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LOCAL GOVERNMENT FINANCE

Moore McDowell

Policy Paper No. 18

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This paper was presented at the Dublin Economic Workshop's Eighth Annual Policy Conference, Kenmare, 18-20 October 1985.
LOCAL GOVERNMENT FINANCE: A SUMMARY

1. The existence of a "problem" arises from the gap between revenue and expenditure.

2. The conventional analysis has accepted broadly the assignment of functions to local authorities, and concentrated on providing tax-based funds to finance them; this has been partly due to a concern to improve political accountability, but also reflects a need to reduce demands on the Exchequer so as to permit a reform of the overall tax structure; all those writing on the matter have called for some form of property tax.

3. There are reasons to believe that local governments could well reduce the level of their activities: the local finance problem could be partly solved by such a move, and a property tax then could be used as an integral part of overall tax reform.

4. The case for a locally variable property tax, independent of the above considerations, has been somewhat exaggerated. It is to be doubted that the implementation of such a tax would, in Irish circumstances, really be conducive to local fiscal autonomy.

5. If the present range of local authority functions is to be maintained, and if either no property tax is introduced, or the property tax is introduced but is effectively standardised across the country, either through Exchequer action or economic pressure, the explicit/implicit Exchequer grants involved should be rationalised in terms of their incentive and efficiency impact.
LOCAL GOVERNMENT FINANCE

INTRODUCTION:
Over the last decade there has been a proliferation of plans, proposals for plans, reports and research papers dealing in part or in whole with the problems of local government finance. Most of the suggested changes made in these documents are very sensible, or, at the worst, plausible. In consequence, this paper is not going to spring a fiscal rabbit from an academic mortarboard which would solve the problems of local finance at a stroke.

Instead, I want to use the problems of local finance as a means of focussing attention on the question which underlies all this discussion, and which is not adequately dealt with in most of the material published on this problem in Ireland. That question is the role, scope and size of local government economic activity.

The background to the various proposals on reform of local government finances is a simultaneous concern about two quite separate issues. The first of these is the perceived need to revise the trend whereby over ten years the dependence of local government on Exchequer grants has increased from 35% of total financial requirements to 65%. The second is related to the desire to use reform of local government finance as a means of making the overall structure of taxation more equitable or more efficient or both. Despite the efforts of various writers to distinguish between the two problems, their common involvement of city hall and its problems has served to confuse the issues involved. This is hardly surprising, since central to solutions offered in each case has been the introduction of a property tax. Indeed, the 4th Report of the Commission on Taxation makes clear that it supports the introduction of either a local or a national property tax as part of an overall tax reform
package, but that the local tax should be introduced only "should it be decided that a system of local taxation is desirable."¹

This paper attempts to broaden the discussion by considering the basic question already outlined (Part I). Then the property tax proposal is evaluated (Part II). Finally, the structure of Exchequer grants to Local Authorities is discussed (Part (III)).
I. **LOCAL GOVERNMENT EXPENDITURE**

Tautologically, the Local Finance problem has to be solved either by instituting new local taxation in some, or by reducing L.A. expenditure, or a bit of both. So far the debate has been entirely in terms of moving from grants to some form of tax finance. The conclusion of all those who have investigated the problem (even Governments which have subsequently acquiesced in rates abolition) is that the only feasible local tax is some variant of a real property tax. With a few minor reservations I would accept that conclusion.

Neither the COT 4th Report, nor the NESC report seriously consider the question as to whether the solution to Local Finance problems might not lie in reducing the activities of the local authorities. I want to suggest that the mere existence of a local finance problem can be taken as prima facie evidence to support the proposition that we already have too much local government.

Most political and economic models of state-local relations proceed from an assumption that there are certain functions which can be more efficiently executed by local rather than central authorities. The reasons for this local advantage are mainly to be found in information costs and monitoring costs. It is generally agreed, I think, that in so far as is possible decisions on expenditures and revenue raising should not be divorced; the breach-ing of this rule opens the door to free-riding with a consequent tendency for 'over-provision' of public sector production.

