THE OUTLOOK FOR THE FINANCES OF LOCAL AUTHORITIES IN FRANCE

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The decentralisation process begun in the 1980s has regularly broadened the scope of local authorities' responsibilities, and therefore their expenses. Meanwhile, their financial situation has deteriorated, deepening the inequalities between territories. Is this trajectory in local public finances still tenable? At present, this question is a burning issue, especially since President Emmanuel Macron announced the abolition of the residence tax, bringing budget balancing difficulties of local authorities to the forefront. This brief presents an overview of the finances of local authorities and the basic principles of local taxation, in order to examine the issues around equality between territories in the future. Externalities, horizontal and vertical tax competition, budgetary discipline and equalisation mechanisms are all key components in analysing the current situation in France. However, in a period of decentralisation, which equals territorial autonomy, local taxation is not enough to offset the profound disparity between communities. Today, more structural actions must be implemented to correct the imbalance between territories.

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- The multitude of decision-making levels in France and its division into some 35,000 municipalities are ill-suited to a context of tax competition.
- While we are seeing renewed spending (particularly investment spending) by local authorities, their long trend of dissaving and their growing debt seem to be a result of the decrease in allocations from the State.
- Financial disparity between local authorities has little connection to the management decisions of elected officials, and justifies corrective equalisation mechanisms, although these lack transparency and have limited effectiveness at the municipal level.
- Local taxation alone cannot make disadvantaged territories attractive without the implementation of more ambitious local planning and development investments.

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Overview of local public finances

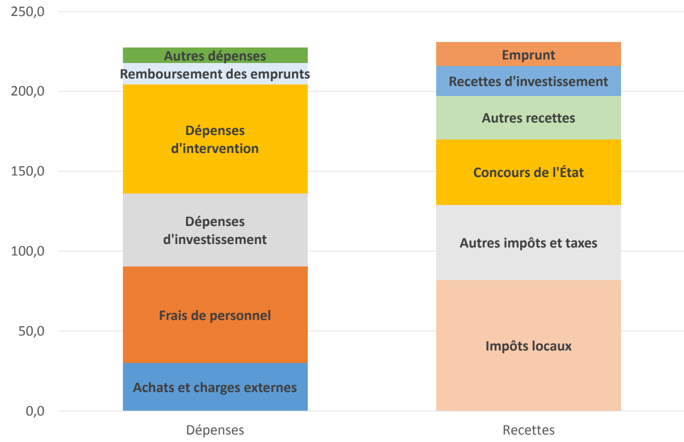
The 1980s model of local public finances, characterised by increasing revenue, a high level of savings, and contained local public spending, has evolved into a model with much tighter financial constraints.

The financing of local authorities

In 2016, the revenue of French local authorities totaled €230 billion. Figure 1 shows that the majority of this revenue (some €130 billion) comes from the local authorities' own resources, i.e. local taxes locales or user fees. Financial assistance from the State and the sharing of resources between local authorities also make up a large share of local financing. While in sharp decline since 2014, the total operating allocations (transfers of money from the central State to local authorities) stood at almost €33 billion in 2016. Lastly, local authorities can take out loans, but this is strictly regulated in France. A loan can only be used to finance investments and not under any circumstances to cover a budget deficit (unlike in the case of the State). French local authorities' outstanding debt stood at €148.6 billion in 2016, and new loans taken out totaled €15 billion. Local authorities cannot create taxes to supplement their budget. Their fiscal autonomy lies in their power to set the rates of the four direct taxes : residence tax, property tax on buildings, property tax on land, and territorial economic contribution (CFE). Indirect taxation (duty on transfer, improvement tax, tax on insurance contracts, tourist tax, etc.) also constitutes a non-negligible share of local tax revenue : around 10% for municipalities and 25% for regions and departments.

The revenue is used to finance local authorities' expenditure, which stood at €227 billion in 2016 (20% of total public expenditure), i.e. 10% of the GDP. A portion of this expenditure, €45 billion, corresponds to investment spending. Since 2016, local authorities have been very active in terms of public investments, with their investment spending making up 55% of total French public investments. Since 2014, the progression of local expenditure has been governed by the Target for Changes in Local Expenditure (ODEDEL).

