Four centuries of fiscal decentralisation in the Netherlands in view of different economic theoretic perspectives

Bos, Frits

CPB Netherlands Bureau for Economic Policy Analysis

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FOUR CENTURIES OF FISCAL DECENTRALISATION IN THE NETHERLANDS IN VIEW OF DIFFERENT ECONOMIC THEORETIC PERSPECTIVES

Frits Bos[1]

The history of the Netherlands reveals major shifts from centralisation of government tasks towards decentralisation and vice versa. In the seventeenth century, the Republic of United Provinces was the first federal state in modern history. Many transformations later the Kingdom of the Netherlands became a big centralised welfare state. Since the 1980s a reverse development has started: the welfare state is being downsized and decentralised. This paper describes and discusses this evolution in view of a broad spectrum of economic theories. Four conclusions are drawn. Firstly, a major reason for changes in fiscal decentralisation arrangements was a deterioration of economic and political circumstances. Secondly, also many other factors, like the increase in communication, mobility, population density, urbanisation and the role of government, necessitated changes. Thirdly, accountability and transparency of local government has been improved substantially. Fourthly, current arrangements are not optimal and should be changed. For example, Dutch municipalities should increase further in scale and the role of Dutch provinces should be reconsidered.

JEL code: D70, H11, H70, N43, N44

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[1] Frits Bos is a senior-economist on public finance and regional economics at the CPB Netherlands Bureau for Economic Policy Analysis. He would like to thank Mark Roscam Abbing, Wim Suyker and Annette Zeilstra for comments and John Blokdijk, John Stikkelman and Martin Vos for statistical assistance.

Executive summary

Fiscal decentralisation has become a major topic for economic policy and theory. History and economic theory learn that a good division of tasks between the various layers of government is essential for an efficient government and therefore for economic growth and welfare. To be optimal, such arrangements should be flexible over time. This paper describes and discusses the history and current practice of fiscal decentralisation in the Netherlands. A large number of tables and graphs are used to illustrate and quantify the major economic, demographic and political changes and their impact on the division of tasks between Dutch central and local government. Also a broad overview is provided of the various economic theories relevant for understanding fiscal decentralisation.

The history of fiscal decentralisation in the Netherlands reveals major shifts from centralisation towards decentralisation and vice versa. The Dutch Republic of the United Provinces was the first federal state in modern history. Due to institutions focused on stimulating trade and growth, it became the richest country in the world. However, after this Golden Age of the Dutch republic, the decentralised decision-making system was not able to reform and meet the challenges of wars with France, England and Prussia and the rise of mercantilism and protectionism in Europe.

The French army helped to break up the political deadlock and helped to install a unitary and French-style state with a central government bureaucracy, a constitution, a national tax system and the abolishment of provinces. After the departure of the French, the United Kingdom of the Netherlands started. The power of the King and the loss of political power of cities and provinces made a much more efficient routing of roads and canals possible. However, unsustainable public finance made that the autocratic rule by the King was not accepted anymore. The King abdicated, the constitution was changed and Parliament was given more power.

Current fiscal decentralisation still reflects to a great extent the constitution of 1848. This constitution was designed by the liberal Prime Minister Thorbecke. It introduced elections for those paying taxes and divided the responsibilities over the central government, provinces and municipalities (‘Thorbecke’s house’); provinces were reinstalled but given a much less prominent role than in the Republic.

In the period up to 1928, government wanted to modernise the economy and reduce social problems. Municipalities played a major role in this, e.g. by improving education and infrastructure and giving poor relief. However, the rising expenditure by municipalities was financed by increasing debt and all kinds of local taxes related to income and wealth. This generated migration by the rich and the gap between rich and poor municipalities widened rapidly.

In 1929, this was resolved by abolishing several local taxes related to income and to introduce a municipality fund organised by the central government. During the next fifty years, a centralised welfare state was constructed. The Dutch central government tried to direct the development of the Dutch economy and society via many new social benefits and

specific transfers to local government, firms and non-profit institutions. During this period, Dutch public expenditure increased to over 60% GDP. The welfare state had an adverse effect on employment and the Dutch economy and public finance became unsustainable.

Since the 1980s, the Dutch welfare state is therefore being redesigned into a smaller and more decentralised welfare state. This implied privatisation, deregulation and decentralisation and a greater role for incentives and performance management. Social assistance and public care services have become more the responsibility of municipalities. The number of specific transfers is reduced, while the general transfers to provinces and municipalities are increased.

Since the 1930s, financial supervision of Dutch local government is generally rather strict due to a combination of standards for financial reporting and budgeting, limitations on lending for microeconomic and macro-economic reasons and early sanctions on financial misconduct. Major improvements in the distribution formulae of transfers by the central government implied that municipalities could more easily be blamed in case of financial difficulties.

The very limited role of local taxes reflects that the Netherlands is a small, urbanised and open economy with a high preference for equality and therefore limited possibilities and tolerance for differences in local public services and local taxes. Major local public services, like education, health care and police, are organised and financed nationally and not by municipalities or provinces. The limited role of local taxes also reflects that national right wing political parties do not want that (left wing) local government can increase expenditure by increasing local taxes.

Since the start of Thorbecke's house in the constitution of 1848, the number of municipalities has been decreased drastically, from 1209 in 1850 to currently 430. Economic theory provides various arguments for enlarging municipalities, like more efficient allocation by internalising more external effects, increase in efficiency due to larger scale, a rising minimum scale due to more and more complex tasks and reducing the vulnerability for local lobbies and personal interest.

At present, the major part of the Dutch municipalities is rather small: 10% has less than 10 thousand inhabitants, 25% has between 10 and 20 thousand inhabitants and for 20% the number of inhabitants is between 20 and 30 thousand inhabitants. The central government policy to allocate more and more complex tasks to municipalities enforces a further scaling up of municipalities. The scale and geographic delimitation of municipalities and provinces should take account of the major external effects. In urban regions, this suggests scaling up of municipalities or very strong cooperation, like in the current city-region arrangements. The commuting patterns suggest that the 150 year old boundaries of provinces are not very efficient for spatial planning; this task is better to be mainly divided over municipalities and the central government.

Several other proposals for improving fiscal decentralisation in the Netherlands are also made, e.g.

- Municipal taxes should be extended by incorporating the central government's taxes on owning and buying a house;

- The current complex and arbitrary formula for the general transfer to municipalities and provinces should be replaced by a link to GDP; like with the current formula, at each new period of government, the size of this transfer can be reconsidered and be subject to budget cuts or a raise of expenditure.
- The number of earmarked transfers should be limited and they should not to be defined too strictly.

1 Introduction

The division of tasks between the government and the market is one of the classical issues in economic analysis. A relatively new issue is fiscal federalism or fiscal decentralisation, i.e. what should be the division of tasks between the various layers of government? The right design of fiscal decentralisation is crucial to economic growth and welfare:

“For the last three centuries, the richest nation in the world has almost always been federal. The Dutch Republic from the late sixteenth through mid-seventeenth centuries; England from the late seventeenth or early eighteenth and mid-nineteenth centuries ... and the United States from the late nineteenth to the present. Similarly, modern China, a de facto federal state, has also experienced sustained rapid growth. India grew very slowly for many decades, but has experienced high growth in the last. In contrast, the large Latin America federal states of Argentina, Brazil, and Mexico, and modern Russia have all fared much more poorly. How do we account for such large differences in economic performance?’ (Weingast, 2009, p. 290).

All over the world, political events have drastically changed fiscal decentralisation: there is often more decentralisation (e.g. the disruption of the Soviet-Union and the increased autonomy of regions in Belgium and Italy) but sometimes also more centralisation. In some countries, local government has been drastically reorganised. For example, in 2007 Denmark reduced the number of municipalities from 271 to 98 and replaced the 13 counties by 5 regions.

In order to better understand the economic consequences of such political changes and to improve policy advice on fiscal decentralisation, international organisations (World Bank, IMF, OECD and EU) have initiated a large amount ot of research (see e.g. Prudhomme, 1995; Ter-Minassian, 1997; McKay, 2001, Rodden et al, 2003, Ahmad, 2007 and Boadway and Shah, 2009). This research tries to take stock of the wide diversity in country practice by for each country giving answers to basic questions like: What are the arrangements? Which seem to work and which seem to work not at all? To what extent does this depend on specific economic or political circumstances?

According to Tanzi (2007, p. 17), there are three large gaps in the fiscal decentralisation literature:

1. The big contrast between the theory and practice of fiscal decentralisation;
2. The link of views on fiscal decentralisation to historical development;
3. The de facto creation of a layer of government above the national government.

By analysing the history and current practice of the tasks and financing of Dutch local government in view of economic theory, this paper addresses two of these gaps. From a Dutch perspective, the third gap refers in particular to the relationship between the European Union and the national governments. Recently, this major issue was addressed by a conference and a book by CPB, the European Commission, and the Dutch Ministry of Economic Affairs (see Gelauff et al., 2008).

The tasks and financing of local government is a hotly debated topic in the Netherlands (see also table 1.1). The sustainability of Dutch public finance may be served by cuts in transfers by the central government to local government and by decentralisation of the provision of social security and publicly financed care services. However, more centralisation may also be needed. For example, in order to reduce congestion more central planning and decision-making could be a solution. Similarly, financial risks of the general government could be reduced by obliging local government to bank at the central government. Reorganisation of local government may also be necessary for improving efficiency of public services, e.g. by abolishing district water boards and transferring their tasks to the provinces.

Table 1.1 Major current policy issues on tasks and financing of Dutch local government

Major issues about tasks

1 To what extent should municipalities organise public care services? Is this an effective tool for containing rapidly rising public expenditure on care of the elderly?
2 Should municipalities -in addition to social assistance benefits- also take over the payment of unemployment benefits? Would this increase effectiveness of (local) labour market policy? Should municipalities also take over payment of social benefits to widows and orphans?
3 Who is responsible for solving problems of poor quarters in cities? What should be the role of the central government, municipalities and private non-profit parties, like social housing corporations?
4 Should small municipalities be merged with other municipalities in order to increase their efficiency, e.g. in view of their increasing role in new and complex tasks like public care services and labour market policy?
5 What should be the role and tasks of provinces? Should they be abolished or should some tasks be transferred or even forbidden (e.g. social policy)? Should they be transformed in three or four big regions? Should they take over all the tasks of district water boards?
6 How many government layers should be responsible for one issue? A maximum of two?
7 How to organize spatial planning and new infrastructure? What is the responsibility of the different layers of government?

Major financing issues

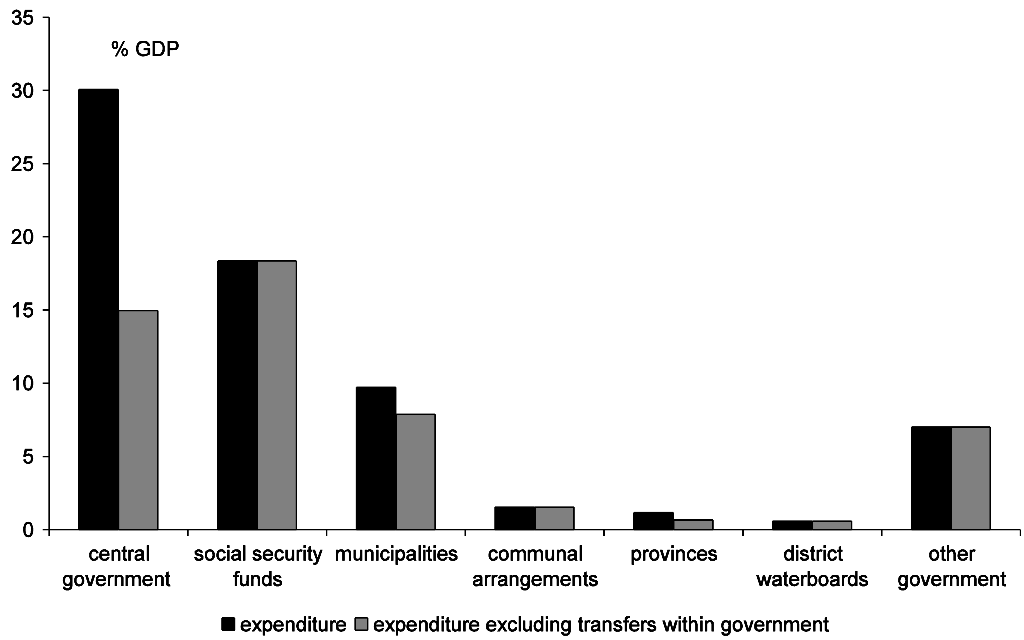
1 How to determine the size of general grants of central government to municipalities and provinces? Are cuts needed, and if so, how big?
2 How to distribute grants over individual municipalities and provinces? Should this take account of their wealth?
3 Should the role of local taxes be increased? And to what extent are differences in local tax rates acceptable?
4 Should the role of general transfers be increased and the number of specific grants be decreased?
5 Should local governments be allowed to arrange their own financing? Are they allowed to speculate with equity stock?
6 What should be the role of local government in meeting national fiscal targets, e.g. the EMU-criteria on government deficit and debt?

Some key-statistics can give a first impression of Dutch fiscal decentralisation (see figures 1.1 and 1.2). In 2009, Dutch public expenditure amounted to 51% GDP. The major part of this is made by the central government and social security funds (45% GDP). This includes

1% GDP contributions to supranational government (in particular EU) and international organisations (e.g. NATO). Transfers by the central government (14% GDP) are a major source of finance for expenditure by other Dutch government, e.g. social security funds (3% GDP), municipalities (5% GDP), provinces (0.6% GDP) and all kinds of functional government bodies, like police regions, private subsidised primary and secondary schools, Public Employment services, universities and national museums.

The 430 municipalities are by far the most important type of local government. Their expenditure amount to 10% GDP; this includes transfers to other local government units. The 12 provinces' expenditure only amount to 1.2% GDP. Joint arrangements, i.e. arrangements between various government units to take care of specific activities like garbage disposal and social workplaces, spent 1.5% GDP. In terms of expenditure, the 27 district water boards are responsible for 0.6% GDP.

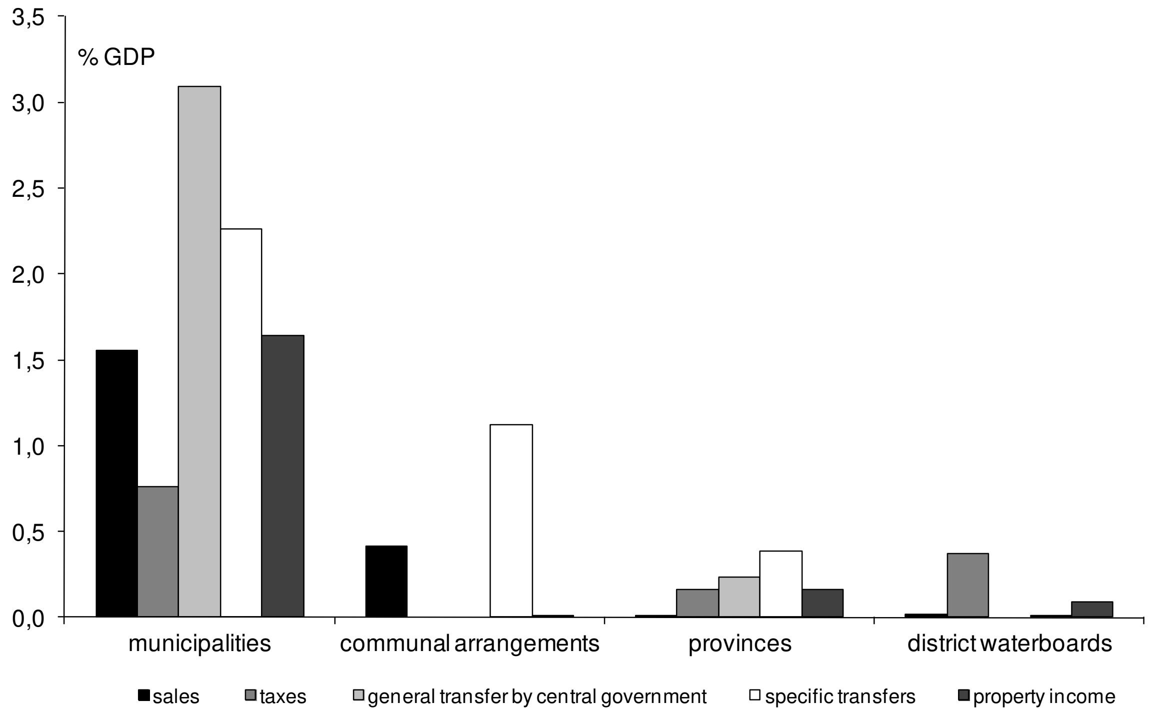
Figure 1.1 Expenditure by the various types of Dutch government (% GDP, 2009; data source: Statistics Netherlands, national accounts)



Local taxes are very small in the Netherlands (1.3% GDP in 2009). They are not only levied by municipalities and provinces, but are also by the district water boards. These three types of government are subject to local elections, i.e. to local political decision-making. However, their official head of government, i.e. the mayor of a municipality, the governor of a province or the count of the district water board, is appointed by the central government.

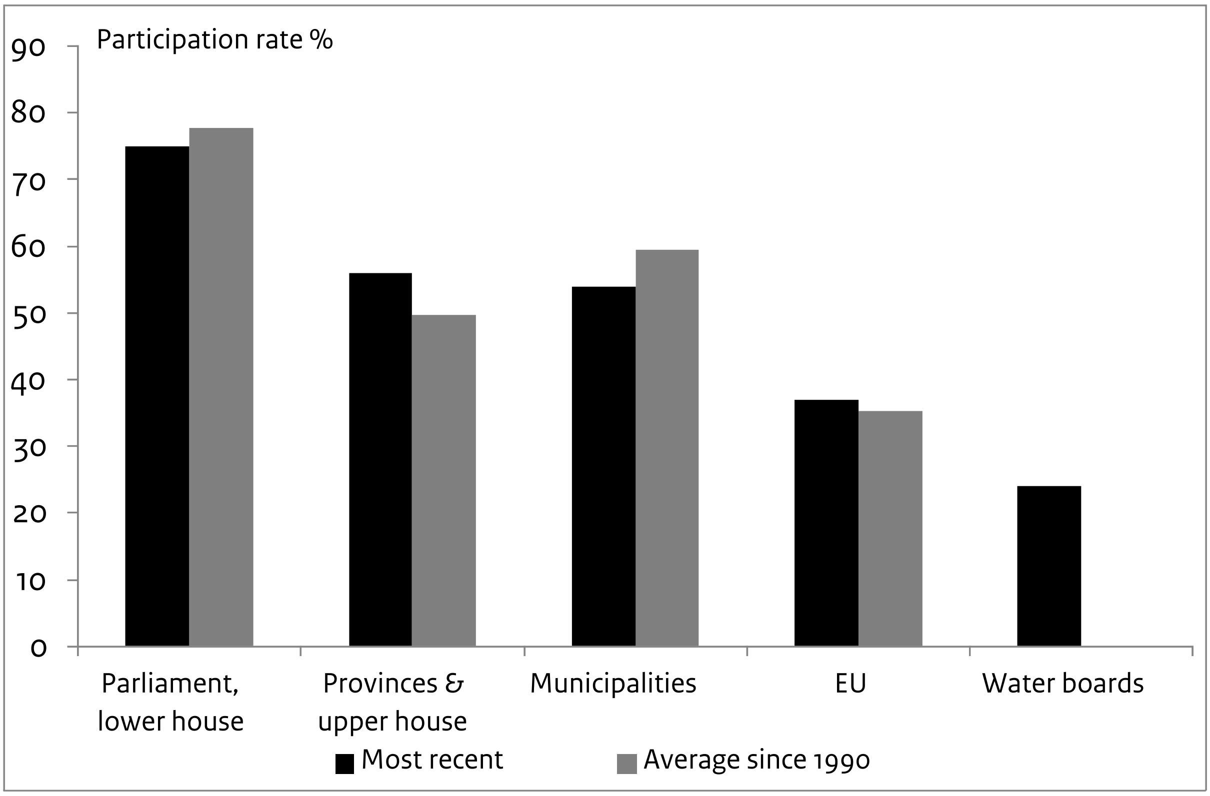
The major sources of finance for municipalities are the general and specific transfers by the central government. Communal arrangements are mainly financed by transfers from municipalities. For provinces, four sources of finance are important: not only the general and specific transfers by the central government, but also taxes and property income. The latter reflects the very solid financial position of some provinces, in particular due to the (former) ownership of power companies. In contrast, the expenditure by water boards is mainly financed by levies.

