# LARGIS

**EQUALISATION**
**European practices and their relevance to Ukraine**

## 1.     Introduction

1.1     This Paper looks at the main questions, which arise in devising an equalisation strategy:
focus: what is equalised?
degree: how much parity is sought?
method: what instruments are used?
measurement:   how are disparities determined?

## 2.     Focus: what is equalised?

2.1     The Council of Europe has recommended that equalisation systems should "enable local authorities, if they wish, to provide a broadly similar range and level of services while levying similar rates of local taxation".

2.2     To achieve this, it would be necessary to mitigate
(1)     disparities between the local revenue bases, i.e. the potential yield of local revenues assuming a common level of effort in terms of tax rates, collection efficiency etc.
(2)     disparities in local needs for municipal services, determined by such factors as
- differences in age structure (proportion of school age children, the elderly etc)
- differences in social structure (single parent households, unemployed, deprived minorities etc)
- differences in environmental and economic conditions, requiring remedial action
(3)     disparities in the costs of providing equivalent levels of services due to such factors as
- differences in wage levels or the price of land
- low population density increasing the overhead costs of institutions like schools
- large, high density populations increasing unit costs of services like refuse disposal or street maintenance.

## 3.     Degree: how far are fiscal conditions equalised?

3.1     The Council of Europe recommendation seeks complete parity between local authorities in the service levels they can provide with a similar level of revenue "effort". In practice only the British system attempts to achieve this. The Swedish system aims are close to parity, the redistribution being based on 95% of the average taxable income per capita and the full average per capita expenditure. Others attempt only partial equalisation. The Danish system, for example, aims to halve the gaps between the per capita revenues of the richest local

authority and those of the rest.

3.2 Factors, which appear to affect the degree of equalisation, include

      (1)     the degree of disparity between local authorities and the scale of resources available to overcome it

      (2)     the extent of local responsibility for personal services like education

      (3)     the degree of political commitment to equalisation.

## 4. Methods: what channels of redistribution are used?

### 4.1 Equalisation by General Grant

The following are examples of equalisation through general grants:

*Britain*: Government calculates for each local authority a Standard Spending Assessment (SSA); this represents the notional cost of the services for which it is responsible according to the appropriate factors affecting *need* (e.g. numbers of school age children in respect of education, elderly people in respect of social services) and *costs* (e.g. low population density, immigrant populations and social deprivation in relation to education, climate and traffic volume in relation to road maintenance). The grant to an authority consists of SSA *less* its share of Commercial Property Tax, and *less* the potential yield of the local Council Tax if levied at a standard national rate.

*Poland*: Gmina (municipalities) with local tax revenues below the national average receive additions to their General Grant based on 90% of the difference between actual revenues (assuming levy of the maximum rate of tax) and 85% of the national per capita average. Gmina with local taxes per capita above 150% of the national average receive deductions from the General Grant as follows

      20% of revenues between 150% and 200%

      25% of revenues between 200% and 300%

      30% of revenues over 300%

This equalisation does not cover tax sharing revenues in the case of the gmina. However, wojewodztwo (provinces) and powiats (districts) receive additions to their General Grant to meet the difference between their per capita tax shares and 85% of the highest tax share; (tax shares in Poland are allocated to the province, district, or municipality where they are collected).

### 4.2 Weighted Tax Sharing

In certain cases distribution of tax shares to local authorities is based on equalisation criteria rather than the origin of the revenues; e.g.

*Germany*: individual Lander distribute a fixed proportion of their tax receipts to municipalities for equalisation purposes. The indices used are per capita revenues at a standard rate of tax plus relative expenditure needs. The latter are mainly calculated according to weighted population, the weighting increasing progressively with size. Criteria vary between individual Lander; some also recognise other factors such as age structure, the proportion of the population on social assistance and the lengths of

road networks.

*Japan and Korea*: both countries estimate the expenditure needs of local authorities by applying the average unit costs of individual services to the local demand (number of school age children, road lengths etc), and then deducting the potential yield of local taxes at standard rates. The ensuing allocation is then reduced pro rata to fit the total distributable pool, which is based on a fixed percentage of national tax receipts.