Figure 1 – Revenue and expenditure of all French local authorities in 2016 (in billion euros)



Interpretation : In 2016, the €227 billion in local authorities' expenditure breaks down into purchases and external charges (€29.9 billion), staff costs (€60.7 billion), investment expenditure excluding repayment (€45.5 billion), intervention expenditure (€68.4 billion), repayment of loans (€13.4 billion), and other expenditure (including financial charges) (€9.3 billion).
Note : The term intervention expenditure refers to expenses of a social nature, subsidies for the non-profit sector, and equipment subsidies granted to other local authorities.
State assistance comprises the total funding allocations (DGF), equalisation and other allowances. Other revenue includes sales of goods and services, subsidies and equity. Other taxes and duties include duty on transfer for valuable consideration (DMTO), domestic consumption tax on energy products (TICPE), and the tax on insurance contracts (TSCA).
Source : French General Directorate of Local Authorities (DGCL).

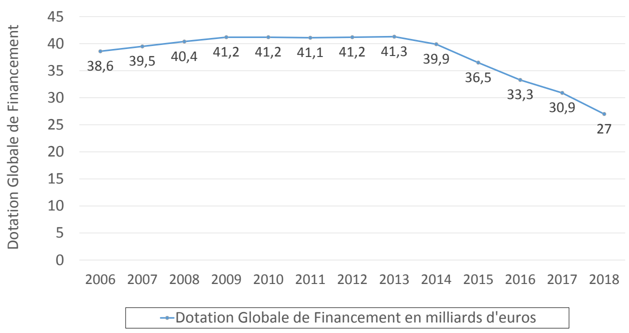
Public finances that are sound now...

Like any other economic agent, local authorities face budget constraints. Decentralisation raises the essential question of balance in local finances, and thus some degree of budgetary discipline by local authorities. This budgetary discipline stands in contrast to a situation of "relaxed" or "loose" budgetary constraint, when the central government assumes responsibility for local authorities' financial obligations as a last resort. If local authorities know that in case of bankruptcy the State will bail them out, then they have no incentive to adhere to strict budgetary discipline. This type of situation has been observed in the past, for example in Sweden between 1975 and 1998, and in Germany with the bailout of Länder of Bremen and Saarland between 1993 and 2004 (see Chabellard and Guihéry (2005). In France, although several municipalities such as Angoulême, Briançon and Digne-les-Bains did suffer financial difficulties in the 1990s, prompting the central government to intervene, there is in fact very little latitude for the possibility of relaxed budgetary constraint, given the strict regulation of the conditions under which local authorities can take out loans. A loan can solely be allocated to new investments by local authorities ; thus, it cannot be used to finance operating expenses, i.e., the local authorities' recurrent expenditure (payroll, supply purchases, etc.). The loan must be temporary, and interest payments are considered an operating expense. If these budgetary rules are not followed, the prefect implements the budget (referred to as "placement under supervision"). In spite of these rules, some cities have recently faced serious budgetary problems, such as Marvejols which was placed under supervision in 2015.

...But their future is uncertain

Nevertheless, some of the current trends are worrying with respect to balance in local public finances. After a freeze in the total funding allocation starting in 2011, it then began a sharp decline in 2014 (Figure 2) to 30.9 billion euros in 2017. This decrease announced by the State in 2013 was motivated by two aims : to slow the growth in local public spending observed for some years, and to involve local authorities in the effort to improve the State's finances.

Figure 2 – Changes in local authorities' debt and gross savings



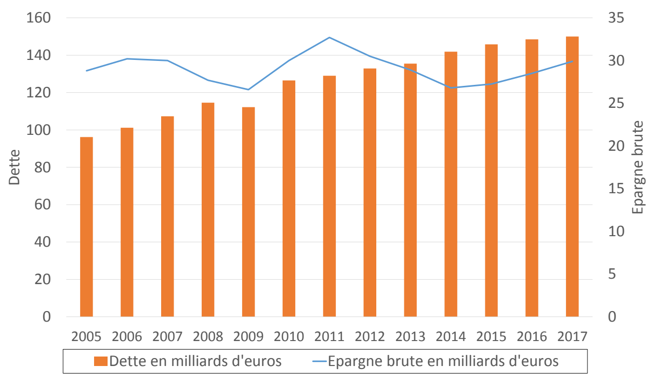
Interpretation : In 2016, the debt of local authorities stood at 148.5 billion euros (orange rectangles), and gross savings stood at 28.5 billion euros.
Note : Gross savings is the internal resource at the local authority's disposal to finance its investments for the fiscal year. It is similar to the principle of "self-financing capacity" (CAF) used in private accounting.