The gap between the two in Ireland, however, has been increasing for a quarter century. This has not been a gradual process: most of the increase occurred in two discrete changes - in the early 1970's and after 1978. In the first case the establishment of the Health
Boards coupled to a rates revolt in the late 1960's resulted in the Government substituting an Exchequer grant for a payment from rates to meet the health costs which had been the responsibility of local authorities. In the second, the decision to abolish 'domestic' rates was responsible.* The result was that the dependence of local authorities on State grants has increased from under 35% to over 65% since the early 1960's. When user charges and similar revenue sources are subtracted from the 'own finance' total, Irish local authorities receive only 12% of their expenditure needs from taxation proper (i.e. rates). ²

That this is an undesirable state of affairs is widely recognised - and this is not limited to academic commentary. The 1972 White Paper on Local Finance and Taxation recognised it; the 1975 ESRI report recognised it; the recent C.O.T. report recognised it. Indeed, one way of looking at the current debate is simply to say it is about closing this gap. There is, however, something to be learned by considering how the gap emerged.

For many years before the various reforms instituted in 1971-2, the central Government, under the Health Acts, had been meeting 50% of the financial responsibilities of the local authorities to finance health expenditure - the scope, quality and entitlements of which were largely dictated by central Government policy. By the late 1960's the costs of these centrally determined programmes were rising so rapidly that the Government was obliged

*When it is remembered that the remaining rates are payable only on commercial and industrial properties, it is hardly an exaggeration to say that what has emerged is a complete divorce between the recipients of the benefits of local government spending and those who are asked to foot the bill.
by political pressure to increase its contribution above the 50% level, and, finally, to accept that it was undesirable to finance health charges from the rates. As a result, by the mid-1970's all health charges were removed from the rates, and the effective local authority contribution fell to zero.

Similarly, in many respects, housing, vocational education and road maintenance, while a financial responsibility of local authorities were programme areas in which increasingly central government determined the levels of expenditure which the authorities were obliged to undertake. Of course, the degree in practice to which different authorities actually met these obligations could vary. Nevertheless it remained the case that over a generation central government increasingly took to itself the right to determine (or at least influence greatly) the level of local authority expenditure, while initially at any rate leaving the local authorities with the job of finding the money. The political consequences of this were first a rapid increase in the number and size of the grants made by the Exchequer to hold rate increases down, and later the collective collapse of political will to maintain any household local taxation between 1971 and 1978.

Development up to and into the 1970's were bound to produce a political revolt against rates - even ignoring the glaring inadequacies of rates as an effective local property tax. By pre-determining expenditure levels (through legislation on programme quality and on entitlements), the central government was actively undermining the local government system. It was offending against the ancient canon of 'no taxation without representation' by divorcing expenditure decisions from the need to impose taxes. At the same time it was increasing the degree to which local revenue and expenditure were being
used as a means of re-distributing income - through the provision of "Merit Goods" (see below) such as housing and health expenditure. Local Government is simply not an optimal means of re-distributing income. Furthermore, the concentrated impact of rates on householders meant that the latter could reasonably believe that local democracy involvement in income re-distribution based on local property taxation would result in expropriation of the "haves" by the "have-nots". So, the growing burden of centrally determined expenditures for purposes not suited to local government, financed by a tax which was perceived to be highly selective in its impact, must inevitably have produced the political alliance which emerged in the late 1960's - between local representatives who were being asked to finance somebody else's programmes and tax-payers who - accurately enough - felt that the local tax structure was not designed to do the job it was being asked to do.

The Great Rates Revolt - more successful, incidentally, than California's famous Proposition 13 - at heart represents the outcome of a mis-allocation of the responsibility for financing particular types of public spending programmes. Discussion of reforms to the local finances which ignore this aspect of the problem end up offering alleviations to the symptoms without dealing with the disease. Hence, before considering taxation and/or grants reforms, it seems desirable to examine the level of LA spending itself.