Figure 1.2 **Revenue by the various types of Dutch government (% GDP, 2009; data source: Statistics Netherlands, national accounts)**



Participation in the elections differs substantially by type of government (see figure 1.3). Most popular is voting for the lower house of parliament: more than 70% of the electorate decides to vote. Voting for the European Parliament and water boards is less than 40%; these government bodies suffer therefore from a serious lack of democratic legitimacy. The seats in the upper house of parliament are chosen by representatives from the provinces. Voting for provinces is therefore also a voting for the upper house. In general, participation in the municipal elections is about 10% point higher than that for the provinces. However, in the most recent election, it was totally uncertain whether the brand new government would also obtain a majority in the upper house. As a consequence, the participation in the provincial election was incidentally much higher.

Figure 1.3 Participation rate in the elections for different government layers.



The purpose of this paper is threefold:

- To provide a brief overview of different economic theoretic perspectives on fiscal decentralisation;
- To provide an overview of the history and current practice of Dutch fiscal decentralisation in view of these different economic theoretic perspectives;
- To describe and discuss the tasks and financing of Dutch municipalities and provinces in more detail.

In policy discussions about fiscal decentralisation, reference is in general only made to the first generation of theories. Before discussing fiscal decentralisation in the Netherlands, chapter 2 provides therefore a general overview of fiscal decentralisation in economic theory. The first generation theories focuses on the trade-offs between preference matching, economies of scale and the internalisation of external effects. The second generation theories take also account of the insights of a whole mixture of new economic theories, e.g. political economy, behavioural economics, agency theory, transaction costs theory and urban economics. They generally emphasize the importance of institutional arrangements and information flows to ensure the right incentives for good governance.

Chapter 3 gives an overview of the history of Dutch fiscal decentralisation. This historical overview illustrates the importance of a good division of tasks between central and local government and the need to reconsider arrangements in view of major economic, demographic and political changes. It also serves as a general introduction to the current arrangements.

The current tasks and financing of municipalities and provinces are described and discussed in chapter 4.

2 Fiscal decentralisation and economic theory

2.1 The first generation of theories

The basic question addressed by fiscal decentralisation is: What is the optimal allocation of economic responsibilities between different layers of government? The theories are commonly known as theories of fiscal federalism, as the pioneering papers mainly addressed the division of tasks within a federal system of government, e.g. the USA. However, the theories can be applied much more generally to cover all other forms of inter-governmental relations. For example, in China the greater economic autonomy of regions and local communities seems to be one of the major reasons of its economic success (see Rodrik, 2007 and Ahmad, 1997). In Gelauff, Grilo and Lejour (2008), the theory of fiscal decentralisation is applied to the division of tasks between the European government and the national governments.

The Netherlands is a unitary state and there is no federal government. In this paper, the theory of fiscal decentralisation is therefore applied to the division of tasks between the Dutch central government and the Dutch local government, in particular municipalities and provinces.

The ideas of the first generation of theories of fiscal decentralisation are summarized in table 2.1. Major contributions were made by Musgrave (1959), Oates (1972), Olson (1969) and Tiebout (1956). They clarify that neither a large scale centralised government nor a fully decentralised government consisting of many small and local jurisdictions is likely to be efficient. The central government should focus on providing national public services, i.e. services whose benefits extend nation-wide or whose provision is subject to substantial economies of scale. Common examples are defence, foreign affairs, national infrastructure, monetary policy, macro-economic stabilization and policies for income redistribution and poverty.

The provision of public services to mainly clear local beneficiaries should be assigned to local government. By providing local public services locally, their quality and quantity can be adjusted to local preferences and circumstances. Local financing of local public services, i.e. by local service charges or by locally set tax rates, helps also to adjust to local preferences and circumstances. People and corporations can vote with their feet and locate in the jurisdiction that offers the bundle of public services and taxes they like best. As a consequence, people and corporations distribute themselves across jurisdictions on the basis of their demands for local public services. Simultaneously, jurisdictions compete for these people and corporations by their services and tax rates[2]. Such policy competition stimulates

[2] Allers and Elhorst (2005) demonstrate that also in the Netherlands local tax rates are to a considerable extent influenced by tax rates in neighboring jurisdictions: a ten percent higher property tax rate in neighboring municipalities leads to a 3.5 percent higher tax rate. Such tax mimicking is less pronounced in municipalities governed by coalitions backed by a large majority. This suggests yardstick competition as the most likely source of tax mimicking. They also find that Dutch voters seem to be able to penalize incumbents for anticipated tax rate differentials, but not for unanticipated tax rate differentials. This limits the effectiveness of yardstick competition as a mechanism to reduce political rent-seeking.

policy learning, preference matching and efficiency. Decentralisation itself may also encourage experimentation and innovation, as individual jurisdictions are free to adopt new approaches to public policy.

Table 2.1 Decentralisation versus centralisation according to the first generation of theories

Advantages of decentralisation (/ smaller jurisdictions)	**Advantages of centralisation (/larger jurisdictions)**
Stimulates preference matching for local public services, in particular when preferences are heterogeneous	
Public services with limited external effects and geographical spillovers should be provided locally	Public services with large external effects and geographical spillovers should be provided centrally
Cross-border externalities of local public services may be partly internalised by voluntary contributions and negotiation	Cross-border externalities of local public services can be internalized without need for voluntary contributions and negotiation
Public services that can be financed by charges or land rent tax should be provided locally	
Local service charges, high local taxes and mobility stimulate preference matching and policy competition	
Local autonomy of borrowing leads via the capital market to fiscal discipline of local units	Hierarchy and restrictions on local borrowing can ensure fiscal discipline at a local level
Economies of scale by voluntary cooperation	Economies of scale without need for voluntary cooperation; uniform policy serves efficiency
Policy competition stimulates policy learning, preference matching and efficiency	Policy learning at central level due to exchange of information and commitment building
Public services for which costs of Information and decision-making increase with the number of participants should be provided locally	Public services for which costs of information and decision-making remain low when the number of participants increases should be provided centrally
Stimulates political participation and helps to protect basic liberties and freedoms	More efficient taxation and fiscal and monetary policy
	Uniform level of public services, taxes and social security serves equity and allows redistribution from rich to poor regions and jurisdictions Public services with a redistributive character (e.g. education and health care) should be provided centrally.

Substantial economies of scale and external effects seem to be very strong arguments in favour of centralisation. However, by voluntary cooperation or outsourcing of some activities jurisdictions may also reap part of the potential benefits of economies of scale. Similarly, some external effects can be internalized by negotiations with neighbouring jurisdictions and asking for contributions. For example, a swimming pool also serving the inhabitants of a jurisdiction close by may be financed partly by an investment grant from that jurisdiction. Decentralisation of tasks is directly linked to the issue of financing these tasks. Taxes and user charges based on the benefit principle are particularly suitable for assignment to the local level, inasmuch as the benefits are internalised to the local tax payers. Following the ideas of Tiebout, the prices of real estate will be influenced by the local bundle of public services and taxes. For example, providing more and better appreciated public services will lead to higher real estate prices. As a consequence, a real estate tax can then be regarded (partly) as a charge for such local public services. Similarly, a tourist tax can be regarded as a tax charging tourists for local public services. Taxes and user charges can also be useful to address negative local externalities or to raise revenues by the polluter pays principle. Examples are parking fees and toll for roads, bridges and tunnels.

Already more than a century ago, Henry George (1897) argued that economic progress, urbanisation and population growth lead to an unfair enrichment of landowners. His slogan 'We must make land common property' suggests that land should be nationalised first and then leased to private parties. However, George preferred taxing the uncultivated land value, because this would be less disruptive and controversial. With this 'single tax' the government could avoid having to tax any other type of wealth or transaction and could support the poor. Introducing a large land tax causes the value of land titles to decrease correspondingly. According to George, the landowners should not be compensated for this holding loss. In line with Tiebout, it could be argued that the value of land also reflects the value of the local bundle of public services and taxes. Taxing private holding gains on land or selling publicly owned land at higher prices may therefore be an efficient and fair way to finance (new) local public services, e.g. roads and railway stations.

For various reasons, many types of taxes are not suited as local taxes (see Norregaard, 1997 in Ter Miniassin, p. 54):

- Taxes suitable for stabilization or redistribution (e.g. income tax) should be left for the central government;
- The base for local taxes should not be very mobile (e.g. taxes on land and housing), otherwise taxpayers will relocate from high to low tax areas and the freedom of local authorities to vary rates will be constrained;
- Tax bases that are very unevenly distributed among jurisdictions (e.g. taxes on major natural resources) should be left to the central government;
- Taxes that can be easily exported to non-residents should not be used as local taxes, as this would weaken the link between the payment of the tax and the services provided.
- Taxes that are fairly easy to administer could be left to local authorities. The more important economies of scale are for a given tax, the stronger the argument to leave the tax at the national level.

When for efficiency reasons most major taxes are to be national taxes, local government will not be able to raise sufficient revenue for local public services and transfers from the central government are therefore required. In order to best adjust to local preferences and circumstances, general transfers by the central government to the local government are then to be preferred to specific transfers. Specific transfers to local government may then only have a role in addressing externalities clearly surpassing the local level (Pigou-subsidies). In addition, transfers between central and local government may also serve equity purposes, i.e. redistribution from rich to poor regions.

Four levels of fiscal decentralisation (see table 2.2) can be distinguished, ranging from full fiscal decentralisation to a fiscally centralised government with full fiscal equivalence, i.e. the same tax rates and mix and quality of public services is provided in the whole country. Nearly all countries have an intermediate level of fiscal decentralisation.

Table 2.2 Four levels of fiscal decentralisation

Level one	Full fiscal decentralisation: Local government is fully responsible for deciding on the size and composition of public services and has to finance all its expenditure.
Level two	Fiscally united local government: Local governments cooperate to finance the provision of national/supra-local public goods; they are also fully responsible for the provision of local public services.
Level three	A fiscally centralised government without full fiscal equivalence: Central government supports local government by transfers: a) lump sum transfers (e.g. per capita) to supplement local revenues in general; b) equivalence payments, i.e. to overcome local differences in tax capacity, local differences in the need for public services or local differences in the costs of producing public services. These transfers can be general (i.e. without explicitly prescribing its use and the requirements), but also specific.
Level four	A fiscally centralised government with full fiscal equivalence: Central government sets uniform standards for local public services and finances all (net) expenditure by local government, e.g. of functional government units.

The first generation of theories of fiscal decentralisation has a strong normative message for local services: provision of local services by local or regional government is more efficient than centralised provision and can also serve democracy. However, the big gap between the theory and practice of fiscal decentralisation has stimulated further thought by stressing the relevance of practical issues and by revealing a dark side of fiscal decentralisation with issues like corruption and soft-budget constraints. It has also shed light on the strictness of the assumptions used for deriving the fiscal decentralisation theorem (see also Oates, 2006), e.g.:

- Local public goods, like a swimming pool, school, park or theatre, have often interjurisdictional spill-overs; by using public or private transport households can consume the local public goods of various jurisdictions;

- Households consist of various persons and are multiple-stakeholders (work, quality of living, specific leisure activities);
- Competition between jurisdictions can stimulate pure imitation instead of specialisation; competition to attract investments may be destructive.
- Jurisdictions provide bundles of public services and have limited possibilities to specialise;
- Equity considerations can imply that a similar minimum set of public services should be available and at rather similar prices/tax rates;
- Like local government, central government may provide different local public services for different jurisdictions, e.g. by delegating the provision to local producers or by using knowledge of the local demand for local public goods.

2.2 The second generation of theories

Key-assumptions in the first generation of theories of fiscal decentralisation are a benevolent central and local government and political competition between jurisdictions due to a high (potential) mobility of citizens and corporations. In this section, four supplementary theoretical perspectives are discussed (see table 2.3.):

- Political economy;
- Behavioural economics;
- Agency theory and transaction cost economics.
- Urban economics and new economic geography.

Table 2.3 Four supplementary theoretical perspectives

Theoretical perspective	Different assumption or supplementary insight
1. Political economy	Politicians, voters and civil servants serve their own interest and not the general interest; lobby groups can influence the political process. Central and local government are not benevolent.
2. Behavioural economics	Economic actors are not always rational; their behaviour may therefore not be in their own interest. Economic actors may also have non-economic motives.
3. Agency theory and transaction cost economics	Information is asymmetric and gives rise to adverse selection and moral hazard. Transaction costs are determined by frequency, asset specificity and uncertainty. The size and type of transaction costs are crucial for determining the best way to organise transactions, e.g. by the market, the central government or the local government. Rigid hierarchies and top-down planning are not always efficient; polycentric systems of governance with self-organisation can be more efficient.
4. Urban economics and new economic geography	Despite falling costs of transportation and communication proximity has become even more valuable Cities are major drivers of economic growth Subsidies on homeownership and infrastructure stimulate to abandon cities Taxes of urban regions should not serve to stimulate rural regions Social policy should help poor people not poor regions Regional policy often fails to reduce regional disparities; new infrastructure may even increase regional disparities

By employing different assumptions, they lead to supplementary insights on the best way to organise fiscal decentralisation.

Political economy

Political economists like Buchanan, Olson and Niskanen do not assume a benevolent central and local government, but investigate the political decision-making process in view of the incentives for participants, like voters, politicians and civil servants. This gives a different perspective on the merits of centralisation and decentralisation (see table 2.4). A benevolent local government will adjust to local preferences and can in this way increase welfare. However, a local government influenced by local lobbies, personal interest and corruption is much less likely to adjust to the local general interest and to increase welfare. Such a local government may also regard its budget as a soft budget constraint, i.e. when local deficits and debts become unsustainable the central government will in the end always provide additional funding. Local government officials may also oppose for personal reasons institutional reform improving local interest (see e.g. Doerner and Ihlanfeldt, 2011). For example, merging with a neighbour city, village or province may threaten their jobs.

Table 2.4 Political economy and decentralisation versus centralisation

Advantages of decentralisation	**Advantages of centralisation**
No central government as Leviathan, no strong central lobbies disregarding local issues	Smaller role for local lobbies, personal interest and corruption
Differences in the bargaining power of jurisdictions at the central level do not lead to differences in the provision of local public goods	No free rider behaviour of small municipalities on the positive external effects of public services provided by neighbouring cities and municipalities
Complementary with other local policy	Complementary with other central policy
Accountability at local level	Accountability at central level
Local taxes as a major source for financing local public goods: less common pool and soft budget problems ; less local rent-seeking behaviour for central government's resources	Local taxes as a minor source for financing local public goods: less tax exporting and false competition by jurisdictions
	Central government bureaucracies are likely to attract more-qualified people, because they offer higher salaries, better careers with greater diversity of tasks, less political intervention and a longer view of issues.
	Too much decentralisation can invalidate and jeopardise sound fiscal and monetary policy

In his pioneering works The Logic of Collective Action and the Rise and decline of nations, Mancur Olson stressed the importance of interest groups and 'insiders' in the political process. He argues that relatively small groups (e.g. committees, advisory bodies and very specific lobby groups) are the most effective in influencing the political process. Big groups are generally rather heterogeneous and individual members can not easily influence the group behaviour. In contrast, small groups are much more homogeneous and individual members can rather easily influence group behaviour. As a consequence, their economic and social incentives for participating in this group are also stronger and such groups will be longer lasting. Small groups are therefore more effective in influencing the political process, as they can easily focus on specific issues, provide strong incentives for its members and are longer lasting. A major way to influence the decision-making process is to manipulate or restrict the circulation of essential information.

This analysis also seems to imply that lobbies and personal interest are generally more effective at a local level than at a more aggregate level, as media coverage will be smaller, special interest groups can more easily cooperate and formal separation of powers is smaller. However, capture at the central level may be higher due to the greater importance of campaign finance, more uneven political competition or poorer information available to citizens to evaluate candidates on nation-wide issues (for an overview of the various arguments, see Bardhan and Mookherjee, 2002). If different regions are heterogeneous with regard to literacy, economic backwardness or socio-economic inequality, capture of local governments will vary correspondingly across regions. The extent of capture will be located somewhere between the extremes of standards of governance across regions; more backward and unequal regions will be worse off compared with centralisation, while more progressive and equal regions will benefit. These tendencies are accentuated in the case of central governments selection on the basis of proportional representation rather than first-past-the-post elections.

According to Riker (1964)[3], the strength of national political parties and the relationship between the national and local parties are important for the political incentives of local government. In the case of strong political parties, career of politicians in local government depends on their party's political and financial support to get re-elected and on the possibility of promotion to the national government. National governing parties, in turn, are interested in supporting local politicians whose policies do not impose significant negative externalities on other jurisdictions and thus on overall national performance. Therefore, strong national political parties which are also important at the local level can provide incentives for local politicians to conduct efficient policies and help to internalise externalities of local policies. Moreover, strong national party systems provide incentives for local governments irrespective of whether local politicians are appointed or elected. Even when local politicians do not need support during elections, career concerns can play an important role.

National parties with clear local counterparts may also have other effects. In the Netherlands, Ministers and secretaries of state are often recruited from alderman in the major cities. Their experience and ideas about topics like infrastructure, social assistance, safety and the financing of local government can then be used to improve decision-making at the national level. However, it may also imply capture of the national government by local lobby

[3] See also Enikolopov and Zhuravskaya (2007).

en interest. For example, Bordignon (2004) finds evidence that local government of the same party as the ruling one at the national level tend to be more frequently bailed out ex ante or through higher transfers ex post.