In response to the scheduled decrease in financial assistance from the State starting in 2014, local authorities not wanting to significantly raise taxes had to resort to other forms of financing, namely, reducing savings and borrowing for new investments. This led to a major increase in their debt between 2004 and 2016, from just over €112 billion to €148 billion, and a dissaving trend between 2011 and 2015. This decrease in gross savings (Figure 3) reflects a tighter financial situation during these years, i.e., a lower capacity for self-financing or repaying existing loans. The renewed growth of gross savings in 2015 attests to greater budget management efforts on the part of local authorities. Mechanically, local authorities' spending has stopped increasing and we even see a significant decrease in spending between 2013 and 2018, with a new uptick at the end of 2018. This last trend could be due in part to the 2020 municipal elections and the associated mechanism of political cycles.

However, the greatest uncertainty may come from the reform of the residence tax, a tax levied solely by municipalities and certain public establishments for inter-municipal cooperation (EPCI)[1]. Implemented in stages starting in

1. EPCIs are groupings of municipalities, some of which levy their own taxes, as in the case of metropolises, urban communities, conurbation committees, and communities of municipalities.

Figure 3 – Changes in local authorities' debt and gross savings



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2018, by 2020 the reform will culminate in abolition of the residence tax for 80% of tax households. Complete abolition of this tax for all French households is planned for 2023. This represents an estimated loss of 24.6 billion euros for the municipal sector (i.e. Municipalities and EPCIs) in 2020. In 2016, the 21.7 billion euros from the residence tax constituted 34% of the revenue of municipalities and EPCIs. This means that to continue supplying the local public services financed by municipal revenue, this reform needs to be offset by compensation from the State.

The compensation mechanism was revealed in June 2019. The departmental share of the property tax on buildings will be transferred to municipalities with adjustment mechanisms for the winners / losers. This scenario maintains the power to fix the tax rate for municipalities, but not for EPCIs. In fact, losses to EPCIs will be offset by a shared national tax, the rate of which is therefore beyond their control. Finally, the lost revenue for departments, which also have heavy expenses for the payment of solidarity income benefits, will also be offset by a shared national tax (such as VAT). This choice of compensation strengthens the decision-making power of municipalities with respect to EPCIs and departments.

Interactions between local authorities

Externalities and tax competition

Economic theory shows that one local authority's choices with regard to taxation or the provision of local public goods have consequences on other local authorities. This is referred to as externality. For example, a municipal pool benefits not only the residents of the municipality, but also those of neighbouring municipalities (positive externality). In the context of superimposed layers of government, there are two main types of tax externalities : vertical externalities and horizontal externalities.

The main consequence of horizontal tax externalities is the existence of tax competition between local authorities. We use the term tax competition when a public decision-maker sets a tax rate without taking into account the effects of its decisions on other local authorities. Indeed, if the tax bases are mobile,[2] local governments compete with each other by reducing tax rates to attract the base to their territory, in order to bring in additional tax revenue. This would be the case, for example, if a local tax on labour were applied where workers are mobile from one municipality to another. What is a rational choice from the municipality's perspective is not optimal when considering the territory as a whole, in that this tax competition drives taxes too far down. The resulting tax rates would be too low to ensure the public services necessary to proper operation of the local authority. This mechanism is exacerbated by increased fragmentation of the administrative map, resulting in small territories and even easier mobility for the tax bases. Consequently, local authorities adopt ways of taxing non-mobile tax bases1 to avoid the adverse effects of the tax competition. In France, local taxation is logically based on land and real estate, that is, immoveable tax bases which ensure some degree of revenue stability, at least in the short and medium term.[3]