Traditionally, public finance has treated the role of government in the economy as fulfilling three functions: Allocation, Distribution and Stabilization. Government spending, in everyday language, was supposed to influence the composition of output in the economy, the relative production of various different types of goods and services (Allocation); it was supposed to affect the
relative disposable income and real consumption of households (Distribution); and it was supposed to help secure the desired time path for aggregate demand—income, output and employment (Stabilization).

The role of local (as opposed to central) government is usually regarded as being confined to Allocative and Distributive functions. In order to understand how Local Government problems have arisen it is necessary to review these.

Allocation: the need for public sector provision of some 'goods' reflects:

(i) the existence of "public goods" - which of their nature will not be produced in socially optimal quantities if the level of output is left to the market; policing is a good example.

(ii) the existence of "merit goods" - goods which, on purely political grounds, or possibly because of potential externalities, it is decided should be produced and made available on a basis other than that of ability and willingness to pay; education and housing are examples; so is health.

(iii) natural monopolies: it is felt desirable that the postal system, electricity generation should be publicly provided lest private monopolists extort unreasonable (what that?) profits; a variant on this is the scale economies argument.

Distribution: public sector spending of a transfer nature is undertaken in order to raise/lower incomes of target groups. It should be noted, however, that spending under Allocation has redistributive implications, at least marginally, while expenditure under Distribution has major allocative implications.
The usual arguments offered in support of the existence of a local government system are outlined in the 1975 ESRI report on the problems of local authority finance. In summary they are as follows:

(i) in terms of matching quality and quantity to demand, a local authority has better information and more flexibility than central government; where services/goods can and ought to reflect such local variations in conditions, local provision is indicated.

(ii) some public goods are entirely or mainly 'local' - e.g. parks; country roads - there is little justification for national level provision;

(iii) income re-distribution can be more flexibly handled when local information on "needs" is used to determine the pattern and level of expenditure;

(iv) (a basically political argument): a healthy democracy needs local government; local governments have to have something worthwhile to do.

Argument (iv) doesn't concern us directly, so I ignore it henceforth. As far as (i) to (iii) are concerned, it is to be noted that Copeland and Walsh rule out the feasibility of any substantial local redistribution policy, in the sense of one which varies as between localities. With this view I entirely agree. I would, indeed, go further arguing that re-distribution is politically properly a matter for national decision-making rather than local, given that local politics are bound to be dominated by local considerations, and will be more open to arguments ad hominem rather than ad principium.

Compared with local authorities elsewhere in the EEC and N. America, Irish local authorities have relatively limited functional areas of responsibility.
distinguishable areas cited by the 1985 NESC report, only 7 are assigned to local government here, although of those not assigned, there is still some residual financial responsibility for education, and there is clearly a strong possibility that in some parts of the country local government involvement in urban transport may soon be introduced. (TABLE 1).

It's not possible unambiguously to categorise the different programme areas of expenditure in terms of allocation, distribution, public goods and merit goods. In TABLE 2, however, is provided a rough breakdown. These methods of classification highlight two aspects of local government expenditure in Ireland. These are, first, the size of the primarily distributive aspect of local authority expenditure; secondly, that as a proportion of local authority expenditure it has in fact been falling, even if only slightly.

Identifiable Merit Good production accounted for over 46% of total expenditure in 1976, and 45% in 1981. Public Goods provision rose from 39% of total expenditure in 1976 to 44% in 1981, while the broader category of allocative expenditure remained roughly constant at about 51%. Distributive Expenditure declined slightly from 41% to 40%.

By and large this trend in the composition of local authority spending is desirable in the light of the arguments being advanced in this paper. The trend is, however, not a strong one and the levels of Merit/ Distributive expenditure remain absolutely high.

The central proposition of this paper is that the local authority financial problem arises primarily from the size of the local authority expenditure rather than the insufficiency of taxes. This implies that a solution
to the problem is to be found in reducing local authority spending. Expenditure reduction here implies removing certain programme areas from the local government's area of responsibility.

If it is agreed that: (i) local governments are not the level of government which should be concerned with income re-distribution; (ii) that merit goods provision is principally motivated by redistributive intentions; then it follows that the public provision of such goods as housing other than on an agency basis for central government should be scaled down, even abolished. The proviso on the agency issue takes account of the possible superior efficiency of using local government as a channel to ensure that funds are used optimally, given variations in local conditions, and to reduce monitoring costs.