These tax sharing arrangements are very similar to equalisation by general grant, the main difference being that the aggregate is a fixed percentage of national/state tax receipts.

4.3     *Local Revenue Redistribution*

In some cases equalisation of revenue capacity is attempted by redistributing local revenue collections; e.g.

*Denmark*: county councils with above average per capita income tax bases surrender funds to a pool from which those with below average bases are compensated.

*France*: in the Ile de France (the Paris Region) communes with Taxe Professionelle bases over 150% above average per capita surrender revenues to a pool compensating those below 85% of the average.

*Sweden*: municipalities and counties levy a rate of tax on personal income. The yields are subject to redistribution. Authorities with below average taxable income per capita receive the difference between their tax revenue (calculated on 95% of a national standard rate of taxes for municipalities and counties respectively) and the national average; those above the national average surrender the difference between their revenue (again at 95% of the standard national tax rate) and the national average.

All authorities are assigned a per capita structural cost of current expenditure. This is a standard assessment of the cost of their services based on factors pertaining to their main responsibilities.  Local authorities surrender income tax revenue or receive additional revenue to the extent that their per capita structural costs fall below or exceed the national average (calculated separately for counties and municipalities according to their service responsibilities).

In all three cases the actual taxes transferred are collected and redistributed by national agencies, so that no cash surrender is involved.

## 5.     Measurement: how are disparities calculated?

*Available, relevant and objective data*

5.1     Equalisation depends on measuring the disparities, which it is intended to compensate. This depends in turn on identifying sources of data, which is
         (1)     readily accessible
         (2)     relevant to the actual revenue bases or expenditure responsibilities of local

government (e.g. data about a particular source of local wealth would not be relevant if there is no local tax which exploits it); and

(3)    objective, i.e. it uses a standard national system of calculation and cannot be manipulated by individual local authorities to inflate their entitlements.

*Revenue disparities*

5.2    Calculations of local revenue potential almost always assume that the municipality levies some standard national rate of tax; to use the actual local tax rate would penalise tax effort. The major issue is whether there is comparable data about the tax base. In Britain it is possible to use the Council Tax base because assessment is carried out on a uniform basis by a national valuation service. In Scandinavia the equalised revenues are the local surcharges on income taxes, which are similarly assessed by a national agency on a uniform basis.
If local revenue bases are not assessed on a standard national basis, some proxy indicators of local revenue potential would have to be used.

*Needs and Costs Disparities*

5.3    There is a wide range in the number and sophistication of needs and costs indicators used. Britain uses a variety of indices in respect of each of seven main sectoral blocks of expenditure: education, social services, transportation, policing, fire protection, debt service and "other services". Sweden bases assessment of per capita structural costs on factors relating to each of 9 spending blocks (day care of children, primary and secondary education, post 16 education, care of the elderly, social security, water and sewage, road maintenance, public transport and other services).At the other extreme is the simple use of population, usually weighted by overall size or age structure. Poland treats all gmina as having a minimum population of 5,000, but above this level population is weighted by factors of 1.1 (10,000 to 15,000), 1.2 (50,000 to 300,000) or 1.25 (over 300,000).

5.4    Availability of relevant data is a major factor in deciding on the number of indicators. Another is variations in responsibility; Britain has to break down its SSAs by sector because some parts of the country have two tiers of local government with different functions.

5.5    Another issue is whether spending needs and costs are derived from some form of unit costing or regression analysis. The problem with unit costing is that it requires a great deal of detailed information and also a specification of standard provision which might be easy for schools or refuse collection, but is difficult for parks or street networks. Regression analysis is used to avoid these difficulties. But regression analysis has its own drawbacks. It tends to translate historic differences in spending levels into variations in "objective need". Because certain types of local authority like London boroughs or northern municipalities in Sweden have always had more money to spend per capita, regression analysis tends to suggest that they (or at least municipalities with their characteristics) need it.

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