From a political economy point of view, an efficient and fair government can only be obtained by incorporating sufficient checks and balances in the political process at the central and local level. Examples are independent auditing committees, evaluation and advice by independent high-quality experts in considering reforms, democratic elections, transparent budgeting and decision-making and a strong and free press. The Dutch tradition of mayors of municipalities and commissioners of provinces being appointed by the central government may also be a way to reduce local capture. In selecting experts advising the central government on reforming local government finance and judging the merits of their advice, the reputation of independence of these experts should also not be overlooked. For example, some consultants and researchers specialised in local public finance issues may be inclined to serve their clientele, i.e. defend the interests of current local government institutions instead of giving advice strictly based on academic research and facts.

Local taxes as a major source for financing local public goods can reduce the common pool and soft budget problem of excessive claims on central government's resources. It can also limit local rent seeking behaviour for central government's resources. According to Chamlee-Wright and Storr (2011), major financial transfers from outside the local community may stimulate the 'dark side of social capital': community based groups may reorient their stocks of social capital away from mutual assistance and toward lobbying and rent seeking. They claim that this happened in New Orleans' post-Katrina recovery. This adverse effect on social capital may also explain the lack of economic success in developing countries or poor regions receiving substantial amounts of development aid.

Behavioural economics

A distinctive feature of behavioural economists like Simon, Kahneman, Tversky, Thaler, Akerlof and Shiller is that they do not assume rational behaviour and economic motives. Instead, they use assumptions of non-rational behaviour and non-economic motives to understand the behaviour of economic actors (see figure 2.1).

Figure 2.1 **Behavioural economics focuses on non-rational behaviour and non-economic motives**

Rational behaviour (perfect foresight and information, no transaction costs, well defined and stable preferences)	Non-rational behaviour (short sightedness, loss aversion, money illusion, unrealistic optimism, bounded rationality, framing matters and animal spirits like confidence, story telling and anti-social behaviour)
Economic motives (profit, income and leisure time)	Non-economic motives (altruism, fairness and identity like culture, religion and way of life)

In their book Animal spirits, Akerlof and Shiller argue that imperfections in human decision-making are a major cause of the current financial crisis and real estate swings. Such imperfections are also important to understand the behaviour of central and local government and the political decision-making process. For example, taxes that are levied implicitly (e.g. as part of the purchase of a good or service) have much less effect on behaviour than taxes levied in a clearly visible and separate way. Citizens can only properly compare the costs of extra local taxes with the benefits of extra local expenditure when these taxes and benefits are well visible and understood.

Table 2.5 **Behavioral economics and decentralisation versus centralisation**

Advantages of decentralisation	**Advantages of centralisation**
Higher local taxes reduce the fly-paper effect and fiscal illusion of general transfers by central government	
Local taxes are generally more simple and visible than national taxes	
Limiting net transfers to other regions and jurisdictions is regarded as fair	Uniform level of local public services, tax rates and social security may serve nation building and reflects national solidarity
Local culture and identity is maintained and stressed; stimulates intrinsic motivation, e.g. via volunteer work	

Mental accounting is the set of cognitive operations used by individual to organise, evaluate and keep track of financial activities. Rational decision-making assumes the fungibility of funds. However, mental accounting violates this basic economic principle (see Thaler, 1999). This applies not only to the labelling of revenue, e.g. as transfer from the central government, local tax, dividends or transfer from reserves or the translating the various revenues administratively into many different earmarked funds. It also applies to the costs and benefits taken into account in deciding on expenditure and taxes, the frequency with which accounts are evaluated, whether balancing the accounts is defined narrowly or broadly or whether balancing is only required in the medium term. Economists can play a role in increasing the rationality of decision-making, e.g. by showing the inefficiency of labelling and by showing long term analyses.

The fly-paper effect indicates that grants tend to stick with budgetary use and thus result in a higher level of public services than would be the case if they were made directly to individuals. This could reflect that political pressures for tax reduction following a grant to the budget are weaker than pressures against tax increase when the grant is made to individuals. The choice among public services may also differ when financed by retention of an unrestricted grant than when financed by increased taxation. An important implication is that evaluation of the effectiveness of a specific grant depends on the premise from which it is made. Spending only part of the central government grant for extra local public services seems to be a waste of resources and a violation of central government policy. However, it could also be regarded as a desirable avoidance of fly-paper effects in line with the preferences of local residents.

According to Janis (1972) in his famous study on the failed American invasion in Cuba in 1961, social interaction in a small group of policy makers and advisers may lead to major policy failures. Such a small group leads to group think by stimulating over optimism and narrow mindedness and urging a consensus opinion. A larger group of policy makers and advisors coming from different backgrounds (e.g. different stakeholders, professions, age, nationality or region) may therefore help to improve the quality of decision-making. This applies also to fiscal decentralisation, e.g. in deciding about major reforms.

Non-economic motives can play a major role in the solidarity between different groups of households and regions, i.e. the willingness to pay for other households and regions. As a consequence, the amount of redistribution nationally and locally can be determined by non-economic motives. Non-economic motives may also explain the provision of public services. For example, stimulating national identity can be a major reason for establishing a national system of schooling with a national curriculum. Similarly, a strong local identity and culture can be a reason for a separate jurisdiction and a different curriculum. For example, in the Netherlands, in the province Friesland, primary and secondary schools also give lessons in the Friesian language.

The existence of non-rational behaviour and non-economic motives can also increase the scope for political economy, i.e. the possibilities for persons and lobby groups to influence the political decision-making process for their own benefit, e.g. misusing arguments of identity.

Agency theory and transaction cost economics

Agency theory stresses the importance of incomplete and asymmetric information for contracts between economic actors, like between the employer and the employee and the insurer and the insured. The political process can also be regarded as a principal agent problem: the voter is the principal and the politician is the agent that does not do what the voter wants due to information problems and transaction costs.

Agency theory can also be applied to the division of tasks between central and local government. The central government can be regarded by the local government as a lender of last resort. This gives the local government a moral hazard problem, i.e. an incentive to spend more than is wise for sound local public finance. The design of the transfers by the central government may also stimulate moral hazard by local government. For example, when some expenditure by the local government is substantially co-financed by the central government, local government has the incentive to exaggerate the benefits and underestimate the costs and risks. To remedy such moral hazard, central government could take over activities of local government. An alternative is to introduce monitoring and independent analysis (e.g. of the health of local public finance or of the costs and benefits of specific projects) or use compensating incentives. For example, fines for providing misinformation about local expenditure or the introduction of a strict supervisory regime and substantial mandatory increases in local taxes in case of substantial local budget deficits.

Table 2.6 Decentralisation versus centralisation according to agency theory and transaction costs economics

Advantages of decentralisation	**Advantages of centralisation**
Decentralisation should be accompanied by monitoring, benchmarking and incentives to compensate for moral hazard	Corporations with affiliates in various locations should preferably face the same local rules and procedures for all their affiliates; this reduces their administrative burden
	Complex and risky projects demanding high technical or managerial expertise should be centralised or outsourced
Big bureaucracies have high internal transaction costs and suffer from control loss, decentralisation can keep bureaucracies small and efficient	
Polycentric systems are more efficient than rigid and hierarchic top down structures	
In a large and heavily populated country, decentralisation is more desirable	In a small country centralisation is more desirable

Neo-classical economics ignore transactions costs. In striking contrast, transaction cost economics stresses the importance of transaction costs for the efficient organisation of corporations, government and the whole economy. Major advocates of transactions cost economics, like Williamson, Dixit and Ostrom, do not start from a simple dichotomy between markets and government and do not look for signs of market or government failure. They stress the variety, complexity and dynamics of the relationships between all kinds of public and private actors and look for specific improvements. According to Dixit (1998, p. XV): "The transactions-costs politics view leads me to argue that the political process should be viewed as ... a process- taking place in real time, governed and constrained by history, and containing surprises for all parties. In this view, the traditional dichotomy of markets versus governments ... largely lose their relevance. Markets and government are both facts of economic life, and they interact in complex ways ... The most we can do is to understand how the combined economic-political system evolves mechanisms to cope with the variety of transactions costs that it must face." According to North (1990), transactions costs are even more important for political markets than for more conventional markets.

Major merits and limitations of decentralisation in view of transaction costs theory are summarised in table 2.6. According to Williamson (2002), complex and uncertain projects should be organised at a high level of governance. Some of these projects may also be outsourced to private partners with a lot of technical and managerial expertise. However, such outsourcing may be subject to moral hazard, as the private partners can have a strong incentive to leave all major risks for the government and it is very difficult for the government lacking such expertise to monitor and prevent this.

In the Netherlands, the disaster with the new North-South underground railway in Amsterdam illustrates these issues. According to the municipal committee of inquiry (2010), the costs for the municipality Amsterdam will be 1.4 million euro instead of 0.3 million euro and the underground railway will be ready in 2017, i.e. eight years later than initially planned. Major causes for this disaster are the absence of independent cost-benefit analysis that could have clarified the risks of this project and major alternatives, insufficient managerial and technical experience for such major incidental projects at the municipal level[4] and too much dependence on hired private expertise; such private experts lacked incentives to control the costs and planning and to inform the town council well and in an early stage.

Williamson (1967) also argued that large hierarchic organisations suffer from control loss, as information gets distorted by transferring it from one level of hierarchy to another. This control loss due to distorted information can be limited by limiting the size of an organisation. This is an argument in favour of decentralisation and smaller organisations. However, for decentralised units to be efficient and effective, they must be sufficiently large in terms of population, activities and income.

According to Ostrom (2005a, 2005b), polycentric systems can be more efficient than rigid and hierarchic top down structures. She studied police service delivery in mid-sized metropolitan areas throughout the United States and concluded that when it comes to the size of a police organisation, bigger is not necessarily better. Smaller police agencies often deliver more personalised services, have higher clearance rates and are able to deploy a higher proportion of their personnel on the street. Metropolitan areas in the USA are policed by a patchwork of agencies, but have also developed locally cooperative networks for delivering public safety across jurisdictional lines. These networks are glued together with an array of formal and informal agreements. Consolidation may therefore be a good solution for some communities, but it is likely not to be a universal cure for improving the performance of police.

Agency theory and transactions cost economics have also some clear messages for an efficient design of transfers:

[4] Such knowledge is only available at the national level, i.e. at the Ministry of Transport and infrastructure.

- General and specific transfers by central government are to be allocated on the basis of objective data and criteria.
- Local authorities have an incentive to misrepresent relevance, costs and benefits of local projects. This argues for monitoring and independent auditing. If this is not effective or very costly, this could also mean that centralisation or general lump sum transfers by the central government are to be preferred to granting specific transfers to local government.

Urban economics and new economic geography

Due to the work of economists like Glaeser and Krugman (see e.g. Glaeser, 2011 and Krugman, 2010), urban economics and new economic geography have been flourishing since the 1990s. These theories stress the importance of location and proximity for producers and consumers and come up with several surprising insights. The drastic fall in costs of transportation and communication during the past decades would suggest a decrease in the value of proximity, density and closeness and therefore the decline of cities. However, better and cheaper communication does not reduce the willingness of people to meet personally, but actually increases it. Furthermore, technological change has increased the returns to knowledge that is produced by people in close proximity to other people. As a consequence, cities still remain attractive for producers and consumers and have continued to be major drivers of economic growth.

Government policies and fiscal decentralisation arrangements should take account of this important role of the city. From this point of view, tax policy, spatial planning arrangements, the delimitation of jurisdictions and transfers from general government to local government should not deter the growth of cities but be spatially neutral. For example, taxes of urban regions should not serve to stimulate poor rural regions. Furthermore, subsidies on homeownership stimulate to abandon cities, as space is scarce in cities and home-ownership is much more common in rural areas. Similarly, subsidies on infrastructure may stimulate working in the city and living outside the city. Such subsidies on homeownership and infrastructure can therefore have adverse effects on the financing of cities via local taxes and on economic growth.

Urban economics and new economic geography have also changed the perspective on regional policy (see also Brakman et al., 2005). They clarify that regional policy often fails to reduce regional disparities in productivity and income. Core regions tend to be better off than their surrounding peripheries. And core-periphery structures are hard to upset since agglomeration advantages pull economic activities to the cores. Policy makers should recognise that disparities between provinces and between regions within provinces are persistent. Regional development funds should therefore be targeted to regional growth poles. But there is here an equity-efficiency trade-off. Agglomeration is positively related to overall productivity and growth, but negatively related to wage equality. Moreover, improving the access of peripheral regions with infrastructure, may also stimulate to live, work and produce in the core and not anymore in the periphery. For example, in the Netherlands, a new tunnel under the Westerschelde-river was intended to improve the accessibility of the town

Terneuzen via Goes, another town in the province of Zeeland. However, the effect was that inhabitants of Terneuzen could more easily accept a job outside their town, e.g. in Goes. Some corporations joined their employees and Terneuzen became a forensic town instead of a new economic centre.

From the perspective of urban economics and new economic geography, it is much more effective to help poor people instead of poor regions. Poor people can help themselves by moving to regions with better prospects. Government could stimulate this, but they should in general not try to create jobs for poor people in poor regions, as this will not work, will be very costly and part of the benefits will leak to other parties, e.g. owners of land or housing. In the Netherlands, the disaster with Blue City illustrates this. Blue City was a project to revitalize the poor region Eastern-Groningen by creating an artificial lake for recreation and building a new village of 1500 houses for the rich and elderly. However, despite major marketing efforts and public investments and some success in attracting recreational activities, after several years only 200 houses were sold. Last year, the municipality and province have therefore decided to redesign and downgrade the project substantially. According to an evaluation by the provincial court of auditors, the project was based on wishful thinking without serious analysis of the prospects, risks and alternatives.

3 Dutch central and local government in view of history

3.1 Introduction

The history of fiscal decentralisation in the Netherlands reveals major shifts from centralisation towards decentralisation and vice versa (see table 3.1). Current fiscal decentralisation still reflects to a great extent the constitution of 1848. This constitution was designed by the liberal Prime Minister Thorbecke. It drastically limited the power of the king, introduced elections for those paying taxes and divided the responsibilities over the central government, provinces and municipalities. In the Netherlands, the latter division of tasks is often referred to as Thorbecke's house of three floors.

Table 3.1 Dutch fiscal decentralisation since 1500

Before Thorbecke's house (= before constitution of 1848)	
1500-1580	Part of the Habsburg empire: efforts by the Catholic kings to impose one tax system and one religion
1581-1794	The Dutch Republic of United Provinces: a federal state
1795-1847	A unitary and centralised state imposed by the French; after 1814 Kingdom of the Netherlands
Thorbecke's house (= constitution of 1848)	
1848-1928	A unitary and decentralised state: more responsibility for municipalities, provinces reintroduced but with a much less prominent role
1929-1982	A centralised welfare state
1983-present	A smaller and more decentralised welfare state

This chapter starts with two episodes before the construction of Thorbecke's house. Section 3.2 is devoted to the first federal state in modern history, i.e. the Dutch Republic of United Provinces. Its successor, the unitary and centralised state imposed by the French, is the topic of section 3.3. In section 3.4., Thorbecke's house and its major changes during the past 160 years will be discussed.

3.2 The Dutch Republic of United Provinces[5]

The Dutch Republic of United Provinces was the first federal state in modern history. It started as a revolt against the reign of King Philip II of Spain. The Dutch revolted because of high taxes, persecution of Protestants and efforts to modernise and centralise the medieval government structures of the provinces. In a legal and formal sense, the republic was a confederation of seven provinces cooperating to serve a common purpose. However, in practice and for major national policy issues, it was more like a federal state, dominated by the richest and by far most populous province (Holland) and its major cities, like Amsterdam.

[5] Major sources for this section are Israel (1998) and de Vries and van der Woude (1997).

To finance the federal expenditure, e.g. on defence, the only federal tax was import duties on foreign trade and other federal revenues were small. The rest should therefore be financed by contributions by the provinces. However, reliable and somewhat up-to-date information by province on variables like population, income and trade was absent. It was therefore decided that the provinces had to contribute in line with the 100 year old ratios used to finance the regular and irregular tax payments to the Habsburg Empire. This implied that Holland with a population of nearly 50% of the Republic contributed about 60%. Despite major uneven economic and demographic developments by province, these ratios were used for the next 200 years; only incidentally some modifications were introduced.

Table 3.2	**Dutch fiscal decentralisation before Thorbecke's house: The Dutch Republic of United Provinces**
1581-1794	- Major role for provinces and cities - Very limited central government dominated by the province of Holland and its cities - Cities have their own law, justice, coin and taxes - Municipalities mainly financed by excise duties - Local water boards increase in scale and are subjected to political control by the ruling elite

The Republic's tax system was not a uniform system. It could best be regarded as a harmonised federal system with regional and local variations, i.e. there were clear difference in tax rates and types of taxes but they reflected major regional difference in welfare, urbanisation and social and economic structure. Such a tax system was much more efficient than imposing one uniform system. In general, due to the important role of excise duties, the poor paid relatively more than the rich. Provinces were also forbidden to introduce taxes (e.g. import duties) that could harm trade with other provinces.

There was no national monetary policy in the Republic. During the first century, fourteen different national currencies were being used: two from Holland, one in each of the other six provinces and six from cities in the eastern part of the Republic. In addition, foreign currencies were very important. At the end of the seventeenth century, the number of national currencies was reduced to two, i.e. those of Dordrecht and Utrecht. Due to a permanent external trade deficit, a major part of these coins were exported.

The Republic became the richest nation in the world. The important role of merchants in Dutch politics implied that the Dutch institutions favoured economic growth. Religious tolerance encouraged skilled immigration. Economic enterprise was stimulated by clear property rights, an efficient legal system, sound banking and limited restrictions on international trade. Taxes were high but levied on expenditure rather than income. The independence of the local populations, which acted rather autonomously and were wealthy, kept the Netherlands from falling into the reign of absolutism that struck the rest of Europe with the Habsburgs and Bourbons. This avoided devastating the development of human capital and economic performance. It was a surprise to many that a nation not based on the church or on a single royal leader could be so successful. The constitution of the Republic was also a major influence to the U.S. constitution.

Dutch water boards originate from 1000-1200 and are one of the oldest democratic institutions in the world (see Kromhout, 2006). In order to control water by drainage and by building and maintaining dikes, ditches and barrages, local water boards were established consisting of all local farmers and other owners of property close to water. Each was responsible for proper maintenance of their part. Elections were held, taxes in kind or cash could be levied and in case of misbehaviour fines and even death penalties were possible. The job as head of the water board (count of the dike) was financially very attractive, as in addition to a fixed salary fees could be charged for all kinds of services. Over time, as the scale of water boards increased, corruption became quite common, e.g. a farmer could buy-off his duty of proper maintenance by paying some money to the head of the water board. Major flooding made clear that to effectively control the threat of water, water boards had to cooperate and merge. The scale of water boards drastically increased and they became subject to political control by the ruling elite.