Turning to allocative expenditures, these need to be treated under two headings. In the first place there is the question of Public Goods. While it is true that, by definition, these can only be optimally produced via collective decision making, it does not follow that only the public sector can produce them. Private supply of public goods under contract is not only a theoretical possibility, nor is it an exotic device to be used only in economies run by mad monetarists; it is something which is in fact widely used in Ireland already. Roads, after all, are often built by private contractors - and even maintained by them. The question obviously arises as to whether substantial elements of the services provided by local authorities could not as well, or better, be provided on a privatised basis. Fire services and ambulance services (at present run by Health Boards) are areas in which not only is it feasible to use the private sector, but on any rational basis the onus of the proof would surely lie with those who maintain that they ought not to be produced privately.
The public good - natural monopoly argument for collective provision does not require collective production. Those who refuse to see this are usually the victims of a failure to distinguish between competition in a field and competition for a field.

The second heading is that of cost-effectiveness. Again, the facts are that the vast majority of studies in the area show that, independent of other considerations, there are many activities at present provided by collective production which could and would be less expensively provided by private sector firms. The trouble here is that there is a confusion between the method of finance and the mode of production. Opposition to "privatising" local government functions would certainly be centred on the unwillingness of households to pay for them. Whether or not this is justified is is irrelevant to the question of how to provide them. If the goods are not "public" goods in the technical sense, the rationale of producing them collectively and distributing the output regardless of willingness to pay is difficult to understand. Given the well known costs of construction of local authority housing, it seems inconceivable that the demand for accommodation could not be more cheaply met by direct rent subsidisation (either from local or central funds, but, for reasons already advanced, preferably the latter). Private sector funds could - and would - build the housing; tenants could - and would - rent them, seeking and obtaining rent subsidies where justified. This would have the added benefit of eliminating the 'ghetto' aspect of public housing.

To summarise, merit goods production accounts for 45% of local authority expenditure; distributive expenditure accounts for 41%. The case for privatising some or all these activities is strong. If their production is not privatised, or if it is, but continues
to be financed from public funds, the burden of this finance should not be laid on local government. The reduction in the local authority financial burden flowing from this implies maintaining some form of Exchequer finance and/or extending "user charges" (i.e., the price mechanism). This would not be sufficient to eliminate the local authority finance problem: on average existing revenues would cover less than 60% of remaining spending. To introduce either an ear-marked national property tax or a local property tax would be appropriate. It would remain in general acceptable if, and only if, the tax was clearly seen to be for the most part not a further means of redistributing income. That implies it should be strictly proportionate in its structure.

II. LOCAL PROPERTY TAXES AS A SOLUTION

The introduction of local property taxation (or a re-introduction of a reformed rates system) has been accepted by virtually all interested parties as an element in the solution of the country's fiscal problems. This stems as much from a drive to reform the overall structure of taxation (reducing income tax) as much as from anxiety to sort out the problems of city hall.

The only effective differences between a "local" and a "national" property tax (whose proceeds in whole or part are remitted to the various local authorities) be in (a) the proportion of the yield in any given area which is received by the relevant local authority; (b) the differences in the rates of tax (on a common base) which apply in different local authority jurisdictions. If there are differences in (a) then, whatever the legal fictions employed, what we have is another central government tax coupled to grant financing of local authorities. If, on the other hand,
there are no differences in (b) then what we have is simply either earmarking of central taxation for local government purposes (if (a) is constant) or another form of general taxation coupled again to grant financing of local authorities.

Since it is clear that a constant value for (a) - preferably unity - is a pre-condition for the tax being a local tax, I shall assume that it is unity. That then leaves the question of (b). As already stated, the implementation of a property tax with local variations has been universally accepted - excepting, of course, those who might have to pay.

My hypothesis has been that the general resistance to local taxation has arisen from the redistributive implications - and that redistribution is neither economically nor politically advisable as a function for local government. If, however, redistributive functions are retained by local authorities, and if these are to be substantially financed through property taxes, then, (i) the tax will excite the same resistance as before; (ii) the rates of taxation will of necessity vary substantially as between jurisdictions. Let us assume that this time a government will be prepared to face up to the general unwillingness to pay - so (i) is not a problem. We are left, then, to consider the implications of (ii).

The existence of local tax differentials raises two issues - avoidance through re-location by households and the impact on the location of industry. Neither of these problems is even considered in the COT 4th report's chapter 5, dealing with a local property tax. This is rather surprising, since such avoidance activity is cited as a barrier to allowing different jurisdictions charge different rates of motor tax. The NESC report,
while instancing avoidance as a problem with locally variable sales taxes, ignores the avoidance issue when dealing with the possible introduction of a locally variable property tax.

One reason for this oversight might be a tacit assumption that avoidance activity is simply too costly where property taxes are concerned, and, therefore, can be safely ignored. Given the legal and fiscal costs of moving house in Ireland, this is understandable. But these affect location decisions only on a short run basis.

Two possibilities have to be considered. The first is that people will relocate in the long run from high tax rate jurisdictions to low tax rate jurisdictions. If this is the case, it seems probable that areas having higher numbers of "poor" will lose "wealthy" tax payers to nearby better-off areas - an explanation of the "flight to the suburbs" phenomenon often cited as a cause of urban blight and ghetto problems in the US. The second is that differential property taxation will cause firms to relocate with similar consequences. Further, the two may re-inforce each other.

A priori we would expect differential taxation of real estate to influence household location decisions. This hypothesis has been supported empirically. Tiebout's model of tax avoidance behaviour, therefore, has to be taken into account in assessing the desirability of local property taxes. It implies a long term trend towards segregation by locality and income, and is often cited as at least a partial cause of inner city blight, the creation of low-income, high tax, low service local jurisdictions with all their attendant problems. This scenario can be avoided, of course, by eliminating or drastically reducing differences in
tax rates as between jurisdictions. This, however, means either extending the borders (and reducing the numbers) of the separate jurisdictions, or regulating their freedom to alter tax rates. Such action may well become necessary to obviate inter-jurisdictional competition through tax rates to increase tax bases. Neither courses of action seems consistent with preserving or enhancing local government authority.

As far as firm location is concerned, not only is it obvious that differential property taxes will affect location for new firms, but there is evidence that existing firms can and will relocate in the face of substantial local tax differences. This increases the incentive for tax rate competition and reduces the viability of local property taxes as a means of financing purely local expenditure.

III. CENTRAL FINANCING OF LOCAL AUTHORITIES

Even if all redistributive functions were removed from local authorities, they would still be obliged to seek some other source of finance in addition to those under their control at present. Despite the reservations expressed in Part II as to the serious viability of property taxation as a locally variable tax, its other aspects commend it as a source of tax revenue. Part or all its yield could be earmarked for the local authorities from within whose jurisdiction it came. Lotteries are another obvious possibility - although the revenues which they would raise would hardly be substantial if a national lottery were also in operation.

Either via earmarking or explicit subvention, unless (and perhaps even if) a substantial local property tax can be made operational, continued financing of local authority spending by the Exchequer seems
inevitable. This is reinforced by the fact that the removal of responsibility for financing redistributive programmes at present carried out by local authorities would almost certainly leave the actual expenditure in the hands of the local authorities for the reasons already outlined in Part I of this paper.

If grants of one firm or another, in substantial amounts, are to be maintained, the question arises as to whether the structure and modus operandi of Exchequer grants could be improved. At the moment, local authorities receive grants from the Exchequer under in excess of 40 separate headings. By this device the Exchequer is enabled to control not only the level of local authority spending, but also its composition, further diminishing the autonomy of local authorities. Further, some of these grants take the form of lump-sum payments, while others are more of the nature of an expenditure subsidy, involving "matching payments" subject to some upper limit.

