# LOCAL FINANCIAL EQUALIZATION IN FRANCE: REALITY AND CHALLENGES IN A CONTEXT OF CRISIS

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## Introduction

There is no denying that ***many concepts of public finance are now more or less blurred, more or less fuzzy, due to the transformations that have been taking place in this area for nearly forty years.*** Some of the terms that were still self-evident a few years ago are no longer consensual. Such is the case with the notion of local financial equalization which lacks a generally-accepted definition, even though it has pride of place in discussions on the free administration of territorial authorities and, in France, ***it was introduced in the Constitution on the occasion of a constitutional review in March 2003.***

However, the most frequently stated goal of financial equalization at the local level is, as we know, to foster harmonization of space, redistribution of wealth and hence reduce inequalities. It is worth underscoring that it is vital that the State provides equal opportunity to territories with often highly disparate characteristics. The idea is to align spending capacity, taking into account ***differences in resources and expenses,*** and to provide services commensurate with the tax effort required of taxpayers.

Needless to recall that beyond reducing inequalities between local communities, the goal is indeed to satisfy citizens' needs just like for the most disadvantaged communities the goal is to offset differences in income level, job or housing opportunities, and more recently to fight nuisances ("incivility", violence, etc.) that particularly affect urban areas.

Moreover, equalization of tax revenue is a counterweight to competition between communities. In other words, it is imperative to rebalance and restore equity between territories whose fundamental *raison d'être* is to improve the well being of their citizens and develop some kind if solidarity between them.

This is precisely what French parliamentarians enshrined through the constitutional review of 28 March 2003. From then on, under sub-paragraph 5 of article 72-2 of the Constitution ***"Equalization mechanisms intended to promote equality between territorial communities shall be provided for by statute".***

The need for such a scheme is fully justified by the new powers transferred to local authorities some thirty years ago[28], but also because the Constitution reaffirms the financial autonomy of these local authorities[29]. It is indeed obvious that ***enhanced local financial autonomy is bound to cause competition,*** sharpen differences and inequalities. However, though for decades such autonomy was a firm reality[30], it is no longer the case and redistribution through financial equalization can be a palliative.

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[28] See M. Bouvier, Finances Locales, Lextenso-LGDJ, 15th edition, 2013.

[29] See M. Bouvier, *L'intégration financière des collectivités locales versus recentralisation,* in Revue Française des Finances Publiques n° 121-2013; *L'autonomie financière locale à travers les crises,* in Revue Française de Finances Publiques n° 119-2012; *L'autonomie financière locale: illusion ou refondation?* In Pouvoirs locaux n°87-2010.

[30] For decades it was taken for granted that financial autonomy of local authorities necessarily involved: on the one hand the capacity to freely manage the funds available to it, and on the other a certain degree of decision making power on tax matters in connection with their own taxes. This implicit common sense has recently been questioned. To begin with, the tax autonomy of local authorities

The current interest in equalization in many countries therefore attests to the reorientation of financial channels and the ***restructuring of the public financial network in a context of crisis***[31]. On top of leading to paucity of resources, the economic and financial crisis has led the State to take centre stage again, which does have a significant impact on the scope of local financial autonomy; ***one can even wonder if the structure of local financial power isn't being completely revamped and whether we are not witnessing a renewal of its relationship with the State.*** The financial governance of territorial authorities is thus undeniably taking place against a backdrop of constant change and shared savings[32].

In the light of such concerns, ***resource pooling seems indispensable, hence renewed interest for equalization*** and more specifically for "horizontal" equalization. Such approach can however only be effective and accepted if the criteria that govern allocation of equalized funds are considered fair and adapted to the local context. In other words, resource or expense indicators need to be correctly defined[33] (just as the concepts of liabilities and expenditures) and local strengths and weaknesses have to be identified.

Moreover, it is worth highlighting how such equalization will be operationalized. It can be based on redistribution of resources between local authorities or on State grant, i.e. ***"horizontal equalization"*** and ***"vertical equalization"*** respectively.

## Part 1: Horizontal equalization schemes

In 2012, horizontal equalization only accounted for 11% of all equalized funds. However, it seems that since the reform of the local tax system through the 2010 Finance Law there has been a move towards such pooling of resources.

### I. The first steps towards horizontal equalization: Departmental Professional Tax Equalization Funds (FDPTP, Fonds départementaux de la taxe professionnelle)

When they were created in 1975, FDPTP, which virtually disappeared with the removal of the professional tax[34], had given real hope for effective horizontal equalization. Such hope was however quickly dashed for the money allocated was always minimal.

These funds were created in 1975[35] in order to equalize the funds obtained from capping communal professional taxes levied on major operations (ports, hydropower plants, nuclear plants, chemical industries, etc.). These so-called "exceptional" institutions were those whose professional tax per inhabitant were twice as high as the national average. The amount exceeding this average was levied and the amount of the corresponding tax paid in to a departmental fund. These resources were reallocated by regional councils to so-called "concerned" and "underprivileged" municipalities.

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was limited. Due to tax relief measures adopted by the State to support the economy of entire segments of the local tax system have disappeared with the multiplication of exemptions and deductions. True enough, losses in tax revenue were indeed partially offset by the State. Local taxes were nevertheless progressively turned into grants, confirming the decline in local tax autonomy.

[31] See M. Bouvier, MC. Esclassan, JP. Lassale, *Manuel de Finances Publiques*, Lextenso-LGDJ, 11th Edition, 2012.

[32] See M. Bouvier, Finances Locales, op. cit.

[33] One can, for instance, consider that the tax potential is too restrictive and that the financial potential, which includes resources other than taxes, makes it possible to better assess the overall real potential of a given community, all the more since some of them have had their tax autonomy considerably restricted.

[34] Main tax levied by local authorities, the professional tax applied to business companies. It was initially (1975) levied on the basis of wages paid as well as capital goods. The "wages" part was abolished in 1999 and in 2010 the finance law replaced what was left of the professional tax (the "capital goods" share) by a new tax called "territorial economic contribution".

[35] When the professional tax was created.

"Concerned" municipalities were defined as those:

* That host at least ten employees of the operation in question, which represent together with their families at least 1% of the municipality's population;

* Where a barrage or dam needed for the operation of an energy producing operation handling nuclear fuels was created in the municipality.

Municipalities could also be "concerned", on an optional basis, in case of hardship or charges in relation to the presence in a neighbouring municipality of an exceptional operation. Injury determination was usually the responsibility of the Provincial Council. It took into account the damage caused to the road network as well as the presence of employees, whatever their number.

"Underprivileged" municipalities were those with a limited tax potential[36]. The provincial council established the distribution key itself (low investment capacity, number of inhabitants, comparison of the tax potential of the municipality with the average tax potential of the department).

## II. Current horizontal equalization schemes

### 1. The National Fund for Municipal and Inter-Municipal Tax Revenue Equalization

The 2011 finance law established a Fund for Municipal and Inter-Municipal Tax Revenue Equalization. This fund is replenished through charges on municipal and EPCI (public inter-municipality cooperation establishments) revenue. For 2013 the Fund has a budget of 360 million euros, 570 million euros for 2014 and 780 million euros for 2015 and then 2% of municipal and inter-municipal tax revenue each year from 2016 (i.e. over 1 billion euros).

Its **contributors** are inter-municipal bodies[37] or isolated municipalities whose financial potential aggregated per capita[38] (PFIA) is higher than 90% of the average per capita aggregated tax potential. The levy is shared between intermunicipal entities and isolated municipalities on the basis of a composite index of resources and levies multiplied by the population size of the intermunicipality grouping or of the municipality. On the one hand, there is the difference between the per capita aggregated financial potential of municipalities and EPCIs and the average per capita aggregated financial potential; and on the other, the difference between the per capita income of the intermunicipality grouping or of the isolated municipality and the average per capita income. The composite index is obtained by adding these ratios, with an 80% weighting for the first and 20% weighting for the second.

This levy is capped at 11% of resources used to calculate the tax potential. Finally, the amounts levied from each intermunicipal grouping are shared between own-source tax revenue EPIC and its member municipalities depending on the tax integration coefficient, and then between member municipalities depending on the per capita financial potential of these municipalities.

[36] The tax potential is then calculated as follows: revenue from national taxes / national basis = average national tax rate. Average rates x municipal tax basis = tax potential. Tax potential / population = per capita tax potential.
[37] Inter-municipal bodies include the EPIC and member municipalities.
[38] The financial potential equals the sum of: tax potential + block grant (excluding wages compensation) + compensation grant + transfer duties + land registration taxes. The PFIA is a financial potential that consolidates that of the group and member municipalities.

60% of intermunicipality groupings are recipients of the fund. They are classified in descending order of a composite index of resources and expenses. Municipalities that do not belong to a grouping with own-source tax revenue whose composite index is higher than a median index.

This index incorporates three elements:

* The relationship between the average per capita aggregate financial potential and the per capita aggregate financial potential for the intermunicipal grouping or the per capita financial potential of the commune that does not belong to any public institution of inter-municipal cooperation (EPCI) with own-source tax revenue.
* The relationship between the average per capita income of local territorial entities and the per capita income of the intermunicipal grouping or of the commune that does not belong to any public institution of intermunicipal cooperation with own-source tax revenue.
* The relationship between the tax effort of the intermunicipal grouping or of the commune that does not belong to any public institution of intermunicipal cooperation with own-source tax revenue and the average tax effort.

Taken together, these relationships provide you with a composite index after 20% weighting of the potential, 60% weighting of the per capita income and 20% weighting of the tax effort[39].