Vertical externalities, on the other hand, result from exercising the power to tax the same base by multiple echelons of government (superimposed tax). This means that any tax change at one level of government affects the revenue of the other levels of government. Let us take, for example, the property tax on buildings (TFPB). The tax base used to calculate this tax is the rental value of the property in question. The rates which are then applied to this tax base are set independently by the different local authorities : municipalities, inter-municipal entities, and departments. Let us suppose, for example, that a department decides to raise the rate of this tax excessively in order to increase its revenue. This in turn prompts an investor to set up their venture in another department, in order to avoid paying this tax, which would also penalise the municipalities in the department not chosen. In terms of vertical and horizontal externalities, the question is raised of whether the municipal or inter-municipal echelon is more relevant. First, the fragmentation of France into 34,968 municipalities pushes tax competition between local authorities to the maximum. Second, since the 2015 NOTRe Act (New Organisation of the Territory of the Republic), every municipality must automatically belong to an EPCI (public establishment for inter-municipal cooperation). Yet the creation of the EPCIs has added an echelon of government, thereby increasing tax superimposition since EPCIs levying their own taxes choose the rate and levy the four direct local taxes, while municipalities continue to apply their own taxation. Therefore, to avoid increased vertical tax competition, opting for taxation at the inter-municipal level and not at the municipal level, with a tax structure levied solely by EPCIs, would lead to fiscal policies on a level that is more in line with the horizontal tax competition mechanisms, and would eliminate one level of taxation. This would thus internalise not only the tax externalities but also externalities relating to the provision of local public goods (pool). Moreover, in the specific case of communities of municipalities with a common business tax system, the EPCI is already gradually replacing municipalities in the management and receipt of revenue from business tax (tax on companies).

Equalisation : why does fiscal disparity need to be corrected ?

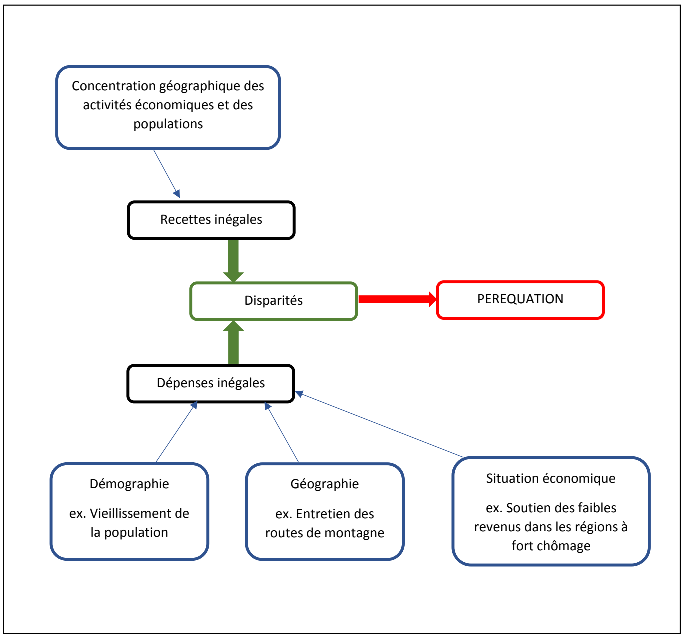
Equalisation is a mechanism of redistribution between local authorities with disparate finances, in order to achieve equal distribution of expenditure or income. This has been a constitutional principle since the 2004 constitutional amendment : "The law provides for equalisation mechanisms intended to promote equality between territorial communities" (Article 72-2, para. 5). There are two types of equalisation. On the one hand, vertical equalisation is the modulation of State allocations to local authorities to benefit those whose own resources are low and/or who bear high expenditure. On the other hand, horizontal equalisation is the allocation of additional resources to disadvantaged communities, by drawing a portion of resources away from communities with a more favourable financial situation. Vertical equalisation totalled €7.8 billion in 2018, i.e., 29% of the total operating allocations, and horizontal equalisation represented €3.4 billion. This is a complex system which lacks transparency due to the succession of changes to its mechanisms. At present, we count 14 funds and allocations : 8 for vertical equalisation and 6 for horizontal equalisation. But is it really necessary to correct fiscal disparity between local authorities ? Indeed, the decision-making and budget autonomy of local authorities is meant as the best possible means of fulfilling the diversity of collective needs within the national territory. However, economic, social and geographic inequalities between local authorities result in disparity, which equalisation seems to limit. This disparity is measures as the ratio of the local public services provided and the tax effort of local taxpayers.