But after the Golden Age of the Dutch republic, wars to contain the expansionist policies of France, burdened the republic with huge debts. Fierce competition for trade and colonies, especially from England, furthered the economic downturn. The three Anglo-Dutch wars and the rise of mercantilism and protectionism had a negative effect on Dutch shipping and commerce. Long-term rivalry between the two main factions in Dutch society, the Republicans and the Royalists, sapped the strength and unity of the country.

The decentralised decision-making system was not able to meet these challenges. The federal power was too small for major reforms, e.g. to introduce a more efficient and fair national tax system and abolish the arbitrary and unbalanced contributions by the provinces. As a consequence, provinces other than Holland could behave more and more like free riders. The debt of Holland was exploding and its tax burden increased to more than 50% of the wage of an unskilled worker. But the Dutch political elite were still not open for major reform, as the massive public debt was a major source of their income. The financial problems weakened the Dutch military power and therefore also the opportunities to protect its international trade. This all led to the economic and political collapse of the Dutch republic.

3.3 A unitary and strongly centralised state imposed by the French[6]

In 1795, a French ‘liberation’ army was invited by ‘patriots’ and helped to break up the political deadlock. William V, prince of Orange and last stadtholder of the Republic, fled to England and went into exile. In 1806, Napoleon made the former republic a kingdom with his brother acting as king. This was succeeded by full annexation and incorporation in the

[6] See for more details van Zanden and van Riel (2004).

French empire in 1810. The Batavian-French period ended with the departure of the French army and the start of the United Kingdom of the Netherlands in 1814.

During this Batavian-French period, the decentralised government structure of the Dutch republic was replaced by a unitary and centralised French-style state. This resulted in the establishment of a central government bureaucracy with various Ministries, a national tax office, a national tax system, compulsory military service, the abolishment of provinces and a national mining law claiming the ownership of all subsoil mineral resources. It also lead to major innovations like a constitution, legal code, population register, land register, family names, house numbers, standard weights (e.g. kilo, meter and liter) and a royal academy of science.

Table 3.3	**Dutch fiscal decentralisation before Thorbecke's house: a unitary and strongly centralised state imposed by the French**
1795-1847	- Establishment of a central government bureaucracy, constitution and law book - Provinces become part of central government - Introduction of a national tax system and abolishment of local excise duties - National mining law: all mineral resources are property of the national government - Water boards supervised by provinces - Introduction of a national system of primary schools mainly financed by fees - Central government tries to set minimum standards for the quality of roads and waterways; local government becomes responsible for their proper maintenance - 1814: Departure of the French, start of the Kingdom of the Netherlands - 1814: Creation of the Dutch central bank - 1830: Secession of Belgium

The national tax system implied that the rates for excise duties became the same for all provinces. The tax system was modelled after Holland's tax system. Holland's real estate tax was introduced in the other provinces. For the rural provinces, it implied a drastic increase of land tax and new excise duties on necessities, like bread and meat. In line with the ideals of the French revolution, the tax system should be made less regressive and fairer for the poor. However, efforts to introduce income tax were not very successful due to massive evasion and collusion with tax collectors. This was resolved by introducing several indirect taxes on income, e.g. on the number of domestic servants, the rental value or the value of the furniture. To ensure sufficient tax revenue, also high and uniform excise duties on necessities, like salt, soap, jenever, turf, milling and grinding, were added. Despite substantial lobbies from the rural provinces, taxing interest from public debt was not considered, as this would make it very difficult to issue new debt. It would also not be fair, as the rich owners of government bonds were already hit by big holding losses. This new national tax system applied for nearly a whole century.

The French mining law of 1810 claiming the state's ownership of all mineral resources was included in the laws of the new Kingdom. This law in French was abolished only nearly two centuries later, i.e. in 2003. Due to this law, the ownership of charcoal found in the Dutch province Limburg and natural gas in the Dutch province Groningen clearly belonged to the central government and not to these provinces or private landowners. As a consequence, the discovery of these major mineral resources did not lead to any regional disparities in the Netherlands. This contrasts with the situation in e.g. Canada, where Alberta is by far the richest province due to its mineral reserves.

In 1814, after the departure of the French, William I became king. He was an autocratic and unselfish ruler with hardly any countervailing power from Parliament. He created the Dutch Central Bank, stimulated the construction of roads and canals ('canal king' was his nickname) and granted cheap loans to industries. The power of the King and the loss of political autonomy of the cities and provinces made it possible to choose a much more efficient routing of roads and canals than before 1795. The King could also impose agreement about the allocation of toll revenues to the neighbouring cities.

In 1830, Belgium started a secession war. Major grieves were under representation in the parliament, central government and army-officers, the unfair tax system and the huge interest payments mainly benefiting the economic elite in Holland. The new national tax system was considered unfair, because it abolished a lot of import duties protecting manufacturing in Belgium and raised excise duties which drastically increased the cost of living.

After the secession of Belgium in 1830, the autocratic rule by King William was not accepted anymore. The public debt was exploding and public finance had become unsustainable[7]. This was caused by high military expenditure (e.g. due to the secession war with Belgium), expenditure on canals and industrial policy, lower tax revenue due the abolishment of some excise duties and higher interest rates fuelled by the rising debt. The King abdicated and the constitution was changed, resulting in much more power for Parliament.

3.4 Thorbecke's house[8]

Thorbecke's house was constructed more than one and a half century ago. During this period, the demography, economy and political system of the Netherlands have changed dramatically. The population grew from 3 million to 17 million, implying an increase in population density with a factor 5. Life expectance doubled from 37 years to nearly 80 years. Material welfare measured by GDP per capita increased tenfold. Also the structure of the Dutch economy was totally transformed. In 1850, agriculture and fishing were responsible for 40% of total employment; their share has now dropped to 3%.

[7] For an overview of the history of Dutch fiscal policy, see Bos (2008).

[8] Major sources for this section are van Zanden and van Riel (2000), van Zaalen (2002),van der Voort (1994), van Zanden and Griffiths (1989), Goedhart (1967) and Bos (2006).

Figure 3.1 Total public expenditure and the role of municipalities and provinces

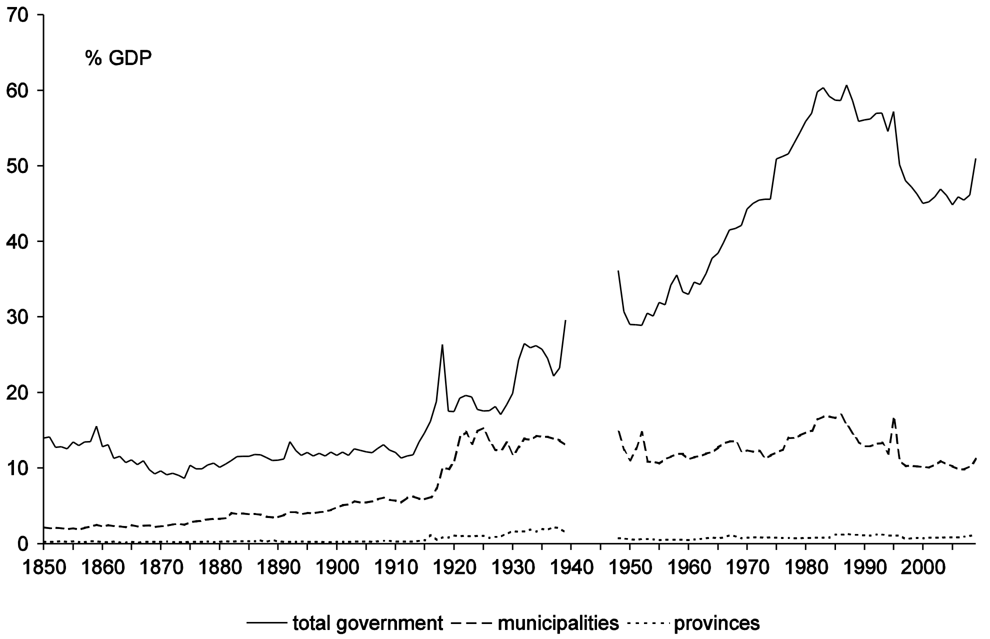


Figure 3.2 The number of municipalities since 1850

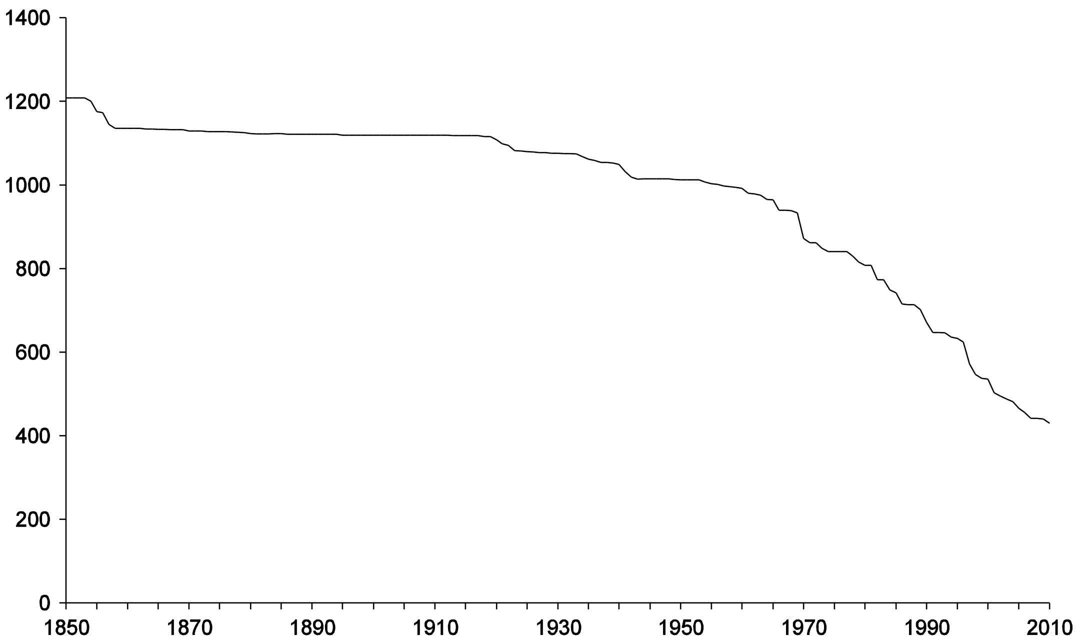


Figure 3.3 **Taxes and social security contributions by type of government (1850-2009)**

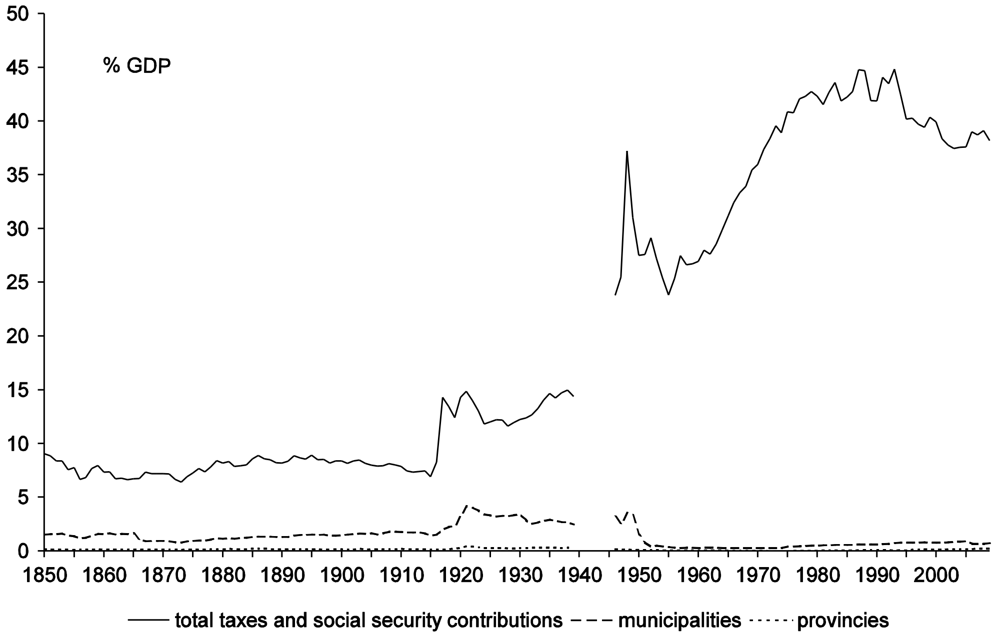


Figure 3.4 **Public debt by central and local government as % GDP (1850-2009; data source: Statistics Netherlands)**

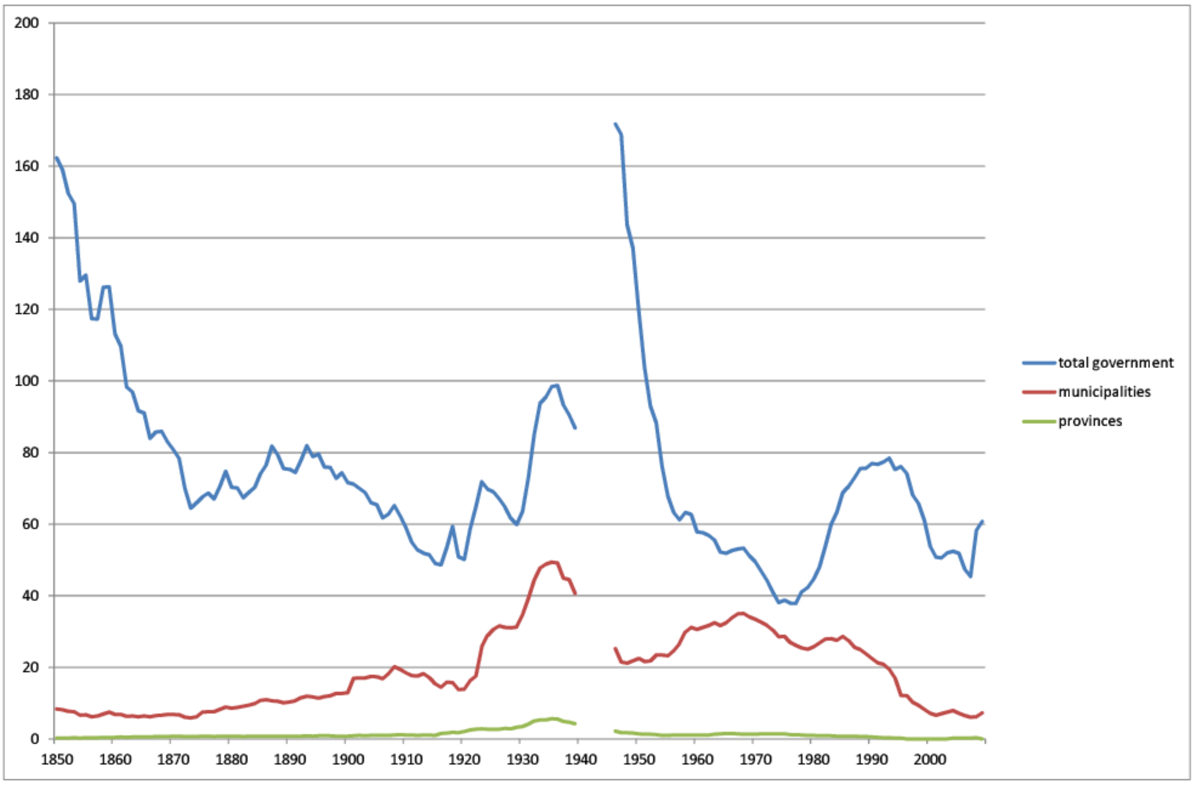


Figure 3.5 Expenditure on primary education by government and private institutions (data source: van der Voort, 1994)

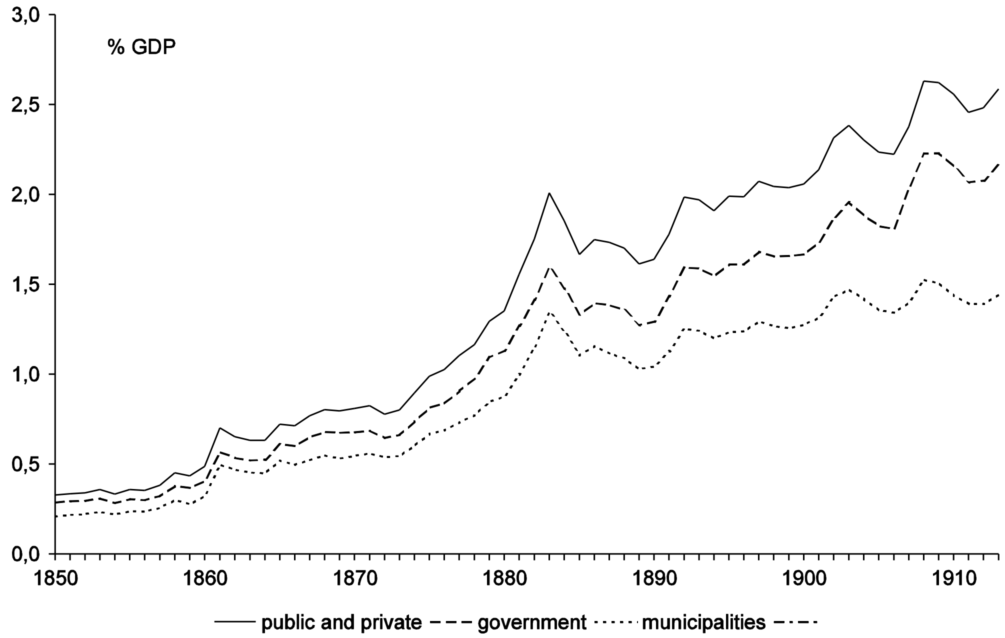
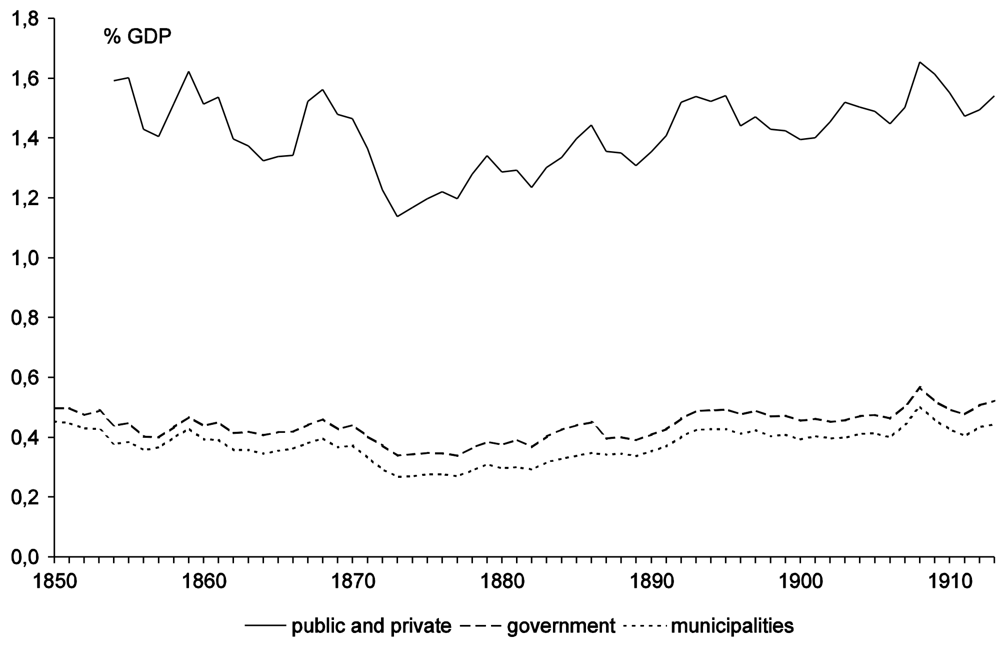


Figure 3.1 Expenditure on poor relief by government and private institutions (data source: van der Voort, 1994)



Inventions like telegraph, telephone, radio, television, internet, steamships, bicycles, trains, cars and planes have created a whole new infrastructure of mass communication and mass transport. Already in 1892, the neurologist Nordau noted that "due to the enormous increase in communication and mobility, the world of an average villager is larger than that of the prime minister of a country one century before – that villager discusses the famine in Russia, a rebellion in Chili, the scandal with the Panama-channel and the world exhibition in the USA. The correspondence of a maid is currently larger than that of a professor a century ago" (Nordau, 1892 according to van der Woud, 2008, p. 99). In the Netherlands, in the period 1850 to 1920, the time needed to travel from one location to another was already drastically reduced by the massive government investments in train and tram. At present, the number of passenger cars is about half of the Dutch population and by public or such private transport people can reach in some hours any place in the Netherlands.

The role of the government also drastically increased: in 1850, public expenditure was 14% GDP and –after a peak of 60% GDP in 1983- it is now 50% GDP. The expenditure by municipalities and provinces increased from 2% GDP to 18% GDP in 1983 to currently 12% GDP.

However, at the same time the number of municipalities drastically decreased, from 1209 in 1850 to currently 430. In 1850, the ten smallest municipalities all had less than 100 inhabitants[9]. One century later, the ten smallest municipalities had between 200 and 400 inhabitants. Currently, Schiermonnikoog is the smallest municipality in the Netherlands with 900 inhabitants and the largest of the ten smallest municipalities has now 6 thousand inhabitants.

A similar drastic increase in scale occurred for water boards: the number of water boards decreased from 3500 in 1850, 2500 in 1950 to currently 27. This drastic increase in the scale of these two types of local government contrasts with the development of the number of Dutch provinces: this was constant and even increased in 1986 to 12 when due to the reclamation of land one new province (Flevoland) was created.

Economic theory (see section 2) offers various explanations for the drastic reduction in the number of municipalities and water boards since 1850:

- The drastic increase in the number and complexity of tasks of the government has drastically increased the minimum scale required for adequately and efficiently performing these tasks.
- The advance of technology has made it much easier to perform such tasks at a larger scale.
- National government policy to ensure that the same set and quality of local public services is provided in the whole country reduces the scope for taking account of local preferences. As a consequence, the potential welfare gains of having many different small municipalities better taking account of differences in local preferences than larger municipalities is greatly reduced.
- The increase in communication and mobility, population density and urbanisation has increased the positive and negative external effects of public services and private activities.
- The increase in communication and mobility has also changed the identity of people. Many people now live, work or go to school in different places than where they were born and

[9] See NIDI, Bevolkingsatlas van Nederland 2000.

raised or are even commuting daily. As a consequence, identity has become less local. For example, in the Netherlands, the outcome of local elections is often determined to a very great extent by national policy issues.

- The increase in the tasks of the local government reinforces the need to contain local lobbies and personal interest and to ensure that really the public interest is served. This implies a scale of the municipality in which individual persons or families living in that municipality can not influence the decision-making process to their own benefit. This requires clear and transparent decision-making and auditing procedures, in particular for small municipalities.

Thorbecke's house is often characterised as a building with three floors: central government, provinces and municipalities; however, in striking contrast with the Republic of United Provinces, provinces play only a minor role in Thorbecke's house (see figure 3.2). The latter can therefore better be characterised as a building with two major floors (central government and municipalities) and one intermediate level (provinces).

In Thorbecke's house, local taxes have always been relatively small and varying between 1 and 5% GDP. This reflects that the Netherlands is a small country with a very open economy in which major differences in local taxes are not considered to be efficient or fair.

In terms of public debt, municipalities have played a major role. During the period 1920-1937, the increase of Dutch public debt from 50% GDP to 100% GDP was mainly due to the increase of debt by municipalities; the increase in local taxes was insufficient to finance the rapid increase in their expenditure. During the period 1950-1970, total public debt drastically decreased, even though the debt by municipalities increased. As a consequence, in the 1970s the major part of Dutch public debt was that of municipalities. From an economic theoretic point of view, this is not very efficient, as the central government should take the role of macro-economic stabilisation and its debt should preferably reflect the major macro-economic and political risks, i.e. those of economic crisis and war. The major role of the debt of Dutch municipalities during these two periods reflects major unbalances in the division of tasks with Dutch central government. Since the 1980s, the public debt figures suggest a much more efficient division of tasks.

In the remainder of this section, Thorbecke's house, i.e. the division of tasks between Dutch central and local government since 1848, will be investigated in somewhat more detail. Three periods are distinguished:

- A unitary and decentralised state (1848-1928);
- A centralised welfare state (1929-1982);
- A smaller and more decentralised welfare state (1983-present).

A unitary and decentralised state (1848-1928)

The increase in government expenditure during 1848-1928 reflects that government wanted to modernise the economy and to reduce social problems. Local government played a major role in improving education, housing and infrastructure (roads, channels, sewerage, water and energy supply), ensuring law and order (police) and giving poor relief. In this period, private parties like churches and charities were even more important than government to provide poor relief (see figure 3.6). The expansion of education served various purposes: to stimulate national identity, to increase the quality of labour and to fight poverty.

Table 3.4	**Thorbecke's house 1848-1928: A unitary and decentralised state**
	- Provinces reintroduced but with a much less prominent role
1848-1928	- All municipalities are granted equal rights; no special privileges anymore for cities
	- 1865: Abolishment of municipal excise duties
	- 1874: Law forbidding child labour under 12 years (but without any inspections)
	- 1901: Law introducing compulsory education for children between 6 and 12 years
	- 1902: Law for stimulating the quality and quantity of housing
	- Rapidly increasing expenditure on education mainly financed by municipalities. Since 1857: public schools are for a small part financed by the central government; since 1917, private (Christian) schools are given the same entitlements for public funding
	- Central and local government invest in infrastructure, public transport , housing and utilities (water, energy)
	- Increasing expenditure by municipalities financed by more debt and higher municipal income taxes
	- Increasingly national water control (1877 Ministry of water control)
	- 1914: Creation of the Municipal Bank serving municipalities and provinces
	- 1917-1919: Introduction of the general right to vote

The increasing expenditure by municipalities was financed by increasing the municipal indirect taxes on income and wealth and their debt. The gap between rich and poor municipalities widened rapidly. The poor municipalities could not raise much extra revenue by raising income tax, while they not only faced major increases in the expenditure on education and infrastructure, but had also to spend relatively more on poor relief. Raising the income tax rates in poor municipalities had even adverse effects, as it stimulated the moving of rich inhabitants from poor to rich municipalities. This migration was facilitated by the major improvements in public transport. In this period, the differences between local income tax rate were very substantial. For example, in 1927, the local tax for an income of 5000 guilders was 55 guilders in Wassenaar (a village famous in the Netherlands for its rich inhabitants and very impressive houses) and 700 guilders in Steenwijk! These problems were resolved in 1929: the municipal indirect taxes on income were abolished and a municipality fund financed by a national municipality fund income tax was introduced. The purpose was not only to reduce the major differences between municipal income tax rates, but also to ensure the same level of public services in each municipality.

In 1914, in order to facilitate financing the increasing local debt, a special municipal bank was created. This bank focused on providing short term credits for specific investments and did not check whether the financial situation of a municipality allowed such investments with an uncertain return. The Dutch central bank therefore intervened. In 1922, the old bank was abolished and replaced by a new municipal bank of which half of the equity stock was owned by the central government and the other half by municipalities, provinces and water boards. The bank stimulated more long term financing of investments and started to serve as an intermediary for payments between central government and local government and between different units of local government.

A centralised welfare state (1929-1982)

The transfer by the new municipality fund was based on two indicators: one for income and one for need. If the disposable household income in a municipality was high in comparison to the national average, this increased the transfer. Similarly, if the expenditure on education, police and poor relief were relatively high, this increased the transfer. The economic crisis reduced the revenues from the municipal fund income tax and increased the local expenditure on poor relief. As a consequence, a major part of the municipalities got serious financial problems. Central government alleviated these problems by providing short term credits. In 1933, a law was introduced for supplementary support by the central government for highly indebted municipalities. This law also gave the central government the possibility to interfere with the municipal autonomy and to impose policy measures, e.g. increases in local tax rates to the maximum permitted or to forbid any new expenditure.

Table 3.5	**Thorbecke's house 1929-1982: A centralised welfare state**
1929-1982	- 1929: Abolishment of municipal indirect taxes on income and introduction of municipality fund - 1929-1931: National standards for accounting and budgeting by municipalities and provinces - 1933: Law for supplementary support to highly indebted municipalities - Central government assumes more and more responsibilities for social security and health care. - Many new specific transfers by central government to local government, non-profit institutions and firms - Housing improved by minimum standards & subsidies to housing corporations and municipalities - Refinements in the distribution formulae for transfers by central government to local government - 1954: After the disastrous flooding of 1953, creation of water board bank for financing dikes - 1960: Redesign of the transfers from central to local government - 1963: First law to restrict and regulate loans by municipalities and provinces - 1970: Provinces loose their local tax; 1981 Provinces get a surcharge on the national car registration tax - Since 1958: increasing role for European Union, i.e. part of national policy transferred to European level - Since 1970: continuing decrease in number of municipalities, i.e. increase in their scale

The first national standards for accounting and budgeting by provinces were issued in 1929; two years later, standards for municipalities followed. The standards prescribed cash accounting and the distinction between a current and a capital account. Provinces and local government were obliged to comply with the golden rule of public finance, i.e. current expenditure should be financed out of current revenue and investments could be financed by loans. Improvement of local accounting and budgeting was urgent considering the financial problems and the enormous increase in size and diversity of activities during the preceding decades. The impact of local government on national spending and lending could not be ignored anymore. Macro-economic information on the aggregate local government was needed by the central government and central bank for their economic and monetary policy. The new standards made it possible to aggregate the figures of individual municipalities and provinces.

The abolishment of the municipal indirect taxes on income did not mean that local taxes became a minor source of finance. For example, in 1932, municipal surcharges on national taxes on income and wealth were twice as much as the revenue from the municipality fund. In practice most of their rates were equal to the maximum rate set by the central government. As a consequence, the municipalities did not have much freedom in differentiating the rates of their surcharges and adjusting them to local needs and preferences.

During the period 1929-1982, Thorbecke's house became a centralised welfare state. The central government assumes more and more responsibilities for social security and health care. This is reflected by major acts, e.g. Sickness insurance act in 1929, Health care insurance act in 1941, Unemployment insurance act in 1952 and Old age pension act in 1956. The Dutch central government tries to direct the development of the Dutch economy and society through many new subsidies, investment grants and other transfers to local government, private firms and non-profit institutions. This is financed by extra taxes, social security contributions, the unexpected revenues from natural gas and –since 1979- a rapidly rising government deficit and debt.

In the period 1950-1982, Dutch public expenditure doubled from less than 30% GDP to over 60% GDP. The welfare state with its generous social benefits had an adverse effect on employment and labour supply and the Dutch economy. Since 1970, employment as a percentage of the potential labour force, i.e. the population between 18 and 64 years, decreased with nearly 40%. The stagnating Dutch economy and unsustainable public finance necessitated a drastic change toward a much smaller welfare state with less generous social benefits.

Directly after the Second World War, two-third of all municipalities had severe financial problems. Two new earmarked transfers for education and poor relief were introduced and put equal to the annual average of the corresponding expenditure by municipalities in the period 1939-1941. More and more requests for supplementary support were also granted by central government. In 1955, two-third of the thousand municipalities received such support.

In 1960, in order to replace the ad hoc and rather subjective system of transfers from central to local government, there was a major revision of this system of transfers. The general purpose was that these transfers should be sufficient to structurally finance the regular activities of municipalities and to the extent that they could not be financed out of local taxes or tariffs. In line with the government's budgeting principles for the central government (see Bos, 2008), the level of the general transfer was linked to trend based economic growth rate and increases in wage rates were fully compensated. In this period of rapid economic growth, this implied that also the transfer by central government to municipalities increased rapidly. The formula for distribution of the general transfer over different municipalities was linked to the number of inhabitants and size of the surface area;

bigger municipalities received more per inhabitant. For specific transfers, more specific criteria were also taken into account.

This new and generally more generous system did not resolve the financial problems of all municipalities. In particular the city of Amsterdam claimed that it was underfunded (see Moor and Slot, 2003). The marriage of the crown princess Beatrix in Amsterdam in 1966 served as a catalyst. Central government wanted to give Amsterdam some money for the extra costs (e.g. safety), but Amsterdam showed that this was not at all sufficient. Central government raised its initial bid, but Amsterdam was still not happy. The wedding ceremony was accompanied by major rows and uprisings. According to Amsterdam, this reflected that the quality of life in Amsterdam was low due to housing shortages, chaos on the roads, bad public transport and problems with the young. These problems by Amsterdam could not be resolved due to a fundamental lack of resources. Amsterdam also claimed that it had many specific costs, e.g. its academic hospitals were more expensive than normal hospitals, the infrastructure for the harbor urgently needed improvement and public transport could only to a limited extent be financed out of tickets. The central government partly agreed with these claims. However, it also distrusted Amsterdam for not willing to increase its efficiency, taxes and tariffs and the absence of any solid underpinning of its claims. These problems were only resolved when the alderman for Finance of the city of Amsterdam (Polak) first started to improve Amsterdam's accounting, including analysis of the causes of the various types of expenditure overruns, and then became secretary of state of internal affairs in the central government. In this job, he made the Ministry of Internal Affairs the coordinator of the contacts of 16 different ministries with the city of Amsterdam. In 1976, after tough negotiations based on analysis of the various claims, central government agreed to raise its transfers to Amsterdam by changing the distribution formula of the general transfer more in favor of big cities, by introducing some new specific transfers often relevant for big cities, by granting money via the law for supplementary support for highly indebted municipalities and by financing the new city hall.

A major problem with judging the requests via the law for supplementary support was the absence of clear criteria. Since mid 1970 various efforts have been undertaken to define in more objective terms the acceptable reasons for financial problems, i.e. those reasons that warrant supplementary support by central government. Distinctions were made between structural reasons (e.g. extremely high expenditure on poor relief), distortions in the distribution formulae of general and specific transfers by central government and specific reasons. To be accepted as a distortion in the distribution formulae the reason should be general and be relevant for at least a group of municipalities. Rough quantification of the effects should also be possible. On the basis of a lot of analysis and discussions between central and local government, the distribution formula of the general and specific transfers were improved and refined on the basis of objective criteria. This drastically reduced the need to ask for funding via the law for supplementary support and defined much more clearly the responsibilities of individual municipalities to resolve their financial problems.

After the Second World War, central government started to regulate municipal investments and loans via ad hoc interventions, e.g. via regulation of the maximum interest allowed on municipal loans. In 1963, this ad hoc policy making was replaced by a law. The basic principle was that investment should not be fully financed out of loans but partly by cash, e.g. at least 25%. In addition, in periods of economic downturn, also a maximum on the aggregate loans by local government could be introduced directly or indirectly by introducing obligatory financing via the municipal bank and restricting this to the resources available.

A smaller and more decentralised welfare state (1983-present)

The transformation into such a smaller welfare state was successful: despite rapidly increasing expenditure on health care, Dutch public expenditure are now about 10% GDP lower than in 1983 (see table 3.7). The transformation was inspired by supply side economics and micro-economic thinking and the philosophy of New Public Management to run the government like a business. This implied privatisation, deregulation and decentralisation and a greater role for incentives and performance management.

Table 3.6	**Thorbecke's house 1983-present: A smaller and more decentralised welfare state**
1983-present	- Social assistance and public care services become more responsibility of municipalities; - An increasing role for public agencies, private firms and incentives; - Privatisation of public corporations and deregulation of housing corporations (1995); - 1985: Accrual accounting for municipalities and introduction of local policy management accounting - Reduction of number of specific transfers to local government, increase of general transfer - Public schools become more independent from municipalities - Police regions replace municipal police (1993); 2015: national police replaces police regions - Continuing decrease in number of municipalities, i.e. increase in their scale - Introduction of city regions - Introduction of functional regions for safety and preventive health care - National fiscal policy becomes embedded in European fiscal policy framework, national monetary policy is transferred to Europe (1993, Treaty of Maastricht)

This also had many implications for the division of tasks between central and local government:

- Privatisation implied selling corporations owned by central and local government, like provincial and municipal banks, water and energy companies and transport companies.
- Deregulation implied a more independent role for e.g. public schools and public and private housing corporations. The role of municipalities in public schools has been reduced: many formerly municipal schools for primary and secondary have been transformed into independent schools receiving their financing directly from the central government. Municipal housing corporations were often transformed into private non-profit organisations. In 1995, the annual subsidies to all Dutch housing corporations were stopped and bought off by a lump sum transfer of 5% GDP.

- Deregulation and decentralisation also implied abolishment and grouping of many specific subsidies, investment grants and other transfers. Already in 1975, central government was aware of the problems with having many small and specific transfers to local government. However, only from the mid-1980s this process of abolishing and grouping specific transfers really started.

Table 3.7 Dutch public expenditure 1970-2009 (data source: CPB standard tables on Dutch public finance)

	1970 level % GDP	1983	2009	1970-1982 change	1983-2009 change
Distributive policy	23.5	36.3	30.1	12.7	– 6.1
Social security	11.4	20.0	12.5	8.6	– 7.5
Health care	2.8	4.8	9.7	2.1	4.9
Education	6.3	6.3	5.5	0.0	– 0.7
Transfers to corporations	3.1	5.2	2.4	2.1	– 2.8
Other policy	17.9	18.6	18.6	0.7	0.1
Public administration and safety	10.3	12.0	13.6	1.7	1.6
Defence	2.7	2.9	1.3	0.2	– 1.7
Infrastructure	3.0	1.7	1.9	– 1.3	0.2
International cooperation	1.9	1.9	1.9	0.1	0.0
Interest	2.9	5.6	2.2	2.7	– 3.4
Total public expenditure	44.3	60.4	51.0	16.1	– 9.4

- More incentives implied a change in financing Dutch social assistance benefits. In the past, municipalities could claim most of their expenses on social benefits to the central government. However, since 2004, they receive a fixed budget which is insulated from the macro-economic developments through a calculation by the CPB. As a consequence, municipalities now have an incentive to reduce the number of social assistance benefits. This new policy seemed to be very successful, as the number of social assistance benefits hardly increased in 2004 and 2005 despite a substantial increase in unemployment. However, recent research (Roelofs and van Vuuren, 2011) indicated that municipalities had mainly reduced social assistance benefits by substitution with the nationally financed disability insurance for the young; a decentralisation of (part of) this disability insurance would remove local governments‟ incentives to divert young people from social assistance to disability insurance.
- More decentralisation and incentives implied that since 2006 municipalities have taken over various tasks of the national social security arrangements for special care, e.g. nursing and cleaning services for elderly and handicapped people.

- Decentralisation implies that child welfare will soon be the responsibility of municipalities and that the role of provinces and central government agencies will be stopped.
- For several decades, local government, some official government commissions and professors in economics advocated that the role of local taxes should be increased in order to better meet local preferences and to stimulate sound financial management. However, in 2006, the opposite happened: part of the local real estate tax was abolished by the national government and replaced by funding via the general transfer to municipalities. Furthermore, for the remainder of local real estate tax, maxima were introduced for the rate and its annual increase. In this way, the right wing national government wanted to reduce and better control local taxes and to avoid that these were used by (left wing) local government to finance extra expenditure or bad financial management.

In order to increase efficiency, several other major changes in the provision of local services were initiated:

- The number of municipalities was reduced with more than 40%, from 773 in 1983 to 440 in 2009.
- Since 1980, Amsterdam is not only organised as a municipality, but it has also introduced boroughs to govern the various neighbourhoods. Amsterdam started with 16 boroughs, but these have been reduced to 6. Rotterdam has followed this example and has introduced 14 boroughs.
- In line with the new public management philosophy, the Ministry of Internal Affairs, the Association of Dutch Municipalities and the Association of city managers started mid 1980s a program to improve financial reporting of municipalities and to start policy management accounting. The City of Tilburg became well-known all over the world for its business-like municipal organization with an advanced managerial information system linking budgets to measurable policy goals (see Hendriks and Tops, 2003).
- Starting from 1994, several city-regions were introduced; at present, there are eight. These are co operations of the major cities and their neighbour municipalities. They cooperate in particular with respect to spatial planning, transport, housing, purchases of land, economic affairs and environmental policy.
- For safety issues like fire, disasters and public order, 25 functional regions have been introduced. These safety regions consist of co operations between municipalities and government agencies, like fire brigades, police, and medical units. The police regions coincide to a great extent with these safety regions. However, a major difference is that safety-regions are financed and organised by local government, while police regions are financed and supervised by the central government. The new central government has decided

to introduce a national police. Geographically, the eight city-regions correspond with eight safety and police regions.

- For coordinating preventive health care by municipalities, also functional regions have been introduced. This started in 1990 with 63 regions, but it has been scaled up to currently 28 regions; for the major cities, this geographically corresponds well with the city-regions.

In 2002, in order to increase accountability and democracy at the municipal level, a new law was introduced. Before 2002, the council could be regarded as the local government and the mayor and aldermen were responsible for actually managing the municipality. Due to the new law, the council becomes more like a parliament that should monitor and check local government, i.e. the mayor and aldermen. To support the council, courts of auditors have been introduced for all municipalities; these courts of auditors should check the legitimacy, effectiveness and efficiency of municipal expenditure and revenue. Furthermore, aldermen are not allowed any more to be simultaneously member of the council. Finally, aldermen could also be recruited without being first member of the council. Efforts to abolish the appointment of mayors by the central government and to choose mayors via local elections failed. However, for some years, councils have much more influence on the appointment of the mayor, e.g. by defining the profile for the new mayor and by introducing a referendum for choosing between the official candidates.

Already since the end of the 1950s, European unification is a major development. It has added a new European layer of government on top of Thorbecke's house. This new government has introduced new laws, rules and procedures (e.g. to ensure fair competition and procurement or to protect the environment), subsidies for poor regions and agriculture and a common fiscal and monetary policy.

In order to receive European subsidies and to influence European regional policy, Dutch local government has to communicate and compete with other, often much larger, European regions.

The European fiscal policy targets refer to the whole government sector, i.e. including not only central but also local government. To the surprise of the Dutch Minister of Finance, in 2003 the Dutch government deficit surpassed the EMU-target of 3% GDP; a major cause was the unexpected and large deficit of Dutch local government. As a consequence, municipalities and provinces have now also to report on their net financial balance[10] and the Dutch Ministry of Finance has allotted a maximum for each municipality and province. The latter becomes relevant when the deficit of the whole Dutch government approaches the EMU-norm of 3% GDP.

[10] This national accounts concept of government deficit is fundamentally different from the public sector accounting principles used by Dutch municipalities and reserves. For example, holding gains on equity stock are not relevant for the government deficit according to the national accounts. However, they are included in the public sector accounting notion 'net operating balance'; the same applies to all kind of additions and subtractions from earmarked reserves. Another major difference is that the national accounts concept regards all purchases of land or capital assets by the full amount as expenditure and therefore as an increase in deficit.

4 Tasks and financing of Dutch municipalities and provinces

4.1 Description

Table 4.1 shows expenditure by Dutch municipalities for their different tasks; nine different functions are distinguished. Their total operating expenditure[11] was 10% of GDP, of which a third is spent on social assistance and social services.

Table 4.1 Operating expenditure of Dutch municipalities (including joint arrangements) by function in 2009 (data source: Statistics Netherlands, statistic on the budget of municipalities)

	Bln euro	% Total	% GDP	1000 euro per inhabitant
Social assistance and social services	19.2	34	3.4	1.2
Spatial planning and social housing	9.5	17	1.7	0.6
Health care and environment	6.3	11	1.1	0.4
Culture and recreation	5.0	9	0.9	0.3
Traffic, transport and watermanagement	5.6	10	1.0	0.3
Education	3.6	6	0.6	0.2
Public administration	4.1	7	0.7	0.2
Safety	2.2	4	0.4	0.1
Economic affairs	1.2	2	0.2	0.1
Total	56.5	100	9.9	3.4

Table 4.2 Operating expenditure of Dutch provinces by function in 2009 (data source: Statistics Netherlands, statistic on the budget of provinces)

	Bln euro	% Total	% GDP	1000 euro per inhabitant
Traffic and transport	2.1	32	0.4	0.1
Welfare	1.7	26	0.3	0.1
Recreation and natural environment	0.7	11	0.1	0.0
Environmental protection	0.6	9	0.1	0.0
Economic affairs and agriculture	0.5	8	0.1	0.0
Spatial planning and housing	0.4	6	0.1	0.0
Public administration	0.3	5	0.1	0.0
Watermanagement	0.2	3	0.0	0.0
Total	6.4	100	1.1	0.4

A similar overview for provinces is provided by table 4.2. Their total operating expenditure are 1% GDP. Traffic and transport is the function with the largest expenditure (30%). Also the welfare expenditure is relatively quite important (25%). However, when the responsibility

[11] This excludes expenditure on capital formation and includes a charge for capital consumption.

for child welfare will be transferred to municipalities as the current government is aiming at, it will shrink to about a third.

The importance of some tasks of provinces is not readily visible when only looking at their expenditure. A major task of provinces is the supervision of municipalities, e.g. their financial management. Provinces should also take action when municipalities have serious administrative problems or when there is a major political crisis.

Another major task of provinces is spatial planning. Since the sixties, spatial planning involves all three layers of government. The central government provides the most general philosophy and planning by structural policy papers and schemes, e.g. a separate fund for infrastructure; the central government is also responsible for translating European rules into national policy. Starting from this national framework, provinces make spatial plans for their region, i.e. what are the locations for housing, agriculture, natural environment, company grounds, roads etc. and what are the changes in the future. Starting from this provincial framework, municipalities make more specific plans and zoning schemes for future development. The provincial parliament then checks whether these municipal plans are indeed in agreement with the provincial plans.

Table 4.3 Size and composition of the revenue of municipalities in 2009 (including joint arrangements; data source: Statistics Netherlands, national accounts)

	Bln euro	% Total	% GDP	1000 euro per inhabitant
Transfer from municipality fund	17.7	37	3.1	1.1
Specific transfers by central government	12.9	27	2.3	0.8
Social assistance	9.4	20	1.6	0.6
Other	3.5	7	0.6	0.2
Sale of goods and services	11.3	23	2.0	0.7
Taxes	4.4	9	0.8	0.3
Property income	1.9	4	0.3	0.1
Total revenue	48.1	100	8.4	2.9

The largest source of revenue for municipalities is the general transfer by the central government. Since the end of the eighties, the size of the municipality fund and the fund for provinces are linked to the change in expenditure by the central government.[12] This implies that municipalities and provinces share proportionally in budget cuts and extra expenditure by the central government. For example, 1 billion euro extra expenditure on education or defence results into about 200 million euro extra revenue for the municipalities and provinces. In addition, in particular at the start of a new period of government, the government can decide for extra cuts or extra expenditure for the municipality fund or the fund for provinces.

[12] This excludes some specific expenditure, e.g. those on social assistance, development aid, infrastructure and the general transfer to municipalities and provinces; it also excludes the expenditure by social security funds. Starting from 2012, this will also exclude the increasing interest payments by the central government.

The specific transfers by the central government are the second largest source of revenue for municipalities. Table 4.4 shows an overview of the specific transfers by Ministry; those by the ministry of social affairs and employment are 60% of the total.

Table 4.4 Specific transfers to municipalities, joint arrangements and provinces by ministry (2009; source: Maintenance report specific transfers 2010)

	Bln euro	% Total	% GDP	1000 euro per inhabitant
Internal affairs	0.1	1	0.02	0.0
Economic affairs	0.1	1	0.02	0.0
Youth & family	1.3	9	0.23	0.1
Agriculture	0.5	3	0.09	0.0
Education and culture	0.9	6	0.16	0.1
Social affairs and employment	9.5	62	1.66	0.6
Traffic and watermanagement	2.1	14	0.37	0.1
Social housing, spatial planning and environment	0.6	4	0.10	0.0
Health care	0.1	1	0.02	0.0
Total	15.3	100	2.67	0.9
to municipalities	13.0	85	2.27	0.8
To provinces	2.3	15	0.40	0.1

The transfer by the municipality fund is allocated to individual municipalities on the basis of a very complex distribution formula using all kinds of objective indicators. This does not only take account of the number of inhabitants, but corrects also for differences in tax earning capacity (real estate value of dwellings and business property) and external circumstances, like a regional function or the social and physical structure. Indicators used are the number of households receiving social benefits, number of people from ethnic minority groups, number of young or elderly, density of addresses and the surface area of the historical centre. However, differences in other revenues, like interest, dividend or from the sale of land, are not taken into account. Supplementary to the general distribution formulae, the Frisian Islands and the four major cities receive a fixed amount. For the province fund and the specific transfers, similar complex distribution formulae are used.

Figure 4.1 shows that the transfer by the municipality fund is on average about 1000 euro per inhabitant in 2009. Due to the use of other indicators, for individual municipalities this ranged from 600 euro to more than 2.5 thousand euro.

Figure 4.1 Transfer of the municipality fund per inhabitant for all Dutch municipalities ranked by number of inhabitants (2009; data source: Statistics Netherlands, statistic on municipal budgets)

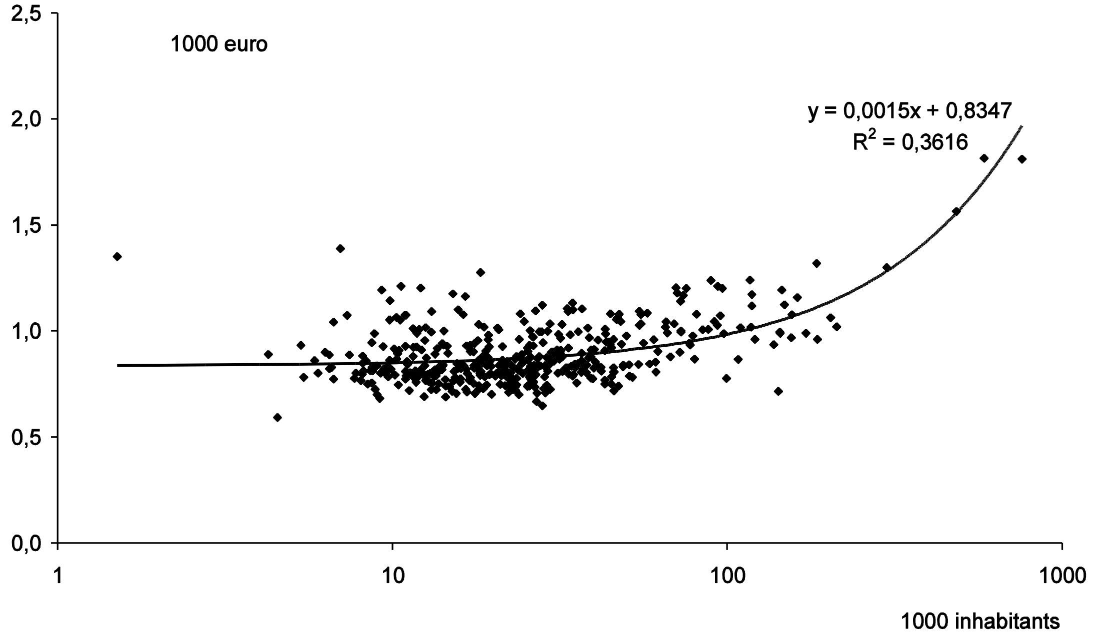


Figure 4.2 Transfers by central government to municipalities for the function social assistance and social services per inhabitant (2009; data source: Statistics Netherlands, statistic on municipal budgets)

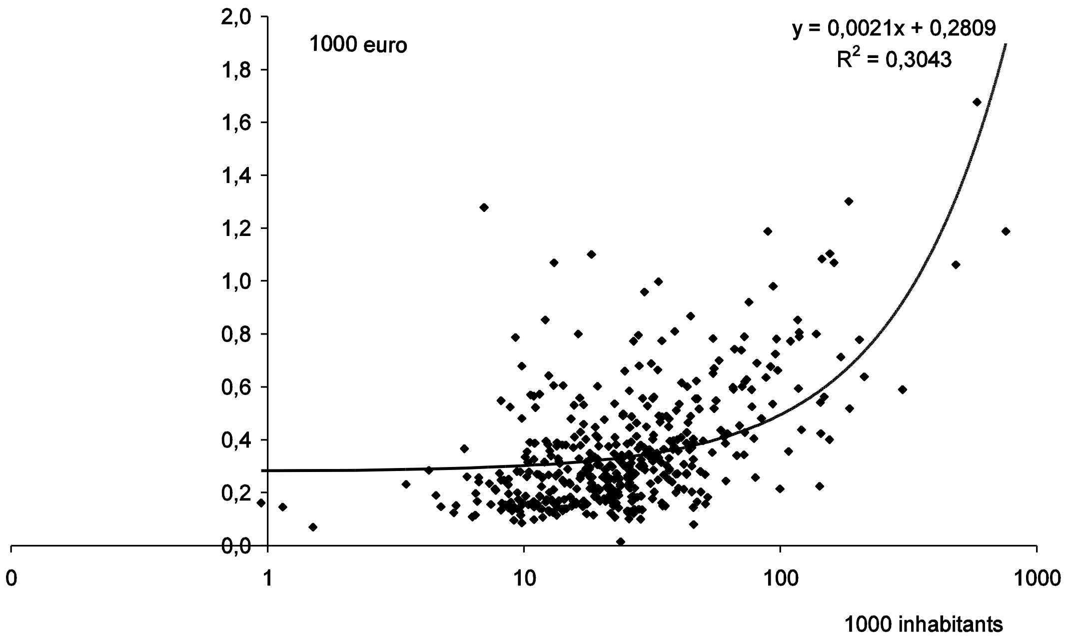


Figure 4.3 **Fees for building permits for a dwelling of 250 thousand euro in municipalities ranked by number of inhabitants (2009, data source: IGG)**

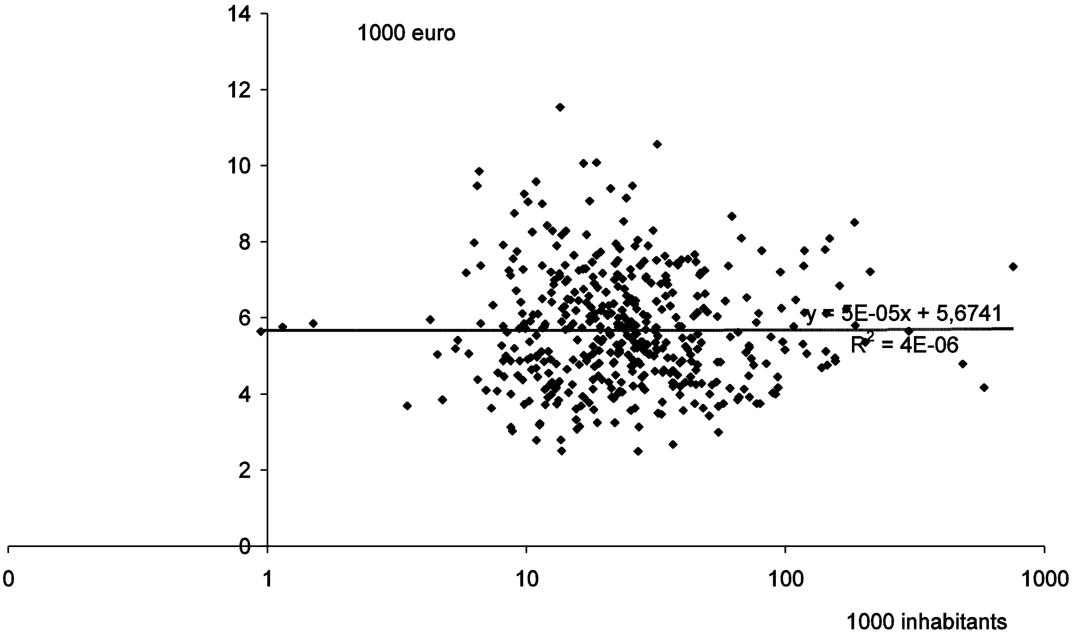


Figure 4.1 **Tariff of the real estate tax on dwellings by municipalities, % of officially estimated real estate value (2009, data source: COELO)**

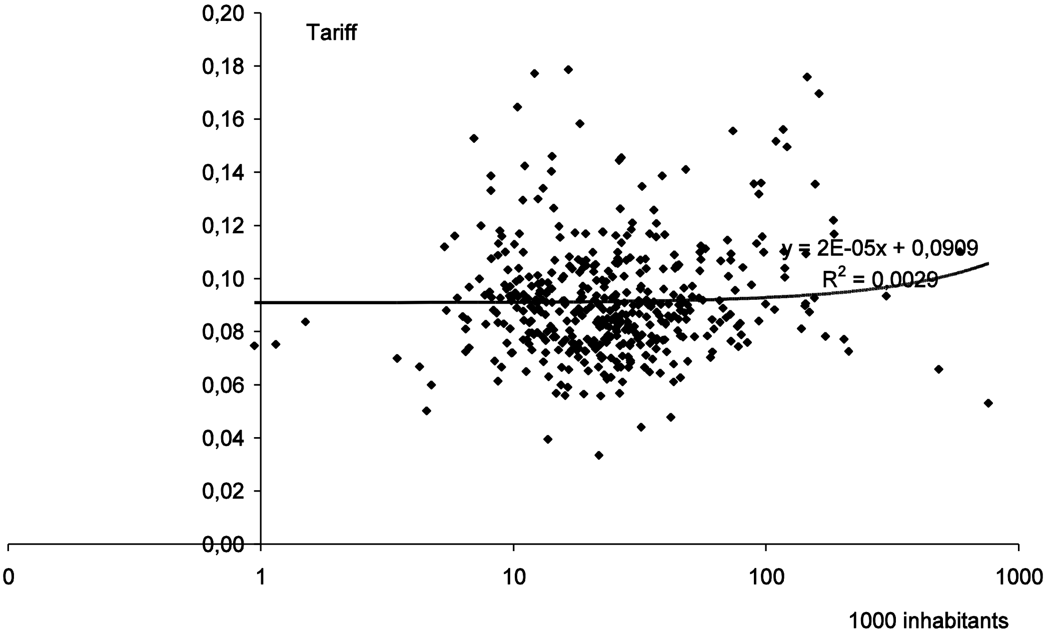


Figure 4.5 The net explicit revenue from the sale of land by municipalities (1970-2009; data source: Dutch national accounts).

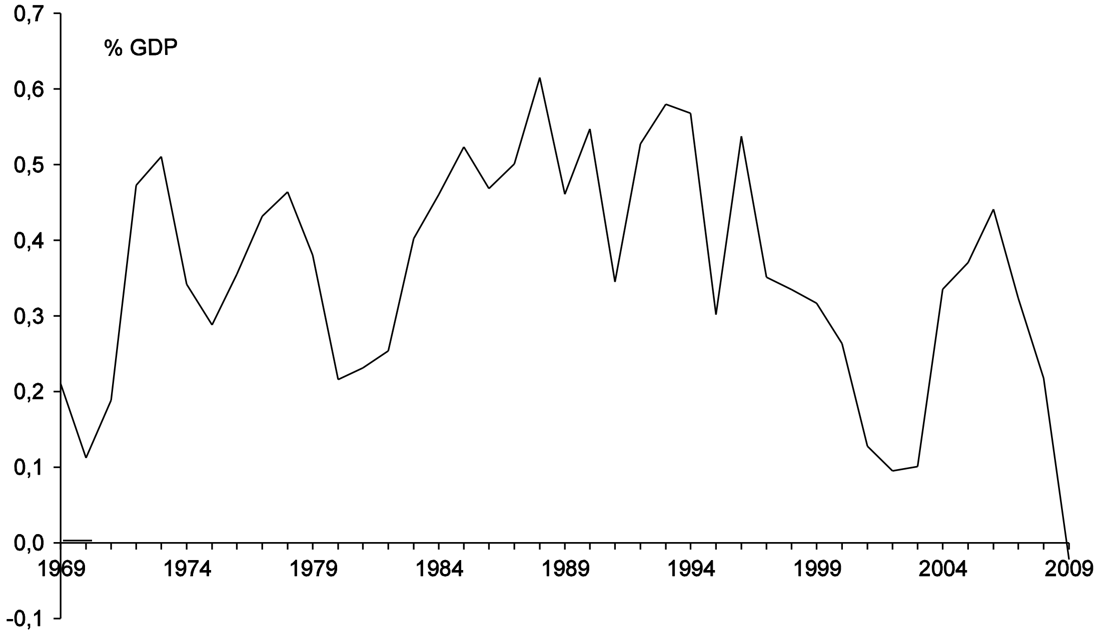


Figure 4.6 Net worth and financial assets of Dutch provinces, 1000 euro per inhabitant (2008, data source: Statistics Netherlands, statistic on provincial budgets)

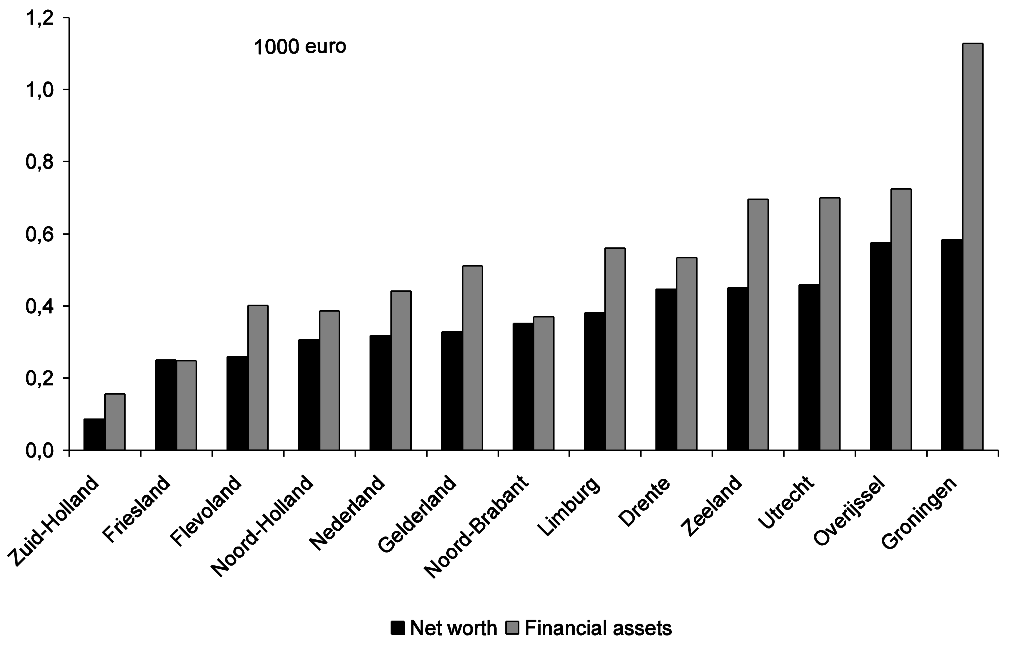


Figure 4.7 **The size of Dutch municipalities in terms of number of inhabitants (2009; data source: Statistics Netherlands)**

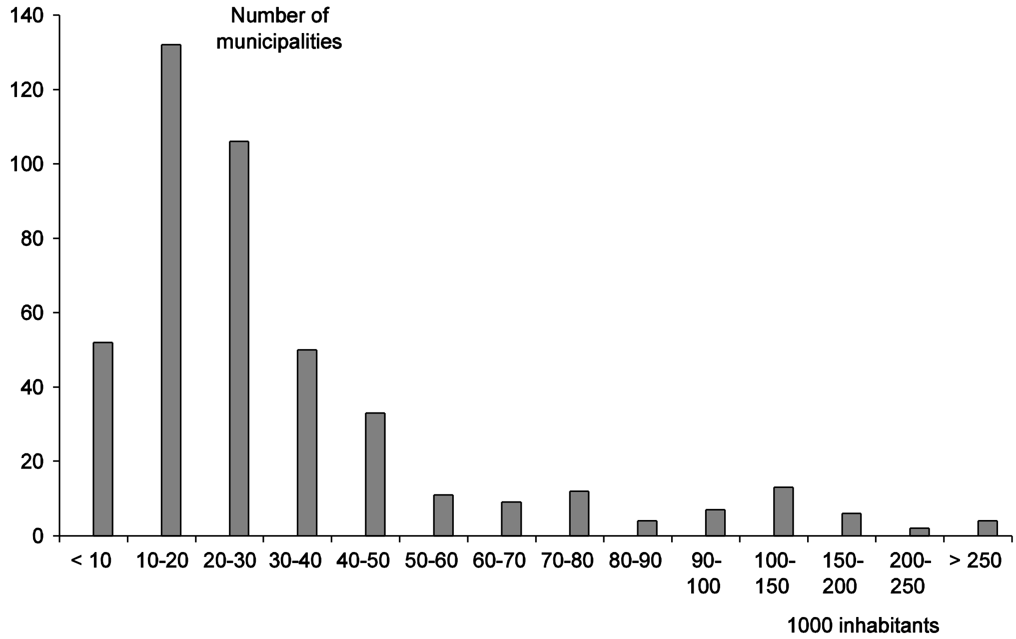


Figure 4.2 shows that larger municipalities receive more transfers per inhabitant for the function social assistance and social services. This reflects that cities attract poor people. "Cities have assets that make them appealing to people who start with less and those assets are things to be prized. The fact that poor people are absent from suburbs is a sign that suburbs are not offering them a decent life ... We have found that poverty rates rise in areas that gain access to subways. This doesn't mean that subways make people poor, but rather that subways provide access that is valued by people with fewer resources" (Glaeser, 2010, pp. 25-26).

Another major source of revenue for municipalities and joint arrangements are the sale of goods and services (11 bln euro). This includes garbage disposal (fees of 2 bln euro), fees for building permits (0.5 mld euro), parking fees (0.5mld euro), passport levies, sales by social workshops and the rental of school buildings and sport centres. Figure 4.3 shows that the fees for building permits differ substantially between municipalities: a building permit for a dwelling of 250 thousand euro costs in some municipalities 12 thousand euro and in others only 2 thousand. However, the figure also shows that these differences are not correlated to size in terms of the number of inhabitants. So, bigger municipalities do not on average charge more than smaller ones.

The municipal taxes amount to 4.4 bln euro in 2009. This mainly consists of real estate tax (2.9 bln euro) and a levy for sewerage (1.2 bln euro); in addition, also taxes are levied on tourists, dogs and the use of public space by bars, restaurants and shops. The average real estate tax is about 0.09% of the officially estimated real estate value of dwelling and 0.3% of the value of business property (the aggregate of the charges for owners and users). Figure 4.4 shows that the tariff of real estate tax is not correlated with the size of a municipality in terms of the number of inhabitants, e.g. bigger municipalities do not charge more than small municipalities.

Property income received by municipalities includes interest, dividend and ground rent. Net revenue from buying and selling land is not included in our overview of total revenue of municipalities. The reason is that the annual operating balance of land exploitation from the municipal accounts does not provide a solid estimate of its importance as a source of revenue. Furthermore, in 2009, the operating balance was only some hundred million euro due to the economic crisis and the drastic reduction of granting land for building houses. The Dutch national accounts provide an alternative measure of the economic importance of buying and selling land for municipalities. It is equal to net explicit sales of land; it ignores any implicit revenue and ignores also the various costs involved, in particular the cost of making land ready for building. According to the Dutch national accounts, during the seventies, the net explicit sale of land was 1 billion of euro, corresponding to between 0.3% GDP and 0.6% GDP (see figure 4.5).

Land is in particular a source of net revenue when the municipality is changing its purpose as part of spatial planning: land used for agriculture is cheap, but when it can be used for building housing or business premises its value increases enormously. This revenue can be explicit, but is often also implicit. The latter occurs when the building corporations buying land get a reduction in exchange for an agreement, e.g. to construct a road or to built and sell houses for below market prices. Such implicit and explicit revenue from buying and selling land is concentrated in municipalities where land for agriculture is transformed into land for dwellings and business premises; smart building companies can skim the cream off by buying the land in a very early stage.

Table 4.5 Size and composition of the revenue of provinces in 2009 (data source: Statistics Netherlands, national accounts)

	Bln euro	% Total	% GDP	1000 euro per inhabitant
Transfer by provincefund	1.3	23	0.2	0.1
Specific transfers by the central government	2.2	38	0.4	0.1
Taxes	1.4	24	0.2	0.1
Property income	0.9	16	0.2	0.1
Total	5.9	100	1.0	0.4

Table 4.5 shows that Dutch provinces have four major sources of finance, the general transfer by the province fund, specific earmarked transfers, taxes and property income. Unlike municipalities, taxes

and property income are an important source of finance. Furthermore, specific transfers by the central government are even more important than the general transfer by the central government. Taxes refer to the provincial surcharge on the national car registration tax. The high property income reflects the richness of several provinces due to equity stock in public corporations, like a big mortgage bank and energy companies.

Figure 4.6 shows that provinces have substantial net worth and financial assets and that some provinces are much richer than others. The figures could be regarded as conservative estimates, as they have been derived from the provincial accounts in which all assets, including financial assets like loans and equity stock, are valued at historical costs. In particular for equity stock already owned for decades by provinces, this is likely to be an underestimate of their market value.

4.2 Discussion

The tasks and financing of Dutch local government raise many issues (see section 1). This section limits the discussion to seven questions:

- Should municipalities further increase in size?
- Should the eight city-regions be abolished?
- What should be the role of provinces in spatial planning?
- Should municipal taxes as a source of finance be increased?
- Should the role of specific earmarked transfers by central government be reduced?
- How efficient is the current linkage of general transfer to municipalities and provinces to the expenditure by central government?
- Should Dutch provinces be merged and scaled up?

Scale, geographic boundaries and external effects

In order to solve budgetary problems of the Dutch government, a group of civil servants supported by researchers has investigated a wide range of options for efficiency gains and budget cuts. They also proposed to further increase in the scale of municipalities. In the moderate alternative, the number of municipalities is reduced from 430 to between 100 and 150. The number of inhabitants ranges than between 40 and 750 thousand inhabitants. In the more radical alternative, the number of municipalities is reduced to 25-30; their average size will then be about 600 thousand. Some provinces, like Drente and Zeeland will then become a municipality. The new Dutch government did not take up these advices; they stress that scaling up of municipalities should depend on their willingness to merge.

Economic theory provides various arguments for larger municipalities, like more efficient allocation by internalising more external effects, increase in efficiency due to larger scale, a rising minimum scale due to more and more complex tasks and reducing the vulnerability for local lobbies and personal interest. These arguments have also been used to understand the reduction of the number of Dutch municipalities during the past 160 years (see section 3).

Urban economics and new economic geography (e.g. the work by Glaeser and Krugman) are major new areas of economic analysis. These analyses stress the important role of cities and human capital for economic success (see ter Weel, et al., 2010). Thousands of years of economic development show that economic activity is concentrated in cities and that human capital and cities are complementary. Cities bring together people who benefit from each other. Most innovation takes place in cities. Interactions between people in cities help them to pick up and develop ideas and innovate. The easy flow of ideas explains to a great extent how cities survive despite the high rents and potential dis-amenities like unsafety, noise and pollution. The attractiveness of a place of business is determined by the attractiveness of cities. Good governance is important for a place of business. The creation of human capital through sound education and the utilisation of human capital in production are crucial for economic success. This is also a major connection between urban development and human capital formation.

Scenarios can show the implications of the ICT revolution and other major trends for the role of cities and the best governance level. Ter Weel et al. (2010) sketch four scenarios: Talent towns, Cosmopolitan centres, Egalitarian ecologies and Metropolitan markets. In all these scenarios, cities are increasingly important, but the size of the representative city differs, from just over 100,000 in Talent towns to many millions in Metropolitan markets. The density of these cities depends on both size and specialisation. Large cities drive up the value of land and stimulate high-rise buildings. Specialisation benefits from frequent face-to-face interactions, which are optimised in dense urban areas. Togher, size and specialisation suggest that urban density is highest in the large and specialised Cosmopolitan centres and lowest in Egalitarian ecologies, i.e. the scenario with small and not specialised cities. In all four scenarios, cities are essential for efficient governance (see table 4.6). In two scenarios, global institutions should play a major role. The European Union is only important for the scenario Talent towns, while the national govenrment is in particular important in case of Metropolitan markets. In none of the scenarios, provinces should play a major role.

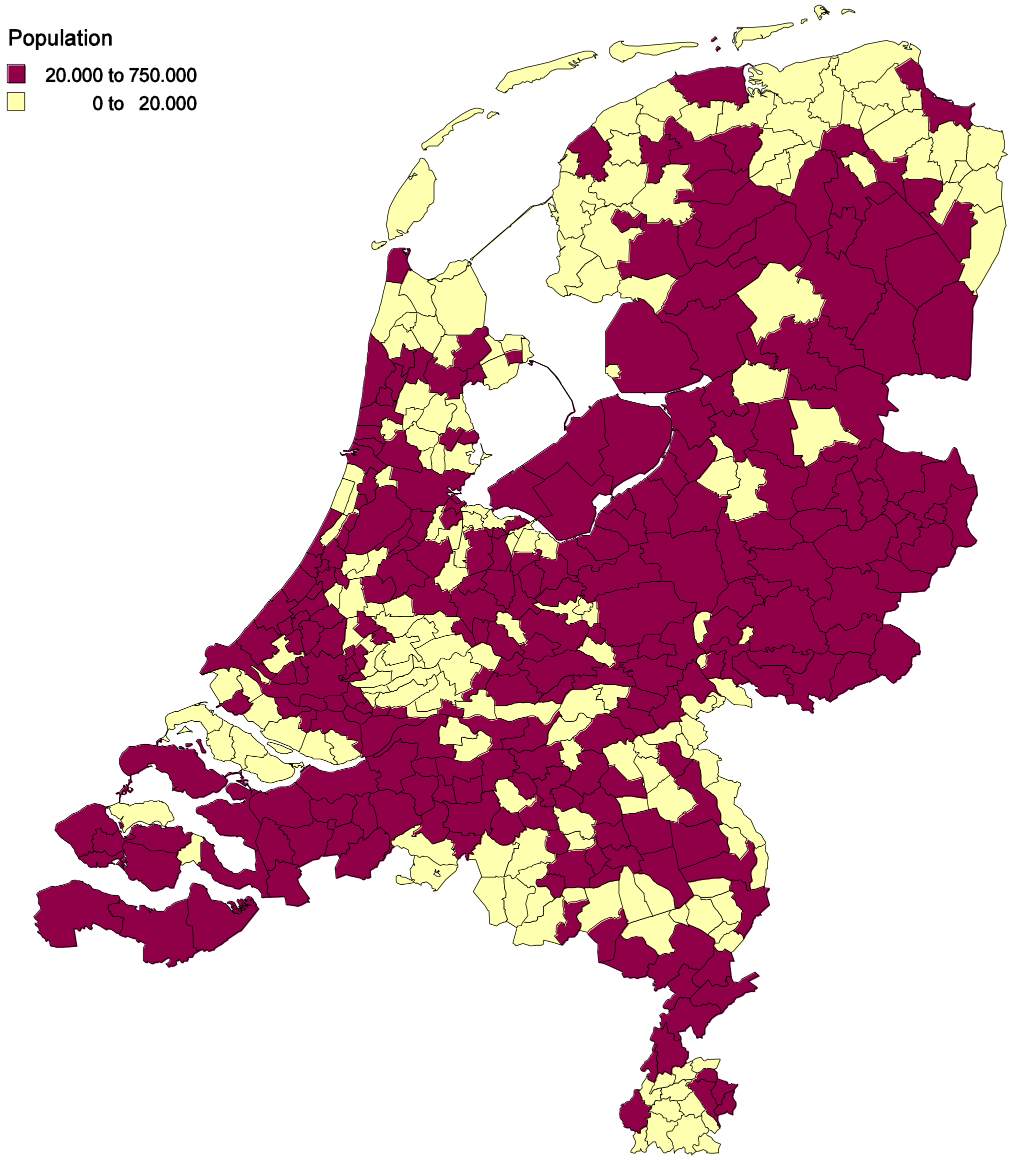
Table 4.6 Subsidiarity: what governance level should regulate economic behaviour? (source: ter Weel et al., 2010, table 9.4)

	Talent towns	Cosmopolitan centres	Egalitarian ecologies	Metropolitan markets
City	x	x	x	x
Province				
Country				x
European Union	x			
Global institutions	x	x		

These general insights can be supplemented with information on the current size of the Dutch municipalities and the external effects.