The allocation due to each intermunicipal grouping and each isolated commune equals the product of its population through the composite index.

Once the contributions and allocations of intermunicipal groupings or isolated communes are determined, payments are distributed between the EPCI and its member municipalities. The allocation is based on the tax integration ratio[40] and then between member municipalities depending on the per capita tax potential of these communes. Allocations can also be freely determined based on a unanimous decision.

It is worth underscoring that funds can only be allocated if the tax effort is above 0.75.

### 2. The Departmental and the Regional Equalization funds for the contribution on the value added of enterprises (CVAE)

The CVAE Departmental and Regional Equalization Funds were created by the 2010 Finance Act[41].

The **Departmental Fund** is meant to finance the most disadvantaged departments and regions (with a tax potential lower than average) whose financial burden is particularly heavy (population size, number of people receiving minimum social benefits, road maintenance). The fund is based on a 25% levy on the CVAE allocated to each department as well as on a levy on the resources of departments whose per capita tax potential and CVAE growth are above the national average.

The **Regional Fund** works just like the departmental fund. It is meant to finance the regions whose charges are particularly heavy (population size, number of high school students, number of trainees in vocational training, surface area).

[39] EPCI's tax effort is calculated as follows: sum of the proceeds of local taxes (land tax, housing tax) collected by the grouping and its member municipalities/share of aggregate tax potential increased by the proceeds of the additional property tax on non-constructed property.

[40] Ratio between the taxes collected by the grouping and those collected by the communes.

[41] The initial 2010 finance act eliminated the professional tax and created a new company levy, the territorial economic tax (CET, contribution économique territoriale). The CET includes two taxes, the corporate property tax (CFE, cotisation foncière des entreprises) and the contribution on the value added of enterprises (CVAE, cotisation sur la valeur ajoutée des entreprises). The CFE rate is voted by the commune or the grouping, that of the CVAE is set by the Parliament and is currently at 1.5%.

### 3. The national equalization fund for transfer duties collected by departments

Transfer duties (DMTO, droits de mutation à titre onéreux) are taxes levied for departments on sales of real estate property.[42] This is their main tax resource. It is totally dependent on the situation of the real estate market, i.e. on the level of transactions taking place on the territory of the department. The major inequalities that ensue justify an equalization mechanism.

The DMTO national equalization fund aims at helping departments whose tax potential is lower that average. It is replenished by two contributions.

The first contributors are the departments in which the per capita amount of duties collected for the previous year is above 0.75 times the average per capita amount of duties collected by all departments that same year. The portion of the per capita amount that exceeds 0.75 times the average per capita amount for all departments is subject to progressive rates of levy.

The calculation is as follows:

- all contributing departments pay in 10% of the portion of the department's per capita amount above 0.75 times and lower than or equal to the per capita amount of all departments, multiplied by the department's population;
- for departments whose per capita amount of duties is above the per capita amount of all departments, an additional tax is levied which amounts to 12% of the portion of the department's per capita amount of duties above one and lower than or equal to twice the per capita amount for all departments, multiplied by the population of the department;
- for departments whose per capita amount of duties is more than twice the per capita amount of duties of all departments, a second additional tax is levied which amounts to 15% of the difference between the department's per capita amount of duties and twice the per capita amount of all departments, multiplied by the population of the department.

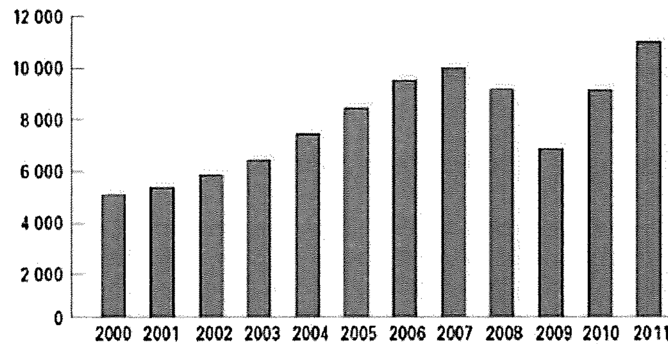
A **second tax** is levied on flows. It is calculated on a yearly basis based on the difference between the amount of duties collected for the base year (n-1) and the average duties collected for the two preceding years (n-2 and n-3). The amount is levied if the difference is higher than this average multiplied by the forecast inflation rate for the previous year and if the total per capita DMTO is higher than 0.75 times the national per capita average amount of such duties collected by all departments that same year. This second levy equals half of the surplus.

The amount levied under each of these two taxes cannot, for any given contributing department, exceed 5% of the duties collected for the previous year.

The departments that benefit from the fund are those whose per capita financial potential is lower than the average per capita financial potential of all departments. One third of the grant is prorated on the basis of the ratio between the per capita financial potential of all departments and the per capita financial potential of the department; another third is prorated on the basis of the ratio between the per capita financial potential of all departments and the per capita financial potential of the department, multiplied by the population of the department; finally, the last third is prorated on the basis of the ratio between the per capita amount of DMTO collected by all departments and the per capita amount of the same duties collected by the department.

[42] Transfer duties are levied for the sole benefit of departments. Their rates are set by the General Council (Conseil général, made up of elected representatives of the department's citizens) and range between 1.20% and 3.80% of the sales price. Duties are paid by the buyer.

**Evolution of transfer rights from 2000 to 2011 (in million Euros)**




Source: *Les finances des collectivités locales en 2012*, report of the Observatoire des finances *locales, July 2012, p. 176.*

### 4. Departmental equalization funds for the proceeds from additional communal taxes levied on transfer duties

Additional communal taxes levied on transfer registration taxes are collected for the Departmental equalization fund when they concern communes with less than 5 000 inhabitants in a non-tourism area.

Distribution between these communes is decided by the Prefect on the basis of a scale established by the General Council taking into account criteria such as tax effort, population size, amount of gross capital expenditure.

### 5. Solidarity Fund for the communes of the Île-de-France region (FSRIF)

The solidarity fund for the communes of Île-de-France aims at reducing inequalities between the communes of the Paris region. It is financed through a levy on the tax revenues of the wealthiest communes and groupings. The criteria taken into account include the financial potential as well as the impact of the removal of the professional tax.

### 6. National individual resources guarantee funds

There are three national individual resources guarantee funds, i.e. one per level of local government: a national guarantee fund for the regions, one for the departments and one for the communes. These funds aim at guaranteeing each commune or grouping, each department or region a level of resources that is equal to the one before the 2010 reform (which led to the removal of the professional tax).

Each fund is financed through an annual levy on higher-than-expected tax revenues in connection with the reform[43], registered with each local authority. In proportion to the losses incurred, the local authorities whose resources are lower than in 2010, receive a grant. As from 2014, the amounts levied or allocated will correspond to the amounts received or given in 2013.

[43] The same reform of the Finance Act for 2010 that abolished the professional tax and created new local taxes (CET, IFER) as well as new equalization mechanisms.

# Part 2: Main vertical equalization mechanisms

Vertical equalization mechanisms are financed through transfers from the State to local authorities. These are grants among which the most important for equalization purposes is the general operating grant (DGF, dotation globale de fonctionnement). Other grants play this role but to a lesser extent. In 2012 the amount of such grants accounted for 90% of equalized funds.

## I. General operating grant (DGF, dotation globale de fonctionnement)

It is allocated to communes and their groupings, departments and regions. It is the highest subsidy paid by the State (41.5 billion Euros in 2013). It is the result of a lengthy development process whose stages attest to the complexity or even the paradoxes and tricks in certain financial decisions. Although several parts of the funds allocated under the DGF are clearly designated as being meant for equalization, setting them apart from the others remain difficult. The DGF is indeed a complex scheme combining equalization and compensation (for charges or revenues lost to tax relief) that cannot be distinguished from each other for they are so closely interlinked.

### 1. Equalization of a local tax led to the creation of an equalization grant

The general operating fund was never born from the imagination of the legislator. It was developed on the basis of long-standing schemes and following successive changes that took place over several decades during which ***a tax was progressively turned into a subsidy.***

#### *a) The source of vertical equalization: the local tax*

In 1941, as a replacement for licensing rights (droits d'octroi) that had been removed, a local retail sales and service provision tax was created in cities. In 1945 it was extended to the whole territory, covering targeted economic activity in all communes. Throughout its existence the local tax attracted some degree of criticism. Its one advantage was that being based on transactions carried out on the territory of the commune, its proceeds fluctuated along with the economy, which encouraged communes to look for ways to develop. It however had one major disadvantage related to inequalities between cities or towns and rural communes: the inhabitants of the latter who went shopping in more developed communes facilitated their growth without any benefit accruing to rural areas.

Because this system increased or at the very least maintained disparities, in 1951 it was decided to establish an equalization scheme. The Finance Act for 1951 thus establishes a levy on the whole proceeds of the local tax, which were meant to be refunded to the poorest communes to provide them with a ***"guaranteed per capita minimum"***. Though substantially amended and made more complex, it is this very scheme established by the State that can now be found in all subsequent systems.

#### *b) From payroll tax to representative payment of the payroll tax*

A Law of 6 January 1966, which entered into force on 1st January 1968, enlarged the scope of VAT to retail trade and removed the local tax. A Law dated 26 December 1959 provided that in case of removal of the local tax, an equivalent substitute resource should replace it. This is how the Law of 6 January 1966 established the payroll tax (a tax created in 1948). The Law of 6 January 1966 thus allocates 85% of the payroll tax to finance local budgets.