Territorial disparity can be the result of both expenditure

2. A non-mobile tax base is one that cannot leave the territory in which it is taxed.

3. In the long term, new constructions and variation in housing prices can have an effect on tax revenue.

Figure 4 – Territorial disparity and equalisation



Interpretation : Geographic, population and economic disparity (blue rectangles) affect both expenditure and revenue (black rectangles), and therefore the ratio of public services to tax effort, also referred to as secondary disparity (green rectangle).

and revenue (Figure 4). The role of local authorities is to meet certain needs which constitute irreducible expenditure in their budget. The cost of providing goods and services can differ from one community to another, depending on their population structure and geographic layout. This is particularly true in the case of expenditure relating to low-income assistance. In France, the active solidarity income benefit (RSA) is paid by the department and, mechanically, is therefore a greater budgetary burden on regions with high rates of poverty. These are obligations that local authorities must fulfil, independently of any political decision on their part. Furthermore, the geographic concentration of economic activities and populations leads to great imbalance in the tax revenue received by local authorities. Economists see fiscal equalisation as a necessity. First, tax competition between local authorities leads to differentiation in the public services they offer, as communities seek to attract a certain type of resident. Taxpayers have different priorities in terms of the goods and services available in a city and can choose where they want to live, known as the "vote with your feet" principle examined by Tiebout (1956). Young parents will be more drawn to municipalities with abundant childcare options, whereas older persons will be more interested in municipalities with an adequate offer of services for seniors. This leads to a form of segregation of the population depending on specific public service needs, and specialisation among communities. In a centralised state, only powerful equalisation mechanisms ensure that the level of public services offered locally does not vary excessively across the entire national territory. Thus, equalisation allows for greater territorial equality. Equalisation can also be an instrument used to contain spending, in the aim of balancing local public finances. Indeed, horizontal equalisation prevents excessive spending by the wealthiest communities and, conversely, limits borrowing by the least wealthy communities.

The existence of disparity between territories is particularly evident at the municipal level, in that it is difficult for small municipalities to manage often irreducible expenses. This is why compensation after abolition of the residence tax is so important, especially given that, while equalisation broadly corrects inequalities between local authorities, there is still significant disparity between municipalities, indicating the relative ineffectiveness of equalisation at the municipal level (Gilbert and Guengant, 2004). This raises the question of the relevance of the equalisation mechanisms, and calls for the existing mechanisms to be made simpler and more transparent, with criteria tailored to different communities.

Necessary restructuring

In light of the components examined in this brief, the restructuring of local authorities and local public finances must focus on three key aims :

- Simplify the local architecture by keeping only two levels of local government : EPCIs and regions.
- Overhaul the equalisation system which, due to its evolution and complexity, no longer effectively corrects the inequalities between territories.
- Adopt an adequate local taxation system, i.e. one that leaves communities latitude in setting tax rates while maintaining the constraints that contribute to local budgetary discipline.

The aim of these three main principles is to limit economic inefficiency related to the territorial fragmentation and the complexity and lack of transparency existing systems. They also foster a stronger sense of responsibility in management of local public finances.

However, alone, this proposed architecture for local public finances is not enough to adequately mitigate the inequalities between territories. It must be accompanied more ambitious structural policy. Inequalities between local authorities have incontestably deepened as a result of various impacts that have affected territories differently : economic crisis, population ageing, business tax reform, decrease in allocations from the State, etc. These inequalities are the source of a geographic divide and territorial fragmentation that can be detrimental to France's economic vitality. The existing mechanisms in place to correct these inequalities have shown their limits. Local taxation can only correct some of the inequalities, but cannot erase the stark differences between communities in terms of attractiveness to both companies and residents. Indeed, to make disadvantaged communities attractive requires investments in local planning and improvements : important measures include developing regional public transport to facilitate mobility, and ensuring internet access to enable teleworking so that people can maintain a professional activity in remote regions.

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