OECD Fiscal Federalism Studies

Institutional and Financial Relations across Levels of Government

Edited by Junghun Kim and Camila Vammalle

OECD Fiscal Federalism Studies

Institutional and Financial Relations across Levels of Government

Edited by Junghun Kim, Camila Vammalle

This work is published on the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the Organisation or of the governments of its member countries, or those of the Korea Institute of Public Finance (KIPF).

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

Please cite this publication as:
OECD/Korea Institute of Public Finance (2012), *Institutional and Financial Relations across Levels of Government,* OECD Fiscal Federalism Studies, OECD Publishing.
http://dx.doi.org/10.1787/9789264167001-en

ISBN 978-92-64-16689-9 (print)
ISBN 978-92-64-16700-1 (PDF)

Series: OECD Fiscal Federalism Studies
ISSN 2225-403X (print)
ISSN 2225-4056 (online)

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Photo credits: Cover © iStockphoto.com/Enkophotography

Corrigenda to OECD publications may be found on line at: *www.oecd.org/publishing/corrigenda*.

© OECD, Korea Institute of Public Finance (KIPF) 2011

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgement of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to *rights@oecd.org*. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at *info@copyright.com* or the Centre français d'exploitation du droit de copie (CFC) at *contact@cfcopies.com*.

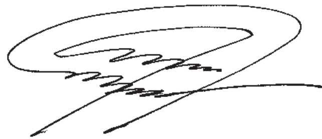
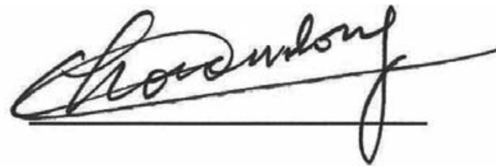
Foreword

The few years since the beginning of the worst economic crisis in decades have been particularly challenging for policy makers, both at central and sub-central levels of administration. As financial markets are putting pressure on governments to reduce their deficits and debts, sub-central governments (SCGs) have once again become key players in implementing national policies as they are responsible for 16% of public debt and 16.6% of public deficits on average in OECD member countries. How much leeway there is for co-ordinating consolidation strategies across levels of government depends on the institutional structure of intergovernmental relations and the effectiveness of the multi-level governance structure, which are the object of this volume.

In 2008, when the subprime debacle set off widespread financial and economic turmoil, governments acted rapidly to try to preserve employment and long-term growth opportunities. Many OECD member countries launched large stimulus packages, often specifically targeting public investment, to compensate for the drop in private investment. Given that sub-central governments are responsible for about 30% of public spending and 60% of public investment in OECD member countries, they played an important role in carrying out stimulus programmes. Compounding the difficulties, the crisis hit sub-central governments with a “scissors effect”, as they face not only decreasing tax revenue but also rising expenditures. Several OECD member countries designed special measures to support sub-central governments, to prevent them from carrying out pro-cyclical measures and to ensure coherence in the overall government response to the crisis. However, after the Greek crisis in July 2010, in a context where budgets at both central and sub-central levels had greatly deteriorated as a result of the crisis and stimulus efforts, priorities switched back to financial consolidation in order to reassure markets about the sustainability of public debt. This sudden reversal is particularly difficult for sub-central governments, which are still reeling from the consequences of the crisis and now have to confront the fact that the special measures taken by central governments to support them were petering out.

This book shows that in spite of a great diversity of financial and institutional frameworks, all OECD member countries face similar challenges, and there is no one type of framework which is more resilient than others. Each country has to design its own strategies, adapted to its financial and institutional specificities. This book relies on evidence-based comparisons to better understand the common stakes and the variety of responses, and to create a tool for policy dialogue and experience sharing. This methodology is often used by the OECD, and implemented through networks and committees such as the Territorial Development Policy Committee (TDPC) or the Network on Fiscal Relations across Levels of Government.

We are both very happy to underline the quality of the relationship between the OECD and the Korea Institute of Public Finance (KIPF) on issues related to multi-level governance and fiscal relations across levels of government. This co-operation has already resulted in two publications: *Governing Regional Development Policy: The Use of Performance Indicators* (2009), and *Making the Most of Public Investment in a Tight Fiscal Environment: Multi-Level Governance Lessons from the Crisis* (2011), and new projects are already under discussion to continue this fruitful co-operation.

Mario Marcel	Won-Dong Cho
	
Deputy Director, Public Governance and Territorial Development Directorate, OECD	President, Korea Institute of Public Finance

Acknowledgements

The OECD Secretariat is particularly grateful to the Korea Institute of Public Finance (KIPF) for its support of the research that was critical input to this report. Special thanks are extended to Mr. Junghun Kim, Director of Fiscal Research and Chair of the OECD Network on Fiscal Relations across Levels of Government.

This report was produced within the OECD Directorate for Public Governance and Territorial Development by the Regional Development Policy Division (RDP), directed by Mr. Joaquim Oliveira Martins. It was co-ordinated by Ms. Camila Vammalle (RDP), under the supervision of Claire Charbit, Deputy Head of the Regional Development Policy Division. It gathers individual contributions drafted by Ms. Camila Vammalle, Ms. Dorothée Allain-Dupré (RDP), Nr. Norbert Gaillard (Consultant), Mr. Hansjörg Blöchliger (Center for Tax Policy and Administration, and Economics Department) and Mr. José María Piñero Campos (Center for Tax Policy and Administration). Active participation from all authors is warmly acknowledged. Valuable comments and inputs were also received from Mr. William Tompson (RDP). Ms. Victoria Elliott provided editorial support. Ms. Jennifer Allain prepared the manuscript for publication and Ms. Jeannette Duboys provided secretarial assistance.

Table of contents

Introduction by Junghun Kim and Camila Vammalle 11

Part I Managing institutional and financial relations across levels of government in times of economic and financial turmoil 15

***Chapter 1* A sub-central government perspective on fiscal policy in a tight fiscal environment** by Camila Vammalle, Dorothée Allain-Dupré, and Norbert Gaillard 17

- Introduction 18
- From stimulus to consolidation: the sub-central perspective 18
- Fiscal consolidation requires the credible commitment of sub-central governments....... 27
- Making the most of reduced public investment in a tight fiscal context 33
- Conclusion....... 39
- Notes 40
- Annex 1.A1. Measures adopted by central governments to support sub-central public investment (2008-09) 41
- Bibliography....... 42

***Chapter 2* The political economy of fiscal decentralisation** by Hansjörg Blöchliger and Camila Vammalle 45

- Introduction and summary 46
- Methodology of the study 48
- The reform context....... 52
- Timing and scope 57
- Designing the reform process....... 63
- Conclusion....... 69
- Notes 70
- Annex 2.A1. Summary of the reforms analysed 71
- Bibliography....... 84

Part II Institutional and financial relations across levels of government: information on countries 85

***Chapter 3* Financial resources, expenditures and debt of sub-central governments** by José María Piñero Campos and Camila Vammalle....... 87

- Spending responsibilities of sub-central governments....... 88
- Sub-central government own revenues: taxes and user fees 99
- Grants in sub-central government revenues 112
- Sub-central government debt....... 121
- Notes 124
- Bibliography....... 125

Chapter 4 **Country notes** 127

Finland 128
France 131
Italy 135
Korea 139
Portugal 142
Spain 145
Sweden 149
United Kingdom 152
Notes 155
Bibliography 156

Tables

Table 1.1. Reduced central government financial support to sub-central governments 29
Table 2.1. The ten case studies 50

Figures

Figure 1.1. Sub-central government net surplus (+) / deficit (-) as a share of GDP in OECD member countries 20
Figure 1.2. Sub-central government capital expenditure as a % of GDP, 2009 compared to 2007 22
Figure 1.3. Sub-central government debt as a share of sub-central government revenues 23
Figure 1.4. Top four OECD member countries in issuing sub-central bonds (excluding the United States) 26
Figure 1.5. Evolution of an index of yields of top- and medium- to low-rated bonds (2007-2010) 26
Figure 1.6. Types of cuts in city spending, 2009 to 2011 32
Figure 3.1. Spending by level of government (2010) 90
Figure 3.2. Participation of each level of government in gross fixed capital formation spending (2010) 92
Figure 3.3. Functional distribution of sub-central government spending (2009) 94
Figure 3.4. Participation of each level of government in spending (2009) 95
Figure 3.5. Participation of each level of government in spending (2009) 97
Figure 3.6. Participation of each level of government in spending (2009) 99
Figure 3.7. Total consolidated sub-central government revenues (2010) 101
Figure 3.8. Sub-central government revenue composition (2010) 103
Figure 3.9. Sub-central government tax revenues 104
Figure 3.10. Sub-central government autonomous tax revenues (2005) 106
Figure 3.11. Composition of sub-central government tax revenue in % of total general government tax revenue (2009) 108
Figure 3.12. Share of sub-central governments in total property tax revenue (2009) 109
Figure 3.13. Share of sub-central governments in total personal income tax revenue (2009) 110
Figure 3.14. Share of sub-central governments in total goods and consumption tax revenue (2009) 110
Figure 3.15. Share of sub-central governments in total corporate income tax revenue (2009) 111

Figure 3.16. Sub-central government user fees (2010) 112
Figure 3.17. Composition of sub-central government grants as a share of total transfer revenues, according to the origin of the grant (2010) 114
Figure 3.18. OECD typology of grants 115
Figure 3.19. Earmarked *vs*. non-earmarked grants as a share of total sub-central government total transfer revenues (2006)..116
Figure 3.20. Mandatory *vs*. discretionary grants as a share of sub-central government total transfer revenues (2006)..117
Figure 3.21. Matching *vs*. non-matching grants as a share of sub-central government total transfer revenues (2006)..119
Figure 3.22. Current *vs*. capital grants as a share of sub-central government total transfer revenues (2010)..120
Figure 3.23. Composition of public debt by level of government (2010)............................122
Figure 3.24. Evolution of sub-central government debt as a share of sub-central government revenues (2000-2010)..123

Introduction
by
Junghun Kim and Camila Vammalle

The recent crisis and its aftermath has increased the demand for more effective public governance and highlighted the importance of the institutional and financial frameworks to design public governance schemes. In such a context, improving public governance is important to secure a fair and sustainable public service delivery and endogenous development in all regions.

In this renewed conscience of the need of improved governance, sub-central actors are often forgotten. Yet, they are a source of solutions, as well as a source of challenges. This report aims to put sub-central governments (SCGs) and their relationships with central governments (CGs) back in the centre of the stage. For this, this report gathers contributions prepared by the OECD in the context of the Territorial Development Policy Committee (TDPC) and the OECD Network on Fiscal Relations across Levels of Government.

The report highlights the great diversity of situations and frameworks across countries. The crisis had a major impact in terms of increasing disparities, in particular territorial ones. Policies designed to address the crisis and its effect (stimulus followed by consolidation) had to and must continue to mobilise sub-central actors, to design tailor-made solutions which address the specific challenges of each region, making the most of its assets in a coherent way.

The report is structured in two interconnected parts: the first part is analytical and the second part gives institutional and quantitative country information and comparisons. The latter aims at providing policy makers with precise information about the actual weight of sub-central governments in spending and revenues, their spending responsibilities, the sectors to which they are more exposed, the characteristics of their revenue sources and an overview of their debt situation. This data feeds the analytical part, by showing the diversity of sub-central government situations, and the different challenges they face as a result of the specific mix of spending responsibilities and revenue sources. It also aims at providing ready-to-use information on on fiscal and institutional relations across levels of government.

In the first analytical part, Chapter 1 aims at assessing the impact of the global financial crisis (2008-09) on sub-central governments' finances, and analyses the role of sub-central governments in national fiscal consolidation strategies, as well as their own strategies for reducing their budget deficits. But in such a tight fiscal context, it is crucial to secure long-term growth through appropriate investment, in particular for innovation and green growth. Given the importance of sub-central governments in public investment in OECD member countries, making the most of scarce resources requires an effective coordination between levels of government. Chapter 1 therefore looks at the lessons of

the implementation of stimulus packages during the crisis to discuss multi-level governance instruments which can help achieve this goal. The main conclusion is that co-ordination across levels of government, multi-level governance instruments, place-based approaches, use of conditionalities, and territorial reforms all seem to be important factors in this regard.

Given the deep changes in the types of challenges faced and instruments available for policy action, the recent crisis and present consolidation urgency may call for institutional and structural reforms of the system of relations across levels of government. Chapter 2 presents the results of a study carried out by the OECD Network on Fiscal Relations across Levels of Government on the political economy of fiscal federalism and local government reforms. This chapter identifies the political and economic factors that influence the design, adoption and implementation of changes to intergovernmental fiscal relations. In pushing for structural reforms, procedural rationalisation such as pilot programmes, experiments, comprehensive packages (bundling), transitional compensation, external expertise, communication, and concentration on principles contribute to securing a majority in favour of the reform.

Part II starts with a cross-country comparison: Chapter 3 gives an in-depth description of sub-central governments' financial resources and expenditure. It is based on a new database developed by the OECD Network on Fiscal Relations across Levels of Government which provides information on the relative importance of sub-central governments in total public revenues and expenditure, the types of revenues of sub-central governments, the specific spending responsibilities of sub-central governments, and the share of sub-central governments in public debt. This chapter aims at giving a tool to make a diagnostic of the financial situation of sub-central governments, and of the room of manoeuvre they have for increasing revenues or reducing expenditure, and the potential impact such expenditure cuts may have in terms of public investment and public service delivery.

Chapter 4 consists of country notes, which provide both institutional and financial data on eight countries (Finland, France, Italy, Korea, Portugal, Spain, Sweden, and the United Kingdom). These will be extended to all OECD member countries at a later stage.

The key messages that emerge from the combination of the analytical and the financial and institutional parts are the following:

- For what concerns the impact of the crisis, the data in Part II shows that sub-central governments which presented the highest deficits in 2010 are those which relied the most heavily on own taxes (states/regions in Canada and Spain, Iceland, Norway, New Zealand, Poland). The effect on deficits was even stronger for those which relied primarily on pro-cyclical taxes such as personal or corporate income taxes (PIT and CIT).
- Spending in social protection increased as a consequence of the crisis, and will likely continue to increase if OECD member countries turn into recession. Therefore, Poland, for which social protection represent an important share of spending may face increasing expenditure in the years to come. This is the case for example for Finland, Norway, Sweