and responsibilities of central and local government would be in the overall system; something which in itself would lead to a reconsideration of fiscal relations between the two.

Fiscal federalism

Locally-decided tax regimes under fiscal federalism mean that taxes raised on the local level are for the most part retained at this level, with sub-national government deciding how to spend the revenue. For Switzerland, this system is facilitated through fiscal competencies of each layer of government clearly being laid out in the constitution. Local consent is equally important to this system where local residents have a final say over which taxes are levied on them.

Fiscal federalism in Switzerland

Power to levy taxes in Switzerland rests at each layer of government, the Confederation, cantons, and the communes. Each has a varying degree of sovereignty to levy taxes, outlined in the federal constitution. This avoids the three layers of government impeding on one other and placing excessive burdens on the taxpayer. A key difference between the Confederation and the cantons is that the former can only levy taxes set out in the constitution, while the latter are free to decide themselves, unless otherwise stated.
Federal authority and the legitimacy to levy taxes is derived from the bottom up.

For the communes, power to levy taxes is limited to those which are explicitly set out by their cantons. The cantons play a key role in the political configuration of Switzerland. The communes are responsible for public tasks that would usually be reserved for upper levels of government in other countries. Given this, the power of the communes to levy certain taxes goes hand in hand with their functional capacity.

One of the most important aspects of fiscal sovereignty in Switzerland is the role of each citizen in deciding the types of taxes to be levied through frequent referenda.

The government can only impose those obligations onto the citizen that are written in the constitution or laws, and as taxes fall under this, any changes to tax rates fall under a change to the constitution, warranting a referendum at both the cantonal and federal level. Owing to the principle of cantonal sovereignty, every canton establishes and organises their own relations to their communes. Each of the 26 cantons has their own municipal laws and their own assignment of responsibilities. Accordingly, every canton has a unique tax situation.

Types of taxes

Taxes in Switzerland can be categorised under individual and corporate tax, and further into direct and indirect tax. Direct tax is income tax for individuals, and capital tax for corporations. Indirect tax is consumption (VAT) and taxes on property. While it is in the remit of the cantons to levy direct taxes, the main source of revenue for the Confederation is indirect consumption tax.55

The different federal indirect taxes levied by the Confederation include VAT, federal withholding tax, and federal stamp duties amongst others. The federal government also has competencies to levy direct taxes, including the direct federal tax on individuals and the profit of legal entities. Others include federal casino tax and the military service exemption tax. For the cantons and communes direct taxes include wealth tax, capital tax, household tax, property gains tax, and inheritance tax to name a few. Other indirect taxes include, dog tax, entertainment tax and water tax.56

Role of central bodies

On the national level, the Conference of Cantonal Governments57 (CCG) looks out for the interests of the 26 cantons over a broad range of policy areas. It serves as a forum through which to engage in sharing best practice and increasing cooperation between cantons. Alongside the CCG are the 12 Conferences of Cantonal Directors, where cantonal ministers of the same sector meet. Conferences exist for all sectors including transport, economy, health, and finance.

The latter of which is the Conference of Cantonal Finance Directors (CDF)58 – which protects the interests of cantons regarding fiscal sovereignty on the national stage and meets up to four times a year. A step below this are the inter-cantonal conferences at regional levels, of which there are six, each encompassing a varying number of cantons.59

Their purpose is to work on issues of regional significance. The Zurich Metropolitan Conference is composed of the eight cantons of Zurich, Aargau, Thurgau, Schaffhausen, Schwyz, St. Gallen, Zug and Lucerne60 – which work together in policy areas like traffic, society, environment and the economy.

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55 Ibid
58 Conference of Cantonal Governments – Overview of different conferences https://kdk.ch/fr/collaboration/conferences-des-directeurs/vue-d-ensemble-conferences-des-directeurs
60 Metropolitan konferenz Zurich – Mitgliedschaft www.metropolitanraum-zuerich.ch/verein/mitgliedschaft.html
Owing to the high levels of decentralisation, dialogue is of utmost importance – a factor which is reflected in these institutions. Through these intergovernmental bodies, collaborative working is facilitated in a way respectful of the principles of tax competition. In the end, the public sector is responsible for decent service provision and the need for consensus for the sake of delivering these for citizens is the overriding concern.

It is simply not feasible for cantons to allow tax competition or considerations to do with the equalisation system to get in the way of working together to deliver shared public priorities. As one official put it, ‘Correct service provision is paramount - and there is a sense that in the end, the need for cooperation will prevail. We do not have an exclusively competitive system of federalism. Competition is important but at the same time it would not be possible without cooperation’.

Factors affecting success

Despite concerns, tax competition in Switzerland has not necessarily led to an erosion of the state or state revenues, economic segregation, or a ‘race to the bottom’. In fact, government on both the federal and cantonal levels can provide quality infrastructure, with the direct involvement of voters in approving or rejecting public projects and the tax revenues needed to fund them.61

Fiscal sovereignty and tax laws are guided by a set of principles enshrined in the constitution. The most relevant are the prohibition of inter-cantonal double taxation, and the prohibition of unjustified tax benefits. The former indicates that ‘one and the same person may not be taxed by more than one canton for the same time period and for the same tax object’.

The latter deals with the temptation of cantons to attract wealthy tax-payers by offering unjustifiable tax breaks to them.62

A natural limit to tax competition emerges as a ‘by-product of cooperation on other issues’.63 Moreover, through cantonal ministers working together a ‘socialisation’ aspect emerges through officials seeing how their tax agenda affects neighbouring colleagues and their cantons. Public opinion also plays a key role in the success of the system, something that highlights the importance of direct democracy and democratic institutions in Switzerland. Voting is regularly exercised at the lowest level and public engagement through town hall meetings, which facilitate discussions on local taxation issues.

Localised taxation brings many advantages for smaller towns and rural communes, because in these areas it is much easier to build a closer relationship with the citizen. One official commented, ‘You are right in front of the paying citizen, and you know their financial situation. This is an advantage for us – as with a central bureaucracy you cannot follow the citizen.’

Fiscal sovereignty at this level also means that a positive case for raising the tax level can be made when people see the value and standards of the public services they receive in return. This strengthens the element of legitimacy of the state in the eyes of the citizen, as it is given through their explicit consent. As local referenda are so frequently conducted with high levels of engagement, their acceptance of the system, including taxes, is greater.

63 LSE Blogs (2012) – Evidence from Switzerland suggests that cooperation might limit tax competition between regions https://blogs.lse.ac.uk/europppblog/2012/09/05/switzerland-tax-competition
The metropolitan/non-metropolitan divide

Associated with the ‘socialisation’ aspect is the fiscal equalisation mechanism that was revised in 2008. The revision to the existing mechanism takes into account the unique fiscal capacities of the different cantons of Switzerland. It aims to strengthen existing cantonal fiscal autonomy, while reducing the disparities that emerge as a by-product.

The mechanism underpinning national fiscal equalisation, consisting solely of non-earmarked resources, can be broken down into three. First, there is resource equalisation that deals with the redistribution of financial resources. Second, is the cost compensation regarding excessive exceptional burdens. And third, there is the cohesion fund which is set up for those cantons experiencing short-term economic hardship.64

The equalisation mechanism occupies a large role in inter-cantonal fiscal relations. There is wide consensus on the need for direct resource equalisation between the cantons.

While there might be certain tensions at times regarding each canton’s equalisation bill, at the end of the day there is an understanding of a shared bond between the cantons and the need to look after one another. As one official put it, ‘There is a bond that reaches far deeper than just money’.

The extent of decentralisation in Switzerland is indicative of differences in attitude between its regions, reflecting not only the rural and urban divide. These differences indicate preferences on issues such as local taxation rates and are what makes the federal structure of Switzerland interesting, yet equally complicated at times. This also reflects the central importance of democratic institutions and participation on the local level, as well as the constant need for inter-cantonal dialogue across the country.

The reality of tax competition

In Switzerland, each canton has a unique fiscal composition. For individuals and corporations, a supposed advantage of this is the resulting tax competition. In Switzerland tax competition is seen as a key characteristic of Swiss federalism and a manifestation of cantonal sovereignty. For it to occur, there are a few conditions that need to be met. First, tax bases need to be mobile and responsive to varying tax differentials. Second, while tax-setting, jurisdictions will set rates strategically with regard to the mobile tax base.65

Whether tax competition is a good or bad thing for Switzerland remains a contested issue. Advocates state how competition offers greater diversity and efficiency of public services. As individuals and companies have the opportunity to choose their location freely, local authorities are incentivised to offer the best possible public services while keeping the tax burden down.66

Related to this is how a form of yardstick competition might arise, where citizens are able to compare the performance of their cantons against each other. This allows for better political decision-making to occur, which takes into account the views of the citizens who are much closer to the process.

There is a democratic, localist argument for this process. With the political and fiscal decision-making bodies at such close vicinity to the citizens, and the bottom-up approach to this decision making, communities are able to set the agenda to their own needs. In this way, within each canton you will find unique tax situations which reflect the concerns of individuals. Ultimately, the closer that decisions are made to the community, the more that policy will come to reflect the needs of said community.67

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64 Swiss Tax Conference Information Committee (2019) – The Swiss Tax System

65 Beatrix Eugster and Raphael Parchet (2011) – Culture and Taxes: Towards Identifying Tax Competition
https://serval.unil.ch/resource/serval:BIB_F6B9B32EC38E.P001/REF.pdf

66 Pierre Bessard – Tax Competition: The Swiss Case
www.libinst.ch/publikationen/Bessard-Swiss-Case.pdf

67 Ibid
Additionally, tax competition allows for a ‘trial and error’ approach on the local level. If an accepted tax reform in one canton proves to be a success, then it would be considered and, if the conditions are right, adopted by other cantons and communes. On the other hand, if a reform proves to be a mistake it would be restricted to the canton that voted for it.68

On the other hand, the main anxiety about tax competition concerns the vast regional differences in the tax burden and how this impacts fiscal inequality across Switzerland. The extent to which competition can and should be legitimate has been called into question.69 Another issue noted is with the potential of communes within cantons slashing their tax rate in order to attract wealthy individuals to live in the area, only for an asymmetrical power dynamic to arise whereby all decisions are made with the needs of these particular individuals taking priority.

Fiscal federalism in British context

While Swiss fiscal federalism rests on the opposite side to how local fiscal policy works in England, it brings to bear certain considerations for our own domestic context. The 26 cantons being in charge of their own tax laws and policies has resulted in a variety of different tax regimes all based on their own circumstances and needs. A guiding principle of the structure of the tax system, with the three layers of government holding powers to levy their own taxes, is to minimise the overall tax burden on the average taxpayer.

The power of the Confederation and the cantons to levy the taxes they want is referred to as original fiscal sovereignty, while the levying powers of the communes that are afforded by the cantons is known as derived fiscal sovereignty.70 All three levels levy direct and indirect taxes. Between the Confederation and canton, the constitution empowering the former to levy a certain tax does not exclude the latter from levying a similar one too. To do so, would require a prohibition that does not exist for direct taxes. Therefore, both levels compete with one another in this area when levying direct taxes. Tax revenues raised by each level of government amounted to CHF 138 billion in 2016. This can be further broken down into CHF 63.9 billion for the confederation, CHF 45.6 billion for the cantons, and CHF 28.4 billion for the communes. On the local level, the most important taxes for the cantons and communes are income and wealth tax for individuals and profit taxes for legal entities.71

Tax returns are given to each taxpayer to fill out, which go on to form the assessment for income and wealth tax for individuals. However, they are not mandatory - meaning that if a return is not submitted to the competent authority, they are assessed ex-officio.

According to a senior tax official of a large Swiss city, almost 99 per cent of taxes are filed in their area, with only 0.5 per cent being written off.72 This plays into the link between local taxation and local democracy, with the idea that ‘if you vote, your acceptance of the system is bigger, and you pay taxes easier’. Coupled with the notion that taxation is inherently political, the closer the process is to the community, the more you feel part of it, and the more willing you are to participate. This feeds into trust building, with trust residing in the citizen, because, ultimately, they are the source of all governmental legitimacy. And with such a strong element of local democratic participation, this legitimacy will only strengthen.

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68 Deloitte (2019) – Tax Competition: Responding to the criticism
www2.deloitte.com/ch/en/pages/tax/articles/tax-competition.html

69 Financial Times – Swiss Tax Competition
www.ft.com/content/cac695c8-bc6c-11db-9cbc-0000779e2340

70 Swiss Tax Conference Information Committee (2019) – The Swiss Tax System

71 Ibid

72 Interview response
There are core factors which come together to ensure that the Swiss system of fiscal federalism works for each constituent local authority, and the Confederation as a whole. Clearly laid out provisions for every layer of government in the constitution, and the principle of democratic participation both feed into building trust and legitimacy into the system. Equally important in this is the role of communication in bringing all aspects together. This aids in forging a sense of shared identity, without which it would be hard to make everyone work towards shared national aims. In a fiscal system where tax competition lies at its heart, such as in Switzerland, a shared identity balances competition with the realisation that cooperation is mutually beneficial for the progress of everyone.

This is the biggest lesson that the UK can learn from the Swiss example. The Conference of Cantonal Finance Directors, as well as many other similar institutions, bring all stakeholders together to discuss shared concerns and successes. This is one of the ways through which the different regions of Switzerland can appreciate one another’s strengths and weaknesses.

The horizontal fiscal equalisation system, while no doubt causing frustration at times, ultimately works so well because of this shared national identity that highlights something bigger than small self-interest. This is something that has been forged over a long time, and cannot be artificially imposed, but needs to grow organically from the bottom up. Doing so will necessitate a radical reconfiguration of central/local relations, but more importantly local/local relations.
Distributing growth funding

Considering the nebulous Shared Prosperity Fund (SPF) will be, in some way, a substitute for regional growth funding, it is worth looking at how our case study nations handle the distribution of their funds. Our consideration of the SPF in this context is based solely in explaining the mechanisms by which the other case study countries allocate their funds and does not consider technicalities of what the SPF could fund and how it will or should replace EU funds. The point is that once the SPF is in place, we will need to know how it will distribute growth funding to the regions of the country. Reflecting on how other countries do it can help us understand how best to do this in the British context.

The SPF is supposedly aiming to ‘reduce inequalities between communities’. However, what this practically means, especially for the ‘levelling-up’ agenda, is yet to be seen. As the following examples demonstrate, how each country tackles their regional inequalities is different, but ultimately, they are working towards the same objective. Looking at these examples will help us understand what raising prosperity means for our own country, and how it will manifest differently across the regions, because not all localities face the same challenges and requirements.

Our case study nations provide us with three distinct approaches to the distribution of single-pot funds:

- Economic development in the narrow sense.
- Increasing prosperity in the broad sense.
- Limiting inequality across regions.

Economic development

In terms of applicability to England, the German model of regional economic growth funding could work well, with the well-developed regional and sub-regional economic indicators used by the Office for National Statistics forming the basis of a basket of indicators similar to how they are defined in Germany. On a wider level, a benefit of this model is the potential that deepened business engagement could bring to the table. Through supporting structurally weak regions in attracting trade and industry to their area, and working towards improving the infrastructure underlying market development, new possibilities open for increased economic activity to play its part in raising prosperity across the UK.

If the Government’s ‘levelling-up’ agenda is focused on increasing prosperity through trade and commerce, then allocating funding with regional economic growth in mind would make sense. It would mean each region could have different priorities, but these would be underpinned by the principle that to invest in building economic structures first and foremost is key to the process.

Improving regional economic structures in Germany

In Germany, the Joint Task for the Improvement of Regional Economic Structures [GRW] focuses on a version of ‘levelling-up’ which is concerned with improvements to the infrastructure underlying market development.

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Footnotes:
73 House of Commons Library (2019) – The UK Shared Prosperity Fund
https://commonslibrary.parliament.uk/research-briefings/cbp-8527
This is seen as the most important instrument in the country’s national regional policy and has been in place since 1969.

Regional autonomy in the GRW

The longevity of the GRW as an initiative can perhaps be partially attributed to its inherently collaborative nature. The German federal model necessitates this – central government can make decisions on money afforded to the states but it is down to the states themselves to decide how to administer funding, as they are charged with regional economic development in the German constitution. This is worth considering in the context of the ‘levelling-up’ agenda, and the relationship between the Treasury and the regional agencies it funds. For example, 36 per cent of central government money to the states has been for land development – but the projects that money has ended up with have been at the discretion of the states themselves.

The GRW affords regions a wide range of funding instruments that they can tailor to their regional requirements. There are a few key areas of economic interest that the fund is geared towards. The first is supporting investment by trade and industry by providing incentives to invest in structurally weak regions in order to enact structural change needed for local growth. Secondly, investments in local commerce-related infrastructure in order to attract business and increase competitiveness. Related to this is investing in measures to stimulate competitiveness of SME’s on the local level. Another key area is investing in measures designed to facilitate networking and cooperation between local players in order to strengthen the local business environment.

The guidelines of the GRW are clearly laid out in the coordination framework agreed between the federal and state levels. Both levels of government are also responsible for funding the GRW on a half-half basis. The rules as laid out in the coordination framework act to transpose EU rules on national regional aid into national law. This framework sets out specific rules relating to the map of Assisted Areas, measures that qualify to receive support from the fund, how the federal portion of the fund is distributed to the 16 states, the management of the fund, as well as statistical analyses and evaluations.

Assisted Areas, as defined by EU state aid rules, highlight the regions that are eligible for GRW support. However, the extent of regional structural weakness of Germany is assessed through national procedure. This entails the use of a variety of indicators in order to rank the regions based on their overall performance, starting from weakest to strongest. The result is then used to judge the degree of support required in each region. A part of the assessment with the regional indicators entails dividing the territory of Germany into labour market regions that are formed along the lines of local employment centres in areas where there is a substantial amount of traffic. These form the variable which are used to rank each region according to the indicators. The different indicators include respective size of the labour market, income levels, and the quality of infrastructure and workforce projections.

74 Federal Ministry for Economic Affairs and Energy (2018) – Boosting the Regional Economy
www.bmwi.de/Redaktion/EN/Dossier/regional-policy.html

75 Federal Ministry for Economic Affairs and Energy (2018) – Framework for the Coordination of the Joint Federal/Länder Task for the Improvement of Regional Economic Structures (GRW)

76 Federal Ministry for Economic Affairs and Energy (2018) – Framework for the Coordination of the Joint Federal/Länder Task for the Improvement of Regional Economic Structures (GRW)

77 Ibid

78 Federal Ministry for Economic Affairs and Energy – Boosting the Regional Economy
www.bmwi.de/Redaktion/EN/Dossier/regional-policy.html
Increasing prosperity

Distribution of the SPF based on a model like this would lead to increasing prosperity in a broader and more holistic sense. If we take prosperity to mean levelling up the country’s socio-economic and health opportunities, this model of distributing funding would give councils the power to use their share to take a holistic approach towards growth and the future wellbeing of their citizens, according to their needs and how they see fit.

In practical terms, how we would see levelling-up manifest in the UK is through the greatest benefits being felt fastest in the places most in need of them - particularly those with faster-ageing populations.

However, it might not increase resilience in the same manner or sense as a fund focused strictly on economic development, such as the case of Germany’s would. Taking into consideration the Fair Funding Review, which is expected to use ‘three main ‘cost drivers’: population, deprivation and sparsity’ as well as other specific cost drivers in local services, this Dutch model seems to be the closest aligned to the current English context.

The municipal fund in the Netherlands

Although the Netherlands does not currently have an explicit regional policy, a regional focus to multiple different policy areas is applied. At the same time, the Ministry of Interior and Kingdom Relations co-ordinates the National Urban Agenda that aims to boost economic growth and innovation in Dutch cities.

On the local level, the Municipalities Fund accounts for over half of all local government income from central government and is designed to ensure a base level of prosperity across the country, using a wide variety of socio-economic indicators. In 2018, the fund accounted for €28.3 billion of the total €57.9 billion income of municipalities across the country. Each municipality is free to decide how they spend the money, and they are accountable for their fiscal decisions to the city council. The share of the fund differs for each municipality and depends on their characteristic, and tax-earning capacity.

The Municipalities Fund and social participation budgeting

As of 2015, the Dutch government charged municipalities with youth social care, jobseeker support and adult social care, under the auspices of a decentralisation agenda aimed at increasing social participation. As part of this, to promote local autonomy and responsibility, the government gave municipal government a single budget for all ‘social participation’ services from the Municipalities Fund. This is reminiscent of the ‘Whole Place Community Budgets’ concept which rose to prominence as a flagship Coalition policy in the early 2010s and is perhaps worth considering anew in the context of the Shared Prosperity Fund.

In terms of characteristics, the Dutch government look at demographic benchmarks such as population, number of young people, number of beneficiaries, location of the municipality, and size of the wetlands. Each benchmark has an amount allocated to it, meaning that municipalities receive money for each resident based on socio-demographic circumstances.

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81 Rijksoverheid – Gemeentefonds www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/gemeentefonds
More specific indicators include living space, regional client potential, students in higher education, households with low incomes, and inhabitants receiving social welfare, amongst others. The distribution of the fund to each municipality also depends on their capacity to levy taxes, with municipalities receiving greater shares if their levying capacity is small.

The Minister of the Interior and Kingdom Relations as well as the State Secretary for Finances, and their departments, oversee the Municipality Fund and are responsible, together with the municipalities, for reviewing the distribution mechanism. The Government is in the process of reviewing this mechanism for 2021, which will look at distribution models in the social domain, and other parts of the fund. The former refers to reviewing how funds are allocated based on the social tasks municipalities are responsible for, and the latter looks at the differences between them as a result of increased collaboration, investments, and revenue-raising potential.

A part of assessing the distribution is dividing municipal tasks into three clusters titled physical domain, social domain, and income. Tasks in the first domain include administration and support, safety, infrastructure and environment, education, and sport and culture. The second domain include tasks such as social services, youth facilities, and adult social support. While the third is concerned with revenue-raising potential through tax. Breaking tasks into clusters helps identify the unique circumstances of each municipality and related challenges they face in a clear manner. The VNG plays an active role in advising central government on the re-design of distributing the fund based on the findings of the review.

One advantage of assessing distribution through clustering the tasks of municipalities, while also taking into account the benchmarks, is that it shows how well the municipality is performing in differing but related areas. Moreover, it shows exactly where municipalities might be facing challenges and needing funding support. At the same time, it helps address the demographic needs facing municipalities that extra funding could help rectify.

**Limiting inequality**

In applying the distribution method of Swiss cost compensation to England, geographical and topographical considerations would play a central role in the, now well-rehearsed, issues surrounding the coastal areas of our island nation. These considerations would need to be put at the centre of our thought if we are to model SPF distributions according to the Swiss method. While demographic considerations would be particularly relevant through the weighting given to the percentage of the population who are elderly, and the percentage living in depravation.

The guiding focus of cost compensation being based on these two categories demonstrates a relatively straightforward way of allocating funding. This can be an advantage, because it would be easier to identify the parts of the country most in need, including our coastal communities, and those areas facing highest levels of deprivation, as well as other key challenges local government need to tackle. Taking this approach would require very serious attention being given to the process of defining the topographic and demographic indicators, with a clear understanding that an annual review of these indicators would be needed to match the evolving circumstances and needs of our country.

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82 Interview response
83 Rijksoverheid – Herziening financiële verhoudingen
   www.rijksoverheid.nl/onderwerpen/financien-gemeenten-en-provincies/herziening-financiele-verhouding
84 Ibid
85 Ibid
Cost compensation in Switzerland

The Swiss take a much narrower view of socio-economic balancing than the Dutch, but with some interesting lessons for England, particularly the geographic aspect, both physical and human. This approach is found embedded within the fiscal equalisation mechanism, particularly the cost compensation instrument. As the sole use of the three instruments administered exclusively by the Confederation, cost compensation is a telling example of how single pot growth funding operates within the federalised structure of Switzerland. It is a necessary part of the overall equalisation system, playing a pivotal role in striking the correct balance between competition and national cohesion.

The realisation that individual cantons face different requirements to execute their tasks because of certain demographic and geographic realities underpins the principle of cost compensation. For 2020, the federal cost compensation component was funded to the tune of CHF 728 million. This gets split equally in half, with CHF 364 million going on cantons with excessive geographic and topographic costs, and CHF 364 million going to cantons with excessive socio-demographic costs. At the same time, certain cantons that may face costs for both geographic and demographic needs would receive funding from both compensation funds, relative to the degree of requirement. For example, in 2020 Bern received CHF 28,014,719 for geographic needs and CHF 11,610,636 for demographic needs. This flexibility shows a level of understanding regarding the costs involved for those regions facing overlapping challenges from both factors.

Looking at the compensation mechanisms more closely, there are a number of indicators against which the amount of money each canton receives is assessed. For geographic costs, the indicators include altitude, terrain steepness, low population density, and low settlement density. The first two are split further. Altitude is judged based on permanent resident population, and from this those who live over 800 metres high. Terrain steepness is judged on productive surface area, and its median altitude.

Cost compensation and oversight

From 2020, certain aspects of how the cost compensation mechanism works will be reformed. Meaning that the amount allocated for cost compensation will be determined by the rate of price increases. Additionally, the federal parliament will decide on occasional adjustments to the legal framework under which the process operates, while shifting to a more rules-based system of allocation that does not require a parliamentary decision on funding every four years. Looking at how these reforms will affect the cantons could inform our decision on the method of funding allocation and the role of parliament in the process.

Indicators for the socio-demographic cost compensation can be split into two categories of costs relating to population structures and costs incurred from density, the latter only applicable to nucleated cities. The indicators for the former are age structure, the integration of immigrants into Swiss society, and poverty. The latter include number of inhabitants, population density, and employment rate. Here again wider indicators are judged by sub-indicators. For age structure these are, permanent resident population and the population over 80. For immigrant integration this includes the permanent resident population and the relevant foreign population. For every canton, these core indicators are weighted against a number of other factors to calculate the final sum to given to them.

86 Pascal Utz and Werner Weber (2018) – Fiscal Equalisation in Switzerland
www.shareweb.ch/site/DDLGN/Documents/23-1_Fiscal%20Equalization%20in%20Switzerland_2.pdf

87 Federal Finance Administration (2019) – Fiscal Equalisation Data
Recommendations

HM Treasury/Ministry of Housing, Communities and Local Government (MHCLG) should launch a consultation with councils – to be undertaken via the Local Government Association (LGA)/CIPFA (Chartered Institute of Public Finance and Accountancy) – to identify the most popular options for local levies under fiscal freedom.

The suggested Commonwealth Games tourism levy in Birmingham should be extended as pilot schemes in the MC9 group of combined authorities, with the LGA and MHCLG working with them to determine any redistribution within the combined authority areas.

The Government should work with councils to develop a German-style infrastructure and connectivity indicator for distributing monies from the Shared Prosperity Fund to ensure non-metropolitan areas can also level-up.