However, the scope of VAT having been enlarged, it was decided to exempt from this tax all taxpayers subject to VAT (Law of 29 December 1968), which once again led to consider a substitute resource to finance local budgets. It was thus decided to fictitiously calculate this substitute resource on the basis of the payroll tax, on the understanding that the State replaces the taxpayers that were previously subject to this tax. This is how the "representative payment of the payroll tax" (VRTS, versement représentatif de la taxe sur les salaires) was created, which was an actual operating grant, the forerunner to the future general operating grant.

The VRTS was allocated under various categories:

- ***the guaranteed allocation:*** it used to be a guaranteed minimum payment calculated on the basis of what local authorities would have received under the 1967 local tax and the 1968 payroll tax. This minimum payment that equals 95% of the amount in 1969, progressively disappeared (through an annual reduction of 5%) by 1988 to be replaced by a second criterion, i.e. tax effort;
- ***the tax effort:*** variable proportion, depending on the fiscal pressure of local authorities on households (property tax and housing tax);
- finally, an Act of 6 January 1966 had created a ***Local action fund*** (Fonds d'action locale). This fund was financed through a levy on VRTS and meant to correct the effects of the previous allocations by providing the poorest tourist and spa communes with allocations (they had lost a lot with the removal of the local tax).

This subsidy in the shape of VRTS quickly turned out to be inadequate due to its sharing mechanism as well the fact that it was wage indexed, i.e. too sensitive to the economic downturn that was to happen in the second half of the 70's. The system was revamped through the Act of 3 January 1979 that established the general operating grant.

### 2. The general operating grant: a straightforward scheme

The DGF was created by the Act of 3 January 1979. The establishment of a genuine State grant was meant to end an ambiguous situation (the VRTS was alternately considered a substitute for a tax or a genuine subsidy). The DGF looked like a real State support measure for local authorities, allocated on the basis of clearly defined criteria (such as their action, their peculiarity and the nation's overall economic performance) and that could be freely used by the community.

The mechanism used to quantify the DGF, as envisaged by the Act of 3 January 1979, provided for a yearly determination of the global amount allocated by the State under the grant. After that, the grant (indexed to net VAT proceeds[44]) was calculated on a yearly basis by applying an initial fixed rate of levy of 16.45%, subject to further revision depending on possible changes to the VAT legislation (in case of change in rates for instance).

The second stage of the mechanism covered the distribution of the grant to the communities concerned. In this respect, the 1979 Act provided for a division of the grant in three parts:

- ***a fixed grant*** in continuation of the former guaranteed allocation, thus ensuring continuity with the VRTS (this share was however meant to diminish over time to be replaced by a second equalization grant).
- ***an equalization grant*** divided into two parts:

[44] Indexation to VAT proceeds was maintained until 1990.

- an allocation based on the ***per capita tax potential*** of the commune, as compared with that of communes in the same demographic group (15 groups: 0 to 499 inhabitants, 500 to 999 inhabitants, etc., up to 200 000 inhabitants). When this potential exceeded three times the average per capita potential for its group, the commune would not receive anything under this portion of the grant. When it was lower, the amount of the grant depended on the difference between the fiscal potential and the group average. The tax potential takes into account the four direct taxes as follows:

Proceeds of national taxes / National basis = average national taxation rates.
Average rates x communal tax base = tax potential.
Tax potential / Population size = per capita tax potential.

This mechanism that was meant to help most disadvantaged communes from the point of view of taxes, was coupled with a second portion.

- an allocation on the basis of the ***households tax*** in line with the "tax effort" that already existed under the VRTS.

➢ ***specific support grants***

One portion representing 5% of the global grant could be allocated to communes through specific support grants. Five options existed:

- a minimum operating grant for communes with less than 2000 inhabitants and higher than average tax potential;
- an additional grant allocated to tourist resorts and thermal towns;
- a grant in addition to the lump-sum grant for demographically growing communes;
- a guaranteed per capita minimum providing all communes with a minimum DGF;
- a specific grant for communes at the centre of a district.

### 3. Growing complexity of the DGF

The DGF was modified in 1986, 1992, 1993 and finally in 2004 and 2005. It evolved as follows:

**i. The DGF from 1985 to 1993**

*a) The communes' DGF*

➢ ***Basic grant (former lump-sum grant)***
The basic grant accounted for 40% of the global grant to be allocated. Each community was entitled to it in proportion with the number of inhabitants.
➢ ***Equalization grant***
It accounted for 37.5% of the global grant to be allocated and was divided into two fractions:

- *First fraction*

30% allocated depending on the tax potential and the tax effort. It aimed at making sure State support would go first to those communes that were most disadvantaged in tax matters but which nevertheless impose considerable tax burden.

- *Second fraction*

7.5% allocated on the basis of the income tax. This scheme was meant to help those communes whose inhabitants had a low fiscal capacity and which were consequently required to make extra efforts in the social area.

➢ ***Compensation grant***

This grant accounted for 22.5% of the whole grant to be allocated and was shared based on the following conditions:

- number of schoolchildren and children domiciled in the commune (4.5%)
- length of the communal road network (4.5%)
- number of social housing units (13.5%)

➢ ***Specific support grants***

The amount to be allocated under specific support grants was established by the local finance committees. It ranged between 2% and 3% of the DGF. Specific support grants were:

- the city-centre grant is meant to take into account specific charges in connection with the use of public amenities by inhabitants of neighbouring communes, these amenities having become necessary due to population flows;
- a grant allocated to tourist resorts and thermal communes (around 2000 communes);
- a grant for popular tourist communes with less than 7500 inhabitants;
- an urban solidarity grant.

*b) The departments' DGF*

At departmental level the DGF was distributed as follows:

➢ *a lump-sum grant* (45% of the departmental DGF)

➢ *an equalization grant* (55%) divided into two fractions:

- a tax potential grant;
- a household tax grant.

➢ *a minimum guarantee grant* which meant departmental grants could increase by at least 55% of the increase of resources allocated for DGF purposes;

➢ *a specific support grant for "social assistance" purposes.*

***ii. The DGF in the Act of 31 December 1993 and the integration of "intercommunal action"***

The Act of 31 December 1993 reforming the DGF (supplemented by the Act of 26 March 1996) focused on simplifying the provisions of the Act of 1985 as well as on ensuring sustainable provision of resources while fostering intercommunality.

**a) The DGF of communes and of their own-source tax revenue groupings**

The DGF of communes was then divided into two parts mostly covering existing grants.

➢ ***The lump-sum grant***

This part of the grant included the former stable components of the DGF, i.e. the basic grant, the equalization grant, the compensation grant and specific support grants (expect for the urban solidarity grant).

➢ ***The land-use planning grant***

This second grant covers three categories of grants:

- A DGF for own-source tax revenue groupings

Each own-source tax revenue grouping gets:

- o a basic grant calculated on the basis of the total population of communes grouped together and weighted by the grouping's ***tax integration ratio***[45] (ratio between, on the one hand, the amount received by the grouping under the four main local direct taxes, the home garbage

[45] The tax integration ratio measures the integration of EPCIs on the basis of their tax regime. The higher the ratio the stronger the integration.

collection tax, the water treatment levy, the compensations for the professional tax relief, and on the other, the proceeds of the same taxes and levies collected for member communes and all institutions of inter-municipal cooperation on the former's territory);
- an equalization grant calculated on the basis of the total population of communes grouped together, the EPCI's tax potential, weighted by the latter's tax integration ratio;
- an urban solidarity grant;
- a rural solidarity grant.

*b) The departments' DGF*

The departments' DGF did not undergo major changes with the Act of December 1993.

### *3. New DGF established by the initial finance laws for 2004 and 2005*

The initial finance law for 2004, supplemented by the 2005 one, not only considerably reformed the general DGF scheme by grouping together grants or compensations for tax exemptions that had until then been scattered, but it also created a brand new DGF for the regions whereas until 2004, only the Île-de-France region benefitted from a DGF.

*a) the regions' DGF*

The regions DGF is divided into two parts: a "lump-sum grant" and an "equalization grant".

➢ ***The lump-sum grant*** integrates various compensations and grants:

- The compensation for the removal of the regional share of the housing tax (abolished by the Amending Finance Law for 2000)
- The compensation for the removal of the share of the professional tax (1999) previously allocated to the regions. It aims at integrating into the DGF compensation for the consequences of this tax relief.
- The compensation for the removal of the tax additional to transfer duties collected for the regions that had been decided under the finance law for 1999.
- 95% of the general decentralisation grant[46] allocated to the regions.

➢ ***The equalization grant***

It equals the difference between all resources allocated for the regions' general operating grant and the lump-sum grant. It goes to the regions whose per capita tax potential is at least 15% lower than the regions' average per capita tax potential.

Half of it is distributed on the basis of the region's per capita tax potential, weighted by tax effort and population size. The other half depends on the tax potential per square kilometre of the beneficiary region (as compared to the regions' average potential).

*b) The departments' DGF*

Since the finance laws for 2004 and 2005, the departments' DGF includes:

➢ A ***lump-sum grant*** which integrates the compensation grant for the removal of the payroll portion of the professional tax, the minimum progression guarantee, the portion allocated on the basis of the households tax of the former equalization grant, 95% of the general decentralisation grant.

It is divided into two fractions:

[46] This grant was established in the framework of the 1982/1983 decentralisation laws in order to make up for the consequences of the transfer of powers.

• A base grant that increases at a rate established by the local finance committee between 35% and 70% of the growth rate of all DGF resources.

• An additional guarantee meant to ensure global progression of the lump-sum grant at a rate established by the local finance committee, which cannot exceed 50% of the growth rate of all DGF resources.