At present, the major part of the 430 Dutch municipalities is rather small: 10% has less than 10 thousand inhabitants, 25% has between 10 and 20 thousand inhabitants and for 20% the number of inhabitants is between 20 and 30 thousand inhabitants (see figure 4.7). Joint arrangements for cooperation on a voluntary basis can partly remedy the economic drawbacks of such small municipalities. However, such cooperation has high transaction costs and the voluntary basis can turn out to be insufficient for efficient and effective decision-making. The central government policy to allocate more and more complex tasks to municipalities enforces a further scaling up of municipalities.

Figure 4.8 **The location of the smallest municipalities in 2009 (data source: Statistics Netherlands)**



The number of inhabitants is not the only economic criterion for scaling up. Figure 4.8 shows that the smallest municipalities are those in the least densely populated regions or in the regions close to the sea or to the border with another country. This is in line with economic logic, as costs of internal communication and transport are higher for such municipalities, local identity is usually stronger and the external effects of public services are more limited due to distance or being close to the sea or the border.

Table 4.7 Jobs, facilities and discomfort explain half of the variation in Dutch land prices (source: de Groot, et al., 2010, table 5.1)

Variable to be explained: Landprices (per m^2 on PC-4 level of aggregation)	Average during 1985–2007	Variance explained (without co-variance)	Variance explained (with covariance)
Gross wage per hour (in €)	6.43	1%	1%
Accessibility of workplaces by car, including correction for traffic jams (thousands jobs)	0.18	13%	25%
Accessability of workplace by public transport (thousand jobs)	0.09	3%	6%
Distance to railway station	67	1%	2%
Distance to natural environment	0.15	2%	4%
Distance to city-park (surface of the park in the district)	213	1%	3%
Distance to sea (district is next to the sea)	75	1%	3%
Historical city-centre (number of official monuments per onehundredthousand dwellings)	1.70	4%	8%
Inside Amsterdam's ring of canals (0–1 variable)	1491	0%	0%
Distance to cultural activities (distance to theatres)	0.16	4%	7%
Distance of restaurants (distance of high quality horeca)	6.63	1%	2%
Distance of shops for fashion and luxury articles (distance to shops for *funshopping*)	0.71	6%	11%
Poor supply of basic shops (distance to such shops)	– 7.73	2%	3%
Inconvenience, degradation and unsafety (share of the population reporting these)	– 1.14	1%	2%
Total		41%	77%

The size of external effects can be measured by analysing the variation in land prices, in particular the difference between the value of agricultural land and the value of land corrected for the value of the buildings (see de Groot, et al, 2010, in particular chapters 5 and 6). For example, what explains that land prices in the centre of Amsterdam are two-hundred times as high as in the country-side in East-Groningen? Table 4.7 shows that the availability of jobs, public and private services (e.g. railway station, city-park, restaurant and theatre) and other circumstances with external effects (e.g. distance to the sea and unsafety) explains half of the variation in Dutch land prices.

Figure 4.9 shows that more than sixty percent of the labour force is prepared to travel twenty minutes by car to the place of work, while only twenty percent of the population is prepared to do that for shopping or visiting a restaurant or theatre. The scope of the positive external effects of a workplace is therefore much larger than that of the external effects of such consumer activities. When travelling by public transport instead of by car, people are even more prepared to travel to the workplace. People are more prepared to travel for attractive natural environment than for urban facilities, but this is still less than for work.

Figure 4.9 People are prepared to travel longer for work than for public or private services (source: de Groot et al, 2010, figure 5.1)

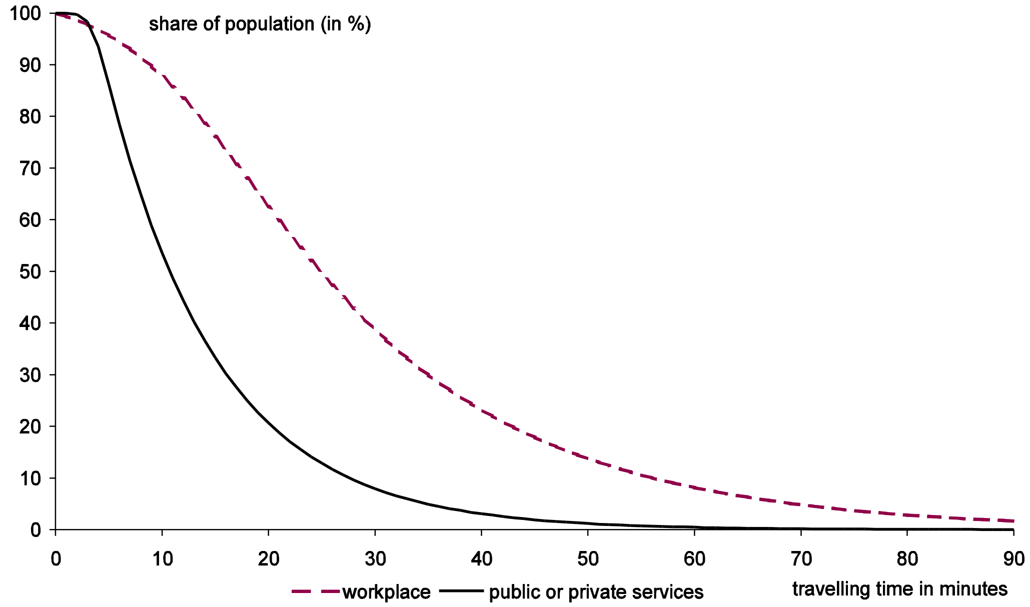
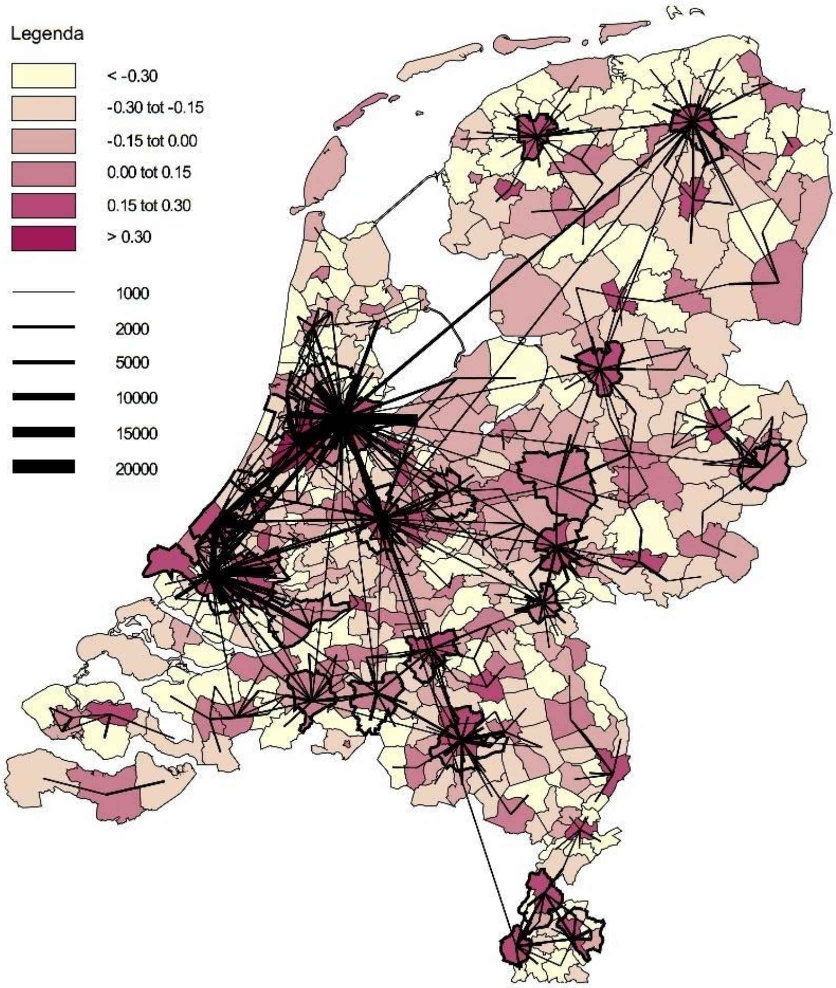


Figure 4.10 Commuting patterns in the Netherlands (source: de Groot et al, 2009, figure 2.7)



An alternative way to measure external effects are commuting patterns (see figure 4.10). People that live in an urban region travel to the centre of the city in order to work in the central business district or to benefit from the facilities in the centre. Commuting patters indicate the attractiveness of city centres and the country-side for living, working and consuming during leisure time. The delimitation of local government should preferably internalise such externalities. For example, strong urban regions should not be governed by many different municipalities; this is likely to result in free rider behaviour and inefficient decision-making for public services with major external effects, e.g. public transport, subsidies for cultural activities and city-parks. Municipalities should also not be much larger than the scope of the external effects, as this leads to conflicts of interest, hold up problems and high transaction costs.

Delimitating municipalities on the basis of external effects could result in very large municipalities that are difficult to manage and suffer from control loss (see section 2). From this point of view, urban regions organised in terms of several municipalities cooperating as a city-region can be regarded as an alternative solution. However, the new Dutch government intends to abolish the current eight city-region-arrangements and does not want to impose larger municipalities in these urban regions. This is unlikely to lead to more efficient government.

One of the major tasks of Dutch provinces is spatial planning. How do the Dutch provinces with their historical boundaries fit into this modern picture of external effects? Looking at the commuting patterns, the urban region with Amsterdam covers major parts of the provinces North-Holland and Flevoland and small pieces of Utrecht and South-Holland. This clearly does not fit with the current provinces. Spatial planning in the Netherlands could be improved by delegating tasks of provinces to municipalities and city-regions. Substantially scaled up provinces could have a role in ensuring coordination between municipalities, e.g. to avoid disruptive competition in company grounds. The central government should focus on ensuring efficient connections between the various urban regions.

More municipal taxes?

Taxes are only about 10% of total revenue of municipalities. In Dutch policy discussions, it is often argued that enlarging the tax base for municipalities would improve efficiency and local democracy. Is enlarging the municipal tax base a good idea?

The incentives of current municipal taxes are already high. The University of Groningen's center for local government (COELO) compares and analyses the real estate taxes rates of Dutch municipalities. The annual report reveals which municipality has the highest rates and the largest increase in rates. Such results are regularly published on the front page of major national and local newspapers and discussed in the local councils. Enlarging the municipal tax base is therefore unlikely to lead to a major increase of these incentives.

Enlarging the tax base for municipalities makes only sense when municipalities can differentiate their tax rates. However, in practice, in particular in small countries with a unitary state, major differences are not allowed. In Dutch history (see section 3), major differences in municipal tariffs resulted into migration and a widening gap between rich and poor municipalities. After the introduction of the municipality fund in 1929, municipal taxes were still a major source of finance. However, most rates were equal to the maximum set by the central government. In the Scandinavian countries, the local tax base is very high and local government is governed by elected local and county councils (see Rattso, 2003). Nevertheless, the Scandinavian model is a unitary welfare state and allows little room for local democracy and accountability, as the central government is in control of all public finance. Local tax rates are mostly close to the official maximum, the revenues from municipal income taxes are to a great extent redistributed by the central government and local and county governments act primarily as agents of the central government.

Table 4.8 Dutch taxes on owning, using or buying houses and business premises

	Bln. euro	% Total	% GDP	1000 euro per inhabitant
Tax on buying houses (6%)	2.7	36	0.5	0.2
Tax on rental value of owner-occupied dwellings (30% tax rate on 0.55% of official real estate value)	1.9	25	0.3	0.1
Municipal real estate state tax (OZB)	2.9	38	0.5	0.2
Total	7.6	100	1.3	0.5

Henry George and others have argued that local public services increase the value of land and houses in their neighbourhood. Taxing the value of land to the extent that it exceeds that of uncultivated land or its value for agriculture would therefore be a good source of finance for such local public services, as it gives local government the proper incentives to maximise its tax revenue (see de Groot et al., 2010). In the current Dutch tax system, central government collects taxes and distributes these via general and specific transfers to local government. Some of the taxes by the central government are related to the value of land and houses, i.e. the taxation of the rental value of dwellings and business premises and the tax on buying houses. It would therefore be a no-regret option to transform these into a municipal land tax. This would more than double municipal taxes. Abolishing the tax on buying houses also abolishes the disincentive on moving and therefore improves the mobility on the housing and labour market.

Less earmarked transfers?

Earmarked transfers can be a major tool for the central government to influence local public expenditure. A general transfer by the central government combined with negotiation and consultation is likely to be much less effective. However, ensuring the efficiency and effectiveness of earmarked transfers is not easy:

- Two layers of government, i.e. central and local government, have to provide information on the results of these transfers and should justify these results to their managers and politicians. As a consequence, administrative burden and political responsibilities are easily doubled.
- Earmarking transfers leads to partitioned management at the central and local level. However, in reality all kinds of economic and social problems are intertwined. For example, in a backward neighborhood many problems are interrelated, like unemployment, unsafety and high drop-out rates at schools. Earmarking transfers (e.g. one for fighting unemployment, one for reducing unsafety and one to improve school attendance) assumes that such problems can be solved in isolation. Earmarked transfers usually also prescribes the specific type of solution that should be used for solving the policy problem. For example, in order to solve a traffic jam, the earmarked transfer prescribes that roads should be built; this ignores alternatives like improving public transport, adding bicycle lanes or charging higher parking fees. Earmarking transfers can therefore make it very difficult to solve problems efficiently

and effectively at a local level. If an efficient and integrated approach is taken, it is an enormous administrative burden to reroute the centrally or locally earmarked transfers. Strict accountants can then also officially declare that the earmarked transfer was used for different purposes or in a different way than intended by the central government.

- Earmarked transfers should preferably be allocated on the basis of objective criteria to individual municipalities and provinces. However, a reliable formula for assessing the needs of individual municipalities and provinces is in practice difficult to find due to all kinds of measurement problems. As a consequence, some will receive too much and others not enough. Earmarking implies that even if you receive too much, you will nevertheless spend it for that purpose. Earmarking reduces by definition the possibility for local government to reallocate the funds for different purposes, for other projects, for other types of policy or for reducing local debt or taxes. The more small municipalities are involved and the more earmarked transfers are defined in a strict and narrow, the larger such inefficiencies.

The number of earmarked transfers should therefore be limited and they should not to be defined too strictly. In order to improve the efficiency and effectiveness of earmarked transfers, their ultimate and general purpose should be defined and the interactions with other problems and solutions and their financing should be investigated systematically.

Which formulae for the size of general transfers?

The general transfer by the central government to Dutch municipalities and provinces is linked to the major part of the expenditure by the central government, e.g. those on defence and education. From a historical perspective, this solution is understandable and clearly an improvement over earlier formula, e.g. a surcharge on national taxes. The current formula could be regarded as a monstrous alliance. Local government is happy because it safeguards them against major budget cuts by the central government; this will only occur when also the other expenditure are cut substantially. It also ensures that they benefit when the central government decides to increase its expenditure. For the central government, the formula is regarded as an efficient device in managing public finance: when major budget cuts are necessary, the budget for municipalities and provinces is also automatically cut. At the start of the new period of government, the new government can recalibrate the budget for local government by deciding on specific additional cuts or extra expenditure.

However, the drawbacks of the formula are easily overlooked:

- It results in all kinds of windfall gains and losses for local government that have nothing to do with their tasks or their financial position.

- It sets a very arbitrary norm on what is a reasonable budget for local government. In the short run, this may not be a problem, but in the longer run it is likely to become an outdated and unbalanced budget (too much or too small) that is hard to change.
- It makes the budgeting mechanism not very transparent and invites spurious political arguments. For example, when some years ago central government decided to increase expenditure on health care, police and education with several billion euro, this automatically increased the budget for municipalities and provinces. According to the official statements, the central government and municipalities and provinces agreed that this extra budget should be spend on the same three policy priorities. However, this is clearly spurious political talk, as municipalities and provinces are hardly responsible for health care, police and education.

It is therefore better to choose a simpler and more neutral formula, e.g. a link to the development of GDP with some delay or with an adjustment for wage rates on the basis of the wage rates agreed upon in the market sector[13]. Like with the current formula, at the start of each new period of government, the government can decide to reconsider the size of the transfer by taking into account all kinds of factors, like new tasks, efficiency and financial health of local government or the prospects of Dutch public finance and the national economy in general.

How efficient are Dutch provinces?

From an economic perspective, the current tasks, scale and financing of provinces do not seem efficient:

- One of its major tasks, spatial planning, is best to be transferred to a great extent to municipalities and city-regions (see above).
- The current tax is a surcharge on the national car registration tax and invisible for the inhabitants. As a consequence, voters will not be aware of the trade-off between local taxes, local expenditure and local debt reduction. The link to car registration implies that when you do not drive a car you do not pay taxes to the province. Due to the rapid increase in the number of cars for decades, the provincial tax revenues have gone up rapidly too. This is not in line with the development in the costs and tasks of provinces.
- The democratic process is not very strong. For inhabitants, the tasks of provinces are too general and the effects of its policy are too indirect and long term. In order to reduce the distance with voters, provinces have taken up social policy, i.e. a task that from an economic point of view should be restricted to central government and municipalities.

[13] Some others have made a similar proposal, e.g. van Zaalen (2002).

- The increasing size of municipalities implies an increasing internalization of local external effects and reduces the role for provinces. Also the cooperation in functional regions for safety and health care reduce the role for provinces. To have clear value added in comparison to municipalities, provinces have to scale up. The reduction in the number of municipalities reduces also the supervisory tasks of provinces.
- Provinces have different roles in different regions; in urban regions with some big cities their role is much more limited than in regions with many small municipalities. One general funding mechanism for all provinces (taxes plus province fund) cannot do justice to such differences.
- Some provinces are substantially richer than others. This reduces the incentive for efficiency, has not lead to any lowering of taxes, has stimulated spending money on social policy and taking over –on an ad hoc basis- some of the financing by the central government. For example, in addition to the central government's earmarked transfer for child welfare, provinces decided to spend part of their own money also on child welfare.
- The general transfer is linked to the expenditure by the central government. As a consequence, there is no clear link with the costs and tasks of provinces.
- Voting for provinces serves also to choose the upper house in parliament. This mixes up voting for local policy issues with voting for national policy issues.

There are therefore serious arguments to reconsider the role and financing of Dutch provinces; scaling up to three or four provinces would only partly solve the problems.

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