It seems obvious to me that the system of sub-dividing grants by functions is inconsistent with the declared aim of maintaining and enhancing local political autonomy. The Netherlands has managed to avoid this by establishing and implementing an agreed scheme of cultural subvention of local authorities on the basis of the total subvention available for all local authorities being divided amongst them according to an agreed index of statistical characteristics (population, income per head, percentage of developed to underdeveloped land......) and then being given to each of them as a block grant.11 Setting up some such allocation mechanism for this country would, therefore, seem desirable - and would have the further benefit of reducing the constant "micro" political pressure of local authorities on central government via T.Ds. and councillors representing purely local interests, with an obvious incentive to free-ride on
everyone else.

If, however, such a block grant system proves to be beyond the capacity of the D.O.E. to dream up and administer, or if it proved politically too difficult to introduce, an important, if rather piece-meal reform of the present system could still be introduced.

Discussing the structure of Exchequer grants to local authorities 13 years ago, the Government White Paper on local finances had this to say: 12

"The system as a whole does not facilitate good financial management; at local level, there is uncertainty as to what grant revenue may be anticipated (and when)..., while at central level, there is the difficulty of estimating....the payments likely to be made.....and of controlling expenditure under open-ended grant schemes."

The problem arises from the linking of grant payments to levels of expenditure. The actual procedures may vary from case to case, but the principal features of such arrangements are adequately described by modelling the system as one of "matching grants". The polar opposite is a lump-sum grant.

It can be - and has been - easily shown that the two forms of grant have major differences in their implications for the spending patterns of local authorities. 13 This holds true, under reasonable assumptions, whether local authorities behaviour is modelled "individualistically" (i.e. maximising some well-defined local social welfare functions) or as reflecting the median voter's preferences. Thus it is applicable to neo-Hobbesian or contractarian models of public sector economic activity.
The conclusions of this analysis are straightforward and intuitively plausible. They are that for any given level of subvention a system of lump-sum grants induces a lower level of local authority expenditure, overall and by programme area, than a system of matching grants. The reasons for this are simple: matching grants have expenditure augmenting substitution effects as well as income effects; lump sum transfers have income effects alone.

The lessons of this for local authority financing are obvious - especially under present fiscal circumstances. The Exchequer should replace any matching/contingent outlays with lump sums. Ideally, of course, the subvention to each local authority should take the form of a single block grant (on the basis outlined earlier) leaving the allocation of that grant to the local politicians.

CONCLUSIONS

My argument has been that the existence of a local finance problem basically reflects an error in role assignment. They should not be in the business of re-distributing income. Their increasing involvement (legislated on them by the Oireachtas) produced at first a rate-payers' revolt (1968-70) and eventually the elimination of local fiscal autonomy. The logical solution to this is not to find new sources of tax, but to enable the local authorities to withdraw from political and economic responsibility for income re-distribution by reducing their roles over a wide area of activity, leaving them, where necessary, to act merely as implementing and monitoring agencies of centrally determined policy programmes in these areas.
As far as a local property tax goes, I am not convinced it will enhance local fiscal and political accountability. That said, I agree wholeheartedly that some form of property tax should be introduced.

Finally, I suggest that in so far as Exchequer subvention is (and has to be maintained) it should move towards block grants - at best on a unitary basis; but if on a programme basis, by eliminating as far as possible any elements of matching finance.

2. There is no binding reason for excluding user charges rather than treating them as an indirect tax. The general problem of local and central finances, however, is that of matching household tax payments with the cost of public sector "output" where the benefits are in general not consumed by the households in proportion to their tax payments.


6. The differential taxation of real property between jurisdictions in the short run produces no incentive to move, as property prices should capitalise the tax liabilities. In the long run, however, the ratio of market price to replacement cost in the various jurisdictions will be affected, and relocation will result.


10. There is some evidence that a local income tax may be preferable in that it causes less relocation, which is plausible a priori – see Alberta H. Charney.


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Source: Derived from Council of Europe Study Service of Local and Regional Authorities.

NOTE: R = Regional level, U = Local level (excluding Department in France).

Absorption of Functions in local and Regional Authorities.