- A ***compensation grant*** that includes past credits previously allocated under the first portion of the general capital grant[47] (dotation générale d'équipement), under the "road network maintenance" and "increased tax potential". This portion is calculated on the basis of the amounts allocated in 2003.
- An ***equalization grant*** composed of an urban equalization grant and a minimum operating grant:

• *The urban equalization grant* (DPU, dotation de péréquation urbaine) is attributed to departments with a population density above 100 inhabitants per square kilometre and whose urbanization rate exceeds 65%[48] when these departments' financial potential is below 1.5 times the average financial potential of urban departments and the per capita income is below 1.4 times the average per capita income. It is allocated on the basis of a composite index that includes the financial potential[49], the beneficiaries of housing assistance and inclusion income support (RSA, revenue de solidarité active), the average per capita income. In 2012 this grant was allocated to 33 departments.

• *The minimum operating grant* (DFM, dotation de fonctionnement minimale) is meant for rural departments. Those departments that cannot receive the urban equalization grant are eligible for this grant. A second condition also needs to me met: the per capita financial potential of these departments must be less than two times the average of non urban departments. The distribution is based on a composite index that includes the per capita financial potential in relation to the size and length of the road network. In 2012 this grant was allocated to 61 departments.

***New method of calculating the tax potential of local authorities***

*The tax potential of communes and EPCIs now takes into account all new taxes levied by these local authorities as a substitute for the former professional tax. Old taxes still apply, whose potential proceeds are still calculated on the basis of a national average rate (housing tax, tax on non-constructed and constructed property), to which are now added new professional proceeds, some of which are partly taken into account in this calculation (CFE, former departmental portion of the housing tax) while others correspond to actual revenues (CVAE, IFER, TASCOM, DCRTP, GIR, mining royalties, gambling proceeds and surcharge on mineral waters). The tax potential of departments is also based on a new tax basket composed of a potential portion (tax on non-constructed property), of new proceeds that replaced the professional tax (CVAE, IFER, DCRTP, GIR), the tax on insurance contracts (TSCA, taxe sur les conventions d'assurance), the former State portion of transfer duties (DMTOs) and the five year average of DMTOs received by the department. There is no longer any regional tax potential. As from 2013 it has been replaced by an indicator of regional tax revenue (IRFR, indicateur de ressources fiscales des regions) including CVAE, IFER, tax on registration certificates for vehicles and the domestic tax on the consumption of energy products (TICPE, taxe intérieure sur les consommations de produits énergétiques). When appropriate, these proceeds are reduced by the amount of the FNGIR levy. Finally, the Finance law for 2012 establishes an "aggregate tax potential" for intermunicipal groupings for the purpose of allocating the national equalization fund for intermunicipal and communal resources. It is calculated on the basis of aggregate tax resources taken into account in the calculation of the tax potentials of EPCIs and their member communes.*

*Source: Répertoire mensuel du ministère de l'Intérieur, 15 February 2012.*

[47] This grant had been established in the framework of decentralisation laws to finance communes and departments equipment. It no longer exists.

[48] The so-called "urbanity" condition.

[49] Let us recall that the financial potential equals the tax potential + the lump-sum grant (not including compensation for payroll portion) + compensation grant 2006 + transfer duties + land registration tax (average of the last five years).

*c) The DGF for communes and their groupings*

The reform of the DGF for communes and their groupings was based on a rationale of globalization. In addition to the compensation for the removal of the payroll portion of the professional tax, the national equalization funds of the professional tax were abolished as such and related in whole or in part to the DGF. The land-use planning grant brings together the intercommunality grant, the urban solidarity grant, the rural solidarity grant and the new national equalization grant. As from 2004 and on the basis of the amounts allocated in 2003, at a progressive rate, the basis of calculation of the new DGF was established.

➢ ***The lump-sum grant***

The lump-sum grant is divided into five parts:

- A **"population-related" base grant** allocated based on the number of inhabitants. This portion has been frozen since 2011 at its 2010 level (for instance, 64.46 euros per inhabitant for communes with less than 500 inhabitants and 128.93 euros per inhabitant for communes with more than 200 000 inhabitants).
- A ***surface-based grant*** allocated based on the number of hectares in the commune. 2010 figures were confirmed in 2011, 2012 and 2013 (5.37 euros per hectare for mountain communes and 3.22 euros per hectare for others).
- A ***compensation grant*** for professional tax reliefs. This portion is meant to disappear and was frozen in 2012 at the 2010 level and down 2% in 2013.
- An ***additional guarantee***, also called ***"guarantee grant"***, which ensures all communes a minimum increase set by the CFL between 0% and 25% of the change rate of DGF.
- A ***"national parks and marine nature parks"*** grant divided into two parts. On the one hand, it is meant for communes located in a national park and, on the other, for island communes located in a marine nature park. This grant is distributed on the basis of the size of the commune located in the park.
- A lump-sum grant for tourist groupings.

➢ ***The land-use planning grant***

It brings together a grant for EPCIs and a group of equalization grants (a national equalization grant, an urban solidarity and social cohesion grant and a rural solidarity grant).

- *The public institution of inter-municipal cooperation (EPCI) grant*

EPCIs with their own-source tax revenue are allocated an ***inter-municipal grant*** based on population, tax potential and tax integration ratio. They also receive a ***compensation grant*** that includes the compensation for the removal of the payroll portion of the professional tax paid to EPCIs as well as for the lowering of the compensation grant for the professional tax allocated to those same EPCIs. The first grant should go down by around 2% in 2013 while the second will go up some 4%.

- *Equalization grants*
  - *The national equalization grant (DNP)*

    The DNP replaced the National Equalization Fund[50] and contained two parts:

    ***The main part*** allocated to communes whose per capita financial potential is lower than the average per capita financial potential of communes in the same demographic group and whose tax effort is above average. Communes with at least 10 000 inhabitants whose financial potential is 15% lower than the average per capita financial potential of communes in the same group and whose tax effort is above 90% of the average tax effort are also eligible for this grant. This portion concerns more than 20 000 communes. The portion

[50] Until 2003 there was a National equalization fund for the professional tax as well as a National equalization fund. The first (FNPTP) had been established by the Law of 10 January 1980 and was meant to subsidize communes with a low tax potential whose households tax was above average; the law of 6 February 1992 had added a rural development grant to this fund to foster rural development. The second fund (FNP) was established through the Law of 4 February 1995 Law in order to strengthen equalization for the most disadvantaged communes.

allocated to communes with 200 000 inhabitants and above has been frozen at the level of 2010.

***The top-up grant*** allocated to communes with less than 200 000 inhabitants that are eligible for the main part of the grant. It is allocated based on population as well as on the per capita tax potential (15% below the average tax average). This portion concerns nearly 20 000 communes.

o *The urban solidarity and social cohesion grant (DSU)*

This grant is meant to overcome specific problems in urban areas. Beneficiaries are:

- communes that belong in the first three quarters of 10 000 + inhabitants communes classified each year on the basis of the decreasing value of a composite index of resources and charges that take into account financial potential, social housing, the commune's per capita income, those receiving housing benefits;
- communes that belong in the first tenth of communes whose population is between 5 000 and 9 999 inhabitants; they are also classified based on the above-mentioned criteria but while retaining average reference values for their demographic group.

o *The rural solidarity grant (DSU)*

The rural solidarity grant aims at helping the most disadvantaged communes and at preserving social life in rural areas. It is paid to town centres to allow them to create or support public utilities and basic facilities. It is also paid to small communes with limited financial resources. It is divided into three fractions:

- the first fraction is called ***town centre*** (bourgs-centres) and goes to rural communes with less than 10 000 inhabitants that are administrative centres of cantons or whose population represents at least 15% of the population of the canton. It also goes to principal towns of arrondissements with 10 000 to 20 000 inhabitants (DSR and DSU may be cumulative but the DSR is then halved). The allocation of this fraction, which benefits over 4 000 communes, takes into account the commune's financial potential and the tax effort.
- a second fraction, called ***equalization fraction***, is allocated to rural communes with less than 10 000 inhabitants whose per capita financial potential is lower than double the average financial potential of communes in the same group. The distribution is subject to a number of criteria that include, in addition to the financial potential, the length of the road network, size of the population aged 3 to 16, financial potential per hectare.
- the third fraction, called ***additional fraction or target***[51], meant for the first 10 000 communes with less than 10 000 inhabitants among those eligible at least for one of the first two fractions of the DSR, classified on the basis of the average per capita financial potential (same demographic group) / per capita financial potential and the per capita average income / communal per capita income ratio. Allocation to communes is based on the per capita financial potential and tax effort, the length of the road network, the number of children aged 3 to 16 and the financial potential per hectare.

[51] Called "target DSR".

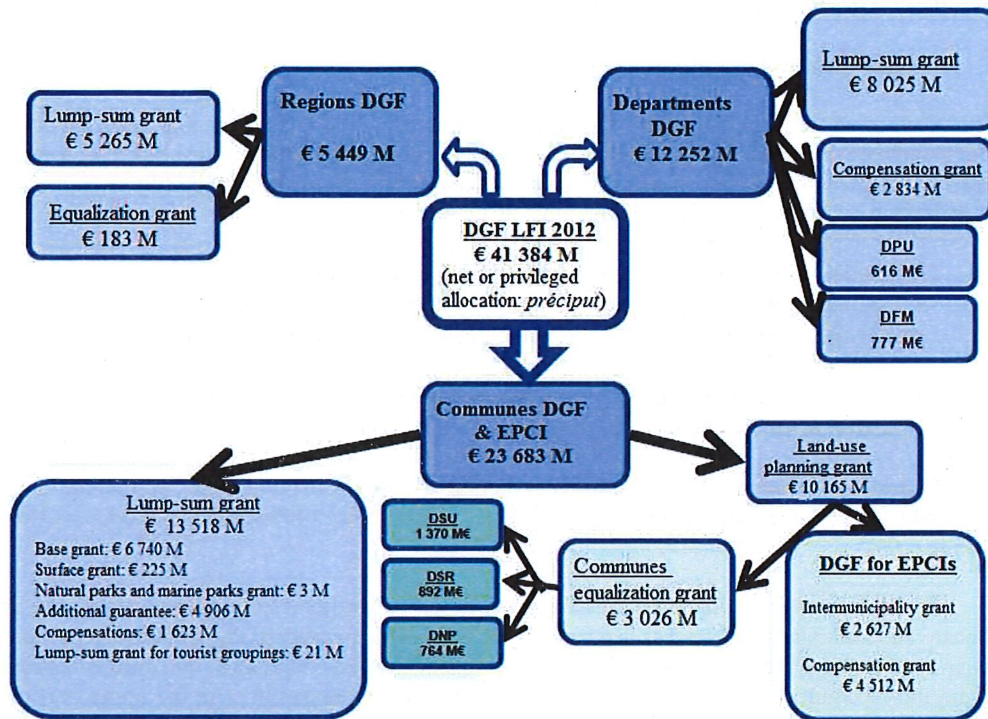
DISTRIBUTION PER DEMOGRAPHIC GROUP TO COMMUNES ELIGIBLE FOR COMMUNAL EQUALIZATION GRANTS IN 2012

| | Number of communes | | | | |
|---|---|---|---|---|---|
| | total (mainland France) | eligible for DSU | eligible for DSR | eligible for "target" DSR | eligible for DNP |
| **Total** | **36 571** | **888** | **34 692** | **10 000** | **24 314** |
| **Grouping – 10 000 inhabitants** | **35 599** | **130** | **34 634** | **10 000** | **23 651** |
| **Grouping 10 000 inhabitants and +** | **972** | **758** | **58** | **0** | **663** |
| **DGF population group** | | | | | |
| **1) from 0 to 400 inhabitants** | 18 971 | 0 | 18 419 | 4 742 | 11 959 |
| **2) from 500 to 999 inhabitants** | 7 388 | 0 | 7 202 | 2 495 | 5 301 |
| **3) from 1 000 to 1 999 inhabitants** | 4 827 | 0 | 4 715 | 1 481 | 3 356 |
| **4) from 2 000 to 3 499 inhabitants** | 2 296 | 0 | 2 237 | 697 | 1 579 |
| **5) from 3 500 to 4 999 inhabitants** | 970 | 0 | 948 | 254 | 677 |
| **6) from 5 000 to 7 499 inhabitants** | 766 | 85 | 744 | 223 | 511 |
| **7) from 7 500 to 9 999 inhabitants** | 381 | 45 | 369 | 108 | 268 |
| **8) from 10 000 to 14 999 inhabitants** | 348 | 267 | 34 | 0 | 232 |
| **9) from 15 000 to 19 999 inhabitants** | 179 | 130 | 24 | 0 | 113 |
| **10) from 20 000 to 34 999 inhabitants** | 235 | 184 | 0 | 0 | 165 |
| **11) from 35 000 to 49 999 inhabitants** | 89 | 74 | 0 | 0 | 66 |
| **12) from 50 000 to 74 999 inhabitants** | 60 | 52 | 0 | 0 | 41 |
| **13) from 75 000 to 99 999 inhabitants** | 21 | 16 | 0 | 0 | 14 |
| **14) from 100 000 to 199 999 inhabitants** | 29 | 27 | 0 | 0 | 22 |
| **15) over 200 000 inhabitants** | 11 | 8 | 0 | 0 | 10 |

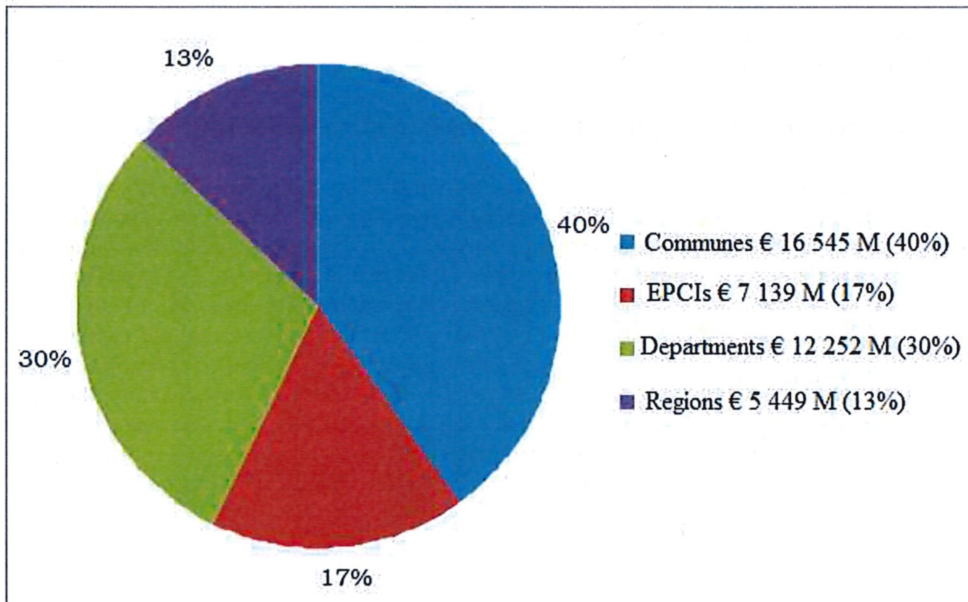
*Source: DGDL, bureau des concours financiers de l'État*

## 4) Indexation of DGF

Up until 2009, the DGF used to move each year on the basis of an index equal to the sum of the forecast evolution rate of the household consumer price annual average (tobacco excluded) for the year of payment and half the rate of evolution of gross domestic product for the current year. After that and until 2010 the DGF came under the scope of State spending and evolved on the basis of the forecast rate of evolution of the annual price average alone. Since 2011, the amount of the DGF is determined on a yearly basis by the finance law. It is currently frozen at the level of 2010.




**Distribution of DGF between the various levels of local authorities in 2012**




*Source: DGCL, bureau des concours financiers de l'État*

## II. Other equalizing grants

### 1) Urban development grant

The urban development grant (55 million Euros in 2013) is fully in line with the logic of equalization of the urban solidarity grant. It was established by the 2009 finance law in order to help 100 cities reduce inequalities in terms of employment, safety, access to public utilities, and in order to develop urban planning policies in the most difficult neighbourhoods.

The conditions to be met in order to benefit from it are as follows:

- Being eligible for the urban solidarity and social cohesion grant.
- Having more than 20% of the commune's overall population living in sensitive urban zones.
- Being under the scope of the National Urban Regeneration Agency (ANRU) and its national urban regeneration programme.

Communes are classified on the basis of a composite index including the commune's financial potential (45%), the number people receiving housing assistance (45%) and the average per capita income (10%).

Two thirds of grant funds are distributed between departments taking into account the share allocated to communes of overseas departments as well as the number of eligible communes in each department and their ranking among the 100 most disadvantaged communes; one third is distributed taking into account the number of communes eligible in each department in the upper part of the ranking as well as their ranking among the 100 most disadvantaged communes.

As for using the funds, the State representative in the department signs a contract with the commune or the EPIC. These funds are allocated for investment projects or action in the economic and social areas. The subsidy is not meant to cover whole or part of the commune's staff expenditure. The representative of the State in the department allocates the grant on the basis of priority objectives set each year by the Prime Minister based on recommendations from the National Council of Towns (CNV).

### 2) Exceptional contingency fund for departments experiencing hardship

The Amending Law of 29 December 2012 established an exceptional contingency fund to support departments experiencing hardship. Its budget amounts to € 170 million financed through a levy on the National Solidarity Fund for Autonomy (CNSA, Caisse nationale de solidarité pour l'autonomie). This fund is divided into two parts. The first amounts to € 85 million and is distributed, after deduction of a share for overseas departments, between half of all mainland departments on the basis of a composite index taking into account the average per capita income, the number of people on independence social allowance (APA, allocation personnalisée pour l'autonomie), on inclusion income support, on compensation benefits and compensatory allowance.

The thirty departments with the highest index are eligible for the fund. The second part of the fund also amounts to € 85 million that can be allocated in the form of exceptional subsidies, under a contract, to departments experiencing particular difficulties related to a deterioration of their financial situation.

### 3) Capital expenditure grant for rural territories

The capital expenditure grant for rural territories is allocated to EPCIs with own-source tax revenue as well as to communes. Funds are allocated by the prefect of the department concerned. They are intended for investments or projects in the economic, social, environmental and tourism areas or projects that foster development or maintenance of public services in rural areas.

Each year a commission of locally elected officials[52] identifies priority operations and establishes applicable subsidy rates. On that basis, the State representative lists the operations to be subsidized, sets the amount of the subsidy and notifies the commission.

Eligible EPCIs are those whose population does not exceed 20 000 inhabitants in mainland departments and 35 000 inhabitants in overseas departments. Those whose population exceeds 20 000 in mainland departments and 35 000 inhabitants in overseas departments but does not exceed 60 000 inhabitants are also eligible when the communes per se are eligible or when the average per capita tax potential is lower than 1.3 times the average per capita tax potential of all own-source tax revenue EPCIs in the same category and whose communes all have less than 15 000 inhabitants.

To be eligible, communes must have a population of no more than 2 000 inhabitants in mainland departments and 3 500 inhabitants in overseas departments, or have more than 2 000 inhabitants in mainland departments and 3 500 inhabitants in overseas departments but no more than 20 000 inhabitants in mainland departments and 35 000 inhabitants in overseas departments. Moreover, the average per capita financial potential of these communes must be lower than 1.3 times the average per capita financial potential of all communes with a population between 2 000 and 20 000 inhabitants.

The funds allocated under this grant are distributed between departments on the basis of criteria such as population size, or the tax or financial potential of EPCIs or eligible communes. Since 2011 the grant has amounted to € 616 million.

### 4) The general capital expenditure grant for departments (DGF)

*a) Before 2006*

Until the initial 2006 Finance Law, the general capital expenditure grant for departments was divided into two parts:

- *A first part split into portions:*
  - a main portion (75%) distributed based on a rate of support (around 3%) for investments other than in rural areas;
  - a "road network" portion (20%) distributed based on the length of the department's road network;
  - a "gross-up" portion (5%) allocated to departments with a low tax potential.
- *A second part split into three portions:*
  - a main portion (80%) distributed based on a rate of support (around 14%) for land development expenses and subsidies paid for rural works;

[52] The commission is made up of representatives of the mayors of communes with a population of no more than 20 000 inhabitants (mainland) and 35 000 inhabitants (overseas) as well as representatives of presidents of own-source tax revenue EPCIs with a population not exceeding 60 000 inhabitants.

- a gross-up portion (10%) for departments with a low tax potential (whose per capita tax potential is at least 40% lower than the average tax potential of departments, or those whose tax potential per square kilometre is at least 60% lower than the average potential;
- a gross-up portion (10%) entitled "land-use planning".

*b) Since 2006*

The 2006 Finance Law abolished the first part of the grant. Funds paid under this first part of the grant, under the "road network" and "tax potential gross-up" portions, are integrated into the compensation grant of the DGF.

The general capital expenditure grant is thus limited to the second part of the grant which is allocated as follows:

- a main portion (76%) distributed on the basis of a rate of assistance to finance land-use planning and rural capital expenditure;
- a gross-up (9%) portion allocated for land-use planning operations;
- a gross-up (15%) portion for departments with a low tax potential (those whose per capita tax potential is at least 40% lower than the average tax potential of departments, or those whose tax potential per square kilometre is at least 50% lower than the average potential).

## Part 3: What kind of equalization scheme to ensure sustainability of public finances?

In this day and age, one may question the sustainability of vertical equalization schemes or at least their quantitative evolution. Take for instance the case of France, where in the framework of its public debt control policy, the State is trying to ***involve the local sector in public finance recovery efforts.*** However, in the light of the financial constraints the public sector is currently faced with, equalization can be considered, for some local authorities, a source of financing that allows them a minimum of financial autonomy.

### I. Local financial autonomy

The public finance programming law for 2012/2017 provides that, following a freeze on grants until 2013, they will be reduced for the following years. This measure which is directly related to the financial difficulties the public sector is experiencing is also fully in line with the measures promoted by the European Union since the Maastricht Treaty (1992) aiming at reducing public deficit and ensuring public finances accounting balance. The process aims at abiding by a "golden rule" and considerably picked-up speed lately due to the economic difficulties encountered in the euro zone. The signing of the Treaty on Stability, Coordination and Governance (TSCG) in the Economic and Monetary Union, referred to as the "European budgetary pact", signed on 2nd March 2012 by heads of States or governments of the member States of the Union (except for the United Kingdom and the Czech Republic) is an important milestone in this process.

It is well known that in keeping with the commitments made under the Treaty, France incorporated its provisions in its domestic legislation. This led to the adoption by Parliament of Organic Law n° 2012-1403 of 17 December 2012 on public finance programming and governance. This law contains most measures in the treaty. Multiannual public finances programming laws are considered tools towards a balanced public financial system. They define the medium-term objective of structural balance, ***which concerns all public administrations and thus local authorities.***

Obviously, the financial issues at stakes in terms of local public finances are no longer national in scope. In other words, it appears that ***local financial autonomy can now only be considered as part and parcel of global public financial governance.***

One may dread that the consequences of this policy to control public spending and reduce State transfers be detrimental to local financial autonomy[53]. Such financial autonomy is in many cases limited to the ability to freely manage allocated funds rather than to control one's taxation policy. Tax autonomy was indeed dissociated from autonomy of management as soon as the taxes paid to local authorities were partly or totally abolished as from 2010. The future of decentralization obviously lies in financial autonomy possibly subject to a certain degree of tax autonomy. This phenomenon that particularly affected regions and departments was recognized by the Constitutional Council when it distinguished financial autonomy from tax autonomy, considering that "it neither stems from Article 72-2 of the Constitution nor from any other constitutional provision that territorial authorities enjoy tax autonomy"[54]. And this despite the fact that the level of financial autonomy is established, in keeping with Organic Law dated 29 July 2004, ***on the basis of own-resources, most of which come from the proceeds of all kinds of taxes.***

Such a development does have consequences on the way we see equalization. One may wonder whether, at least with regards to the reduction of vertical equalization, this is not a step towards reversing the mechanism. One should indeed wonder, were a reduction of State transfers to become unavoidable and sustainable, whether one may not consider a blanket reduction in grants to be unfair and if, to maintain equity, one should not take into account the financial situation of the local authorities concerned. In that case, resources reduction criteria may need to be identified instead of resources allocation criteria.

Moreover, communes considered "wealthy", which would thus need to contribute more substantially, could request that effective management be taken into account, on the assumption that it would be unfair to limit the financial ability of well performing communes.

**Maximum progress of State financial support for territorial authorities**

| 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|
| 50.53 | 50.53 | 49.78 | 49.03 |

*Source:* Public finances programming law 2012-2017.

Finally, countries such as France but also all States that need to ensure sustainability of their public finances, may be moving towards a rebalancing of horizontal and vertical equalization schemes. Nevertheless, should the crisis deepen, equalization funds would shrink. This would accelerate the use of alternative sources of financing (royalties, public/private partnerships, etc.) and hence widen the wealth gap between communities that could no longer be solved through equalization. Many would thus lose financial autonomy despite article 72-2 of the Constitution.

## II. Revamping equalization: the dilemma

For the reasons mentioned above, there is an urgent need to ***redefine the notion of equalization***. One can indeed wonder if this notion as it is usually understood and which one is systematically referred to – i.e. a quasi arithmetic but not absolute compensation of inequalities – is

[53] See: http://lecercle.lesechos.fr/economic-societe/politique-eco-conjoncture/conjoncture/221149240/integration-financiere-collectivite
[54] Decision n° 2009-599, DC dated 29 December 2009.

still relevant. To this day, it has too often led to intricate and inefficient schemes unable to achieve their goals and whose effects were in the end uncontrollable.

Inequalities between territories must obviously be taken into account and it is only legitimate to want to level the playing field. But that is not enough. It would mean looking at equalization from a ***strictly public finances accounting point of view*** (which goes back to the 15th century and comes from *peroequatio*, the verb *peroequarer*, i.e. "equalize" in Latin). True enough, this approach isn't totally wrong, but it isn't 100% true either since it obviates the need to take into account the current dynamics of the financial sector.

It actually corresponds to a static view of society and sets aside the fact that ***equalization is way of regulating and harmonizing the local system as well as a tool to redirect funding channels and reorganize the local financial network.*** It also leaves aside the fact that ***equalization should follow a logic of financial autonomy, i.e. a logic of accountability,*** central to any decentralization process. ***Nowadays, equalization can only be considered in the light of the overall evolution of public financial management, one of whose basic principles is accountability***[55].

When equalization is merely considered a way to make up for inequalities, it does not foster accountability of beneficiaries. It rather leads to dependency and thus contradicts the principle of management autonomy, or even decision-making autonomy. ***It does not follow the financial culture which is currently developing the world over either,*** a culture followed in France since 2006 with the implementation of the organic law dated 1st of August 2001 on finance laws (LOLF); ***a results-based rather than a resource-based culture.***

In other words, from our perspective, ***the autonomy/equalization couple as it is usually understood is not consistent with its new environment*** in so far as the notion of equalization does not seem to have been rethought in the light of the financial context that corresponds perfectly to the first term (autonomy) but only partly to the second (equalization). Put differently, one needs to consider at least that ***equalization should allow the most disadvantaged communities not to become dependent on assistance, but to acquire the ability to offer their own services to their citizens and to tackle the root causes of inequalities themselves.***

Existing schemes, whether horizontal (redistribution by communities at the same level) or vertical (redistribution by the State), were not designed for that purpose. Whether ***equalization is extensive*** (grant allocated to all communities in a given group) or ***intensive*** (grant allocated on the basis of criteria related to resources or charges) the result is the same: implemented procedures tackle the symptoms without taking into account the cause of the problem and more so without ensuring that the communities concerned can take care of themselves. It is also worth noting that ***good regulation of the local system requires harmonization, which calls for economic development to generate new sources of wealth.*** Financial equalization is indeed a must, but it can only go hand in hand with measures to foster economic development and consequently investment, otherwise it would lead to a race to the bottom and would become unbearable for financers, i.e. on the one hand, the wealthiest territorial authorities and, on the other, the State.

It is now recognized that it is crucial for the State to control its spending. In our eyes, the same principle should apply to local finances. Indeed, even if globally speaking their situation seems pretty satisfactory, the uncertainty surrounding the functioning of our societies suggests it may not always be the case. Besides, in so far as the management of local finances depends on the management of State finances, ***financial equalization must necessarily be reconsidered against a backdrop of rationalisation and reform of public finances.***

[55] See Mr Bouvier, "L'âge de la nouvelle gouvernance financière et de la responsabilisation généralisée des acteurs publics : un autre constat social, un autre État", in *RFFP* n° 92-2005.

***In other words, it needs to be redesigned in the light of new public management.*** Not only does its cost have to remain constant, without leading to a deterioration of the situation of local authorities, but it must go hand in hand with results assessment and set aside the "hand-out rationale". What we mean by that is that equalization must be part and parcel of the decentralization process which contributes to the State's financial reform. It is equally essential to ***keep in mind the principles of accountability and assessment of measures implement at all times***. Equalization has to be considered through the lense of accountability of the political and administrative system.

In the end, ***reflection has to be steered towards the good governance of a complex local and national public financial system.*** It has to take into account the evolving general public financial system. But the underlying issue is not strictly financial. It is essentially related to the ability to organize and regulate a complex local/national system with multiple actors and to avoid its development getting out of hand.

This is the reason why, in terms of public finances management, it is essential to establish joint State/local authorities bodies to regulate, in time and space, and through consultations, on the one hand the evolution of public resources and spending, and on the other the equalization measures to be implemented at the various levels of the communities (regions, departments, groupings). These structures should obviously be tasked to coordinate, harmonize, through negotiations and on a multiannual basis, the financial decisions envisaged by all sides. Their job would also be to identify the equalization schemes adapted to the specificities of the territories concerned and to assess their performance. On this last point, the implementation of projects financed should be evaluated as well as the relevance of the equalization measures implemented. On that basis, ***asymmetrical decentralization*** would foster adaptation of the powers vested into local authorities to the economic, social, geographical reality of each region or sub-region.

*2013 PLF equalization schemes*

<table>
<tr><th></th><th>Regions</th><th>Departments</th><th>Intermunicipal [illegible]</th><th>Communes</th></tr>
<tr><td rowspan="3">Vertical equalization (€ 7 567 M)</td><td rowspan="3">Equalization grant for regions - € 193 M</td><td>Minimum operating grant (DFM)€ 626M</td><td rowspan="3">Intermunicipal grant - € 2 724 M</td><td>Urban solidarity and social cohesion grant (DSU) - € 1 491 M</td></tr>
<tr><td rowspan="2">Urban equalization grant (DPU) - € 787 M</td><td>Rural solidarity grant (DSR) - € 969 M</td></tr>
<tr><td>National equalization grant(DNP) €776M</td></tr>
<tr><td rowspan="3">Horizontal equalization</td><td rowspan="3">Equalization fund for the proceeds of levies on the added value of enterprises (as from 2013: estimated at € 27 M)</td><td>Equalization fund for departmental transfer duties – in 2012: € 579 M among which € 459 M and € 120 M set aside.</td><td>Optional community solidarity grant (DSC)</td><td>Solidarity fund for communes in the Île-de-France region – FSRIF - € 230 M</td></tr>
<tr><td rowspan="2">Equalization fund for the proceeds of levies on the added value of enterprises (as from 2013: estimated at € 47 M)</td><td colspan="2">Departmental equalization fund for the professional tax (FDPTP) – disadvantaged collectivities share** - € 431 M</td></tr>
<tr><td colspan="2">Equalization fund for intermunicipal and communal tax revenue – FPIC - € 360 M in 2013</td></tr>
</table>

*Source: Annex to the Finance bill for 2013.*

## Part 4: What kind of equalization scheme could be contemplated for the Sahara region in the immediate future?

This is a tricky question and would warrant an in-depth field study. On the basis of the information available on the situation of the local sector in Morocco, we could move towards a solution that, in the immediate future, should be based on vertical equalization without limiting the autonomy of the regions and that should allow the Sahara region to increase its other resources. Before contemplating a horizontal equalization scheme, one should indeed know the exact financial situation of the Sahara region as well as its management capacity. It would also be worth considering implementing a local tax system to provide the region with genuine tax autonomy that could take a number of forms, from the power to set tax rates to the power to adopt taxation rules. A preliminary study would be required here.

We already know that some local authorities have substantial cash whereas others don't, that budgeted operations are not always fully implemented, that training should be developed, that the questions of tax autonomy, inequalities, etc. arise and local authorities in the Sahara region are aware of that. At this juncture and in order to provide a quick answer to the question of much-needed interregional solidarity, one should not transpose just any type of horizontal equalization scheme to the Moroccan context to finance the Sahara region. There would be genuine risks that uncontrollable negative systemic effects would develop within the local system and beyond.

In other words, before contemplating fair and efficient horizontal equalization, which is not that easy, it would seem wiser, to respond to the urgency of the situation, to go for vertical equalization and progressively move towards horizontal equalization to eventually substitute it or complement it. As we already know, like many other countries, Morocco has to remain vigilant and keep its finances under control and the State will not necessarily be able to support such top-down financing by itself and in the long term. It will have to rethink public and private regional funding sources and, more generally, local funding sources, and move towards horizontal equalization.

It is worth adding that the draft organic law on finance laws currently under discussion and that aims at rationalizing State financial management, should also be taken into account in the discussion on equalization in so far as it is highly relevant to territorial State organization. This draft law aims at making public managers accountable and is necessarily part of the regionalization plan.

This is why in so far as, on the one hand, these two draft organic laws have yet to be adopted by Parliament and, on the other, that no comprehensive and precise study has been carried out on the financial situation of Moroccan local authorities, we believe that it will only be possible to put forward an ad-minimum solution consistent with what currently exists and that could easily be developed and adapted to the Sahara region. What we have in mind here is the existing VTA distribution system in favour of local authorities that may, with minor adaptations, be a starting point for effective financial solidarity.

It is worth highlighting that the 1996 reform, that was the product of an ambitious project, had the merit of fostering the principles of equality of opportunity and accountability, which are still valid but that should be made sustainable by introducing a stronger logic of performance, as well as by taking into account the diversity of situations and territories. This concerns distribution criteria as well as the very structure of grants that should be reorganized. Indeed, despite various positive aspects and tangible improvements, the system is now outdated and is no longer in line with the

major developments that are taking place in Morocco at the institutional level (regionalization) and in terms of public finances constraints (see 2013 budget).

It seems to us that the upgrading of the distribution system should go hand in hand with State budgetary reform (organic law on finances laws – LOLF – which is among Morocco's major reform projects) provided they both contribute to Morocco's new public financial governance. This is what led us to focus on two elements:

- first, the importance of management capabilities of the Sahara region, which need to be encouraged; these should be a priority feature of the equalization scheme;
- second, this region should sooner rather than later benefit significantly from the VAT grants scheme in so far as it is intended to play a major part in its territorial development.

## I. Main positive aspects of the VAT distribution scheme for the purpose of financing the Sahara region

### 1) New vision of financial relations between the State and local authorities: the basis of vertical equalization

By establishing the principle of sharing the proceeds of a national tax (VAT) between the State and local authorities, Law 30-85 on VAT introduced in Morocco a brand new vision of relations between the State and local authorities, to enhance equality between the two and acknowledge their role in economic and social development. Besides, by moving towards this type of financing, the Moroccan legislator also opted for a modern type of funding that many foreign countries already follow, i.e. sharing the proceeds of a State tax to ensure equalization of this resource.

This funding mechanism undoubtedly contributes to greater financial management autonomy. The share of VAT proceeds allocated to local authorities represents a global resource reserved by law for local authorities, i.e. it is guaranteed and different from the proceed of VAT levied on the territory of local authorities.

### 2) Modernity of the distribution scheme adopted as from 1996

In comparison with the previous system, the new distribution scheme adopted as from 1996 is an undeniable "revolution" in terms of approach. This is due to the following features:

- its new ambition to turn the distribution of the share of VAT proceeds meant for local authorities into a means of controlling local finances and correcting wealth inequalities;
- VAT grants that combine global and specific grants. The first, which can be freely used, are allocated on the basis of objective criteria that foster management autonomy and accountability of beneficiaries. They represent the greatest share of all grants (76%), the second (24%) aiming at supporting specific regions.

The allocation of VAT grants is based on criteria that have made it possible for all communities to benefit, except for regions that did not at the time exist as local authorities. In total, 89% of communes benefited from these grants, in that the system has played a key role in ensuring the survival of all these small rural communities and by allowing them to enjoy a budgetary and financial situation they had never enjoyed before. Moreover, it is worth noting that the scheme takes

into account resource capacities, at least in part. The criteria used in this respect intend to reduce inequalities (with the block grant and the tax potential indicator).

### 3) An ambitious approach that combines several goals

The 1996 logic aims at combining equity and solidarity, while trying to make local authorities more accountable for their own resources. Regardless of systemic limitations, the positive and even novel nature of the overall scheme is indisputable. It aims at greater equity through the block grant that ensures all local authorities obtain minimum resources. The same holds for the quest for solidarity between local authorities, which is apparent on two levels: the sharing of the overall envelope between the three categories of local authorities, and the tax potential criterion which makes it possible to implement equalization between local authorities, taking into account inequalities in the tax burden. These various criteria could already largely benefit the Sahara region.

Moreover, the goals of accountability and performance feature prominently in the system, through the "promotion of one's own resources" which is intended to reward the efforts made by the communes to collect and develop their own resources.

## II. Main negative aspects of the VAT distribution scheme

### 1) Excluding regions is no longer justified

Exclusion wasn't initially deliberate. It stemmed from the fact that the regions became local authorities through the system of distribution contained in the 1992 Constitution, and thus after the legislator established the sharing of the proceeds of VAT between the State and local authorities in 1985. Such exclusion can no longer be maintained since the region should be the optimal framework for future development. Against this backdrop, the Sahara region could find itself in a prominent position.

### 2) Limited reference to good management and accountability

The capacities of beneficiaries to make effective use of the additional resources allocated to them are not taken into account. Yet the existence of considerable surpluses in some budgets, as well as the heavy burden of personnel costs in operating expenses would warrant following good management and performance criteria.

## III. Recommendations

1) VAT allocation to local authorities must be a dynamic process. It must move from a handout rationale to a performance rationale. It must be designed so as to allow the Sahara region not to be mollycoddled, to be content with hand-outs, but to acquire the ability to offer services to its population on its own and to tackle by itself the root causes of inequalities. It must follow a logic of performance and assessment of results.
2) This overall objective thus requires adjusting the system in a number of ways, especially with regards to grants allocation criteria and their structure. It also requires thinking about the interest of the Sahara region as a strategic space for development and cooperation. This region has to be considered a strategic distribution space for the purpose of urban planning and equitable distribution of public utilities. It seems like the proper place to ensure harmonization of public utilities distribution. It may well be able to boost the development of decentralised State services and create synergies with local institutions.

3) It would also be a good thing for the operational framework of the grant allocated to this particular region to be enshrined in the draft organic law on regionalization or in an organic law on public regional and local finances. Management of the scheme must absolutely be guided by clear texts. As things stand at present at the local level, it is the Directorate-General for local authorities (Direction générale des collectivités locales) which is steering and regulating the system. Another solution may be to make grant distribution the responsibility of a Regional Committee. The danger however is that the distribution system be manipulated with the dreaded rise in practices more directed towards transactions between representatives of local authorities than towards the general interest. This warning however does not preclude considering whether it would be worthwhile to establish a joint body to regulate, through consultation, equalized funds. This structure may not only be asked to contribute to the coordination of the system but also to give useful advice on its performance, on the proper or improper implementation of funded projects.
4) It is on the basis of data on the Moroccan territorial system that a new distribution system must be built, which obviously does not prevent it from being complemented with proven procedures. Because each State has its own specific geographical, institutional, cultural, material characteristics, no one system is directly transposable and there are no ready-made solutions. To this end, the territorial map of the Sahara region must be established to lead to a monograph, a genuine ID photo of the region. A number of socio-economic characteristics must be collected, such as on the population, disaggregated by age, gender, young people under the age of 18, type of activity, unemployment rate, surface area, length oh highway, level of basic equipment (drinking water, electrification, transport networks), existing public utilities, state of housing, etc. These elements must be complemented by financial information to determine the region's basic characteristics such as average per capita fiscal capacity, average per capita recovery rate, average per capita expenditure (operation/investments), etc. The information gathered must be of high quality and be regularly updated and checked.
5) Adopt variable geometry synthetic indicators: objective distribution criteria must be retained taking into account the region's specific geographical framework. These distribution criteria must here again be based on very precise media identification in order to achieve the objectives mentioned above. These distribution criteria must not only satisfy the objectives mentioned above, but they must also be flexible. Therefore, synthetic, variable geometry indicators should be put forward. In addition, an efficiency and financial accountability indicator must be added, based on the level of expertise of agents responsible for the local government.
6) A regulation to ensure the financial security and autonomy of the Sahara region. The Sahara region must enjoy genuine financial autonomy, which can only go hand in hand with genuine financial security. It must be protected against some sort of State guardianship as well as against the risk of decrease in transactions or a decrease in the VAT rate that could entail a reduction in the amounts allocated. It wouldn't be healthy either for the region to be mollycoddled and totally dependent on a grant that, as has been stated, could go down depending on the level of economic activity or on State policies. This is the reason why thought should be given to the implementation of a tax system for this region alone, to meet its financial needs and possibly implement horizontal equalization. The whole of the grant could keep up with VAT proceeds as is the case today but with a regulating device in the shape of an adjustment variable in case the proceeds should go down. This adjustment variable could be the second portion of the VAT share allocated to local authorities, composed of specific grants. This portion could be reduced in proportion to the decrease in VAT proceeds, so that portion I of global grants needn't be reduced.

# ANNEX

## France's local tax system: main taxes

Just like the State, French local authorities, i.e. communes and their groupings, departments, regions[56], can levy taxes to finance their expenses. Their tax power is nevertheless limited since it does not allow them to create, modify or abolish a tax. In keeping with the 1958 Constitution (article 34), these questions fall under the purview of the Parliament.
The local tax system includes around 50 direct and indirect taxes. We shall only mention the most important ones here.

## I. Direct local taxes

Direct local taxes are the main fiscal revenue for local authorities. Four major taxes (housing tax, territorial economic contribution, tax on constructed property, tax on non-constructed property) stand out. In addition, other indirect taxes of lesser importance coexist, but they cannot be considered negligible.

### A. Four main direct local taxes

**1) Tax on constructed property**

The tax on constructed property is levied for communes and their own-source tax revenue groupings as well as for departments. It is payable by all owners of constructed buildings. Its rate is set by local authorities.

**2) Tax on non-constructed property**

The tax on non-constructed property is payable by all owners of vacant lands. It is levied for communes and their own-source tax revenue groupings. Its rate is set by local authorities.

**3) Housing tax**

The housing tax is levied for communes and their own-source tax revenue groupings. Any occupant, owner or tenant of residential premises on 1st January of the year must pay the housing tax. Its rate is set by local authorities.

**4) Territorial economic contribution**

The territorial economic contribution includes two taxes, the corporate property tax (CFE) and the company value-added contribution (CVAE). The CET is payable by any natural or legal person regularly self-employed in France. Its rate is set by local authorities.

The CFE is a tax meant for communes and own-source tax revenue groupings. It applies to company constructed and non-constructed property. It is based on company value-added[57]. Its rate is set by Parliament (1.5%). It is a tax shared between communes and their groupings which receive 26.5% of it, departments (48.5%) and regions (25%). Each community receives a CVAE that corresponds to the value added of companies located on its territory.

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[56] France is organized in 36 700 communes, the smallest of which with less than 50 inhabitants, 101 departments (from 75 000 to 2 600 000 hectares), 26 regions (from 260 000 to 11.5 million inhabitants). Communes are grouped in some 3 000 own-source tax revenue public institutions of intermunicipal cooperation.

[57] The added value equals the difference between the production in the year and the consumption of goods and services from third parties (external services, raw materials,..)

### B. Other direct local taxes

**1) Tax on refuse collection**

It is an optional tax that can be levied to cover the cost of collecting household refuse. Its rate is set by local authorities.

**2) Sweeping tax**

Communes can levy a sweeping tax when they are responsible for street cleaning. Its rate is set by local authorities.

**3) Communal and departmental mining concession tax**

The mining concession tax is a compulsory tax that replaces the territorial economic contribution for mining companies. Its rate is set by local authorities.

**4) Flat-rate tax on network businesses (IFER)**

IFER is a tax established by the 2010 initial finance law. It is payable by big companies of energy, telecommunications and transport networks. The proceeds of IFER are distributed to territorial authorities.

## II. INDIRECT TAXES AND REGISTRATION FEES

### A. Town planning taxes

**1) Development tax**

The development tax is levied for communes, departments and the Île-de-France region. It is payable by those granted authorization to build or upgrade a property. The tax is calculated on the basis of a rate voted by local authorities (between 1% and 5%) applied to a tax base established using a flat rate according to the surface of the property.

**2) Payment for low-density**

This is a communal tax whose rate is set by local authorities. It is payable by the builder and the tax is levied when he does not respect a certain density threshold. The payment (calculated by local authorities) cannot exceed 25% of the value of the land.

**3) Payment for public transport**

Companies must finance operating and investment expenses related to urban public transport of communes or their groupings. This payment is based on salaries paid. The tax rate is established by the local council.

**4) Tax on commercial premises**

This tax is payable by companies with a retail stores sales area above 400 square meters and an annual turnover of at least € 460 000. The tax depends on the turnover per square meter; it is based on a scale applied to square meters.

### B. Transfer rights

**1) Departmental transfer rights**

Transfer duties levied on the sales of properties are for the sole benefit of the department. Their rate is set by the General Council between 1.20% and 3.80% of the sales price. It is payable by the buyer.

### 2) Taxes levied in addition to business undertakings transfer rights

The commune and the department levy a tax in addition to the transfer rights levied by the State in case of sales of business undertakings. The rates applied are 0.4% for communes and 0.6% for departments for transfers whose price ranges between € 23 000 and € 107 000 (exemption under € 23 000) and 1% for communes, 1.4% for departments, above € 107 000.

## C. Other indirect taxes

There are many taxes whose proceeds can be more or less important. We shall only mention a few here:
- communal or departmental tax on ski-lifts (it is optional and cannot exceed 3% of gross proceeds);
- communal or departmental tax on final electricity consumption;
- communal levy on the proceeds of casino gambling;
- communal tax on mineral waters;
- tax on driving licences (for the benefit of regions);
- tax on registration certificates for motor vehicles (payable by the owner of the vehicle for the benefit of regions);
- the city tax is a tax established by communes and levied by hoteliers from their clients;
- communal entertainment tax (compulsory tax levied on sporting events, the price of cinema tickets, automatic devices, ...);
- advertisement tax levied for the benefit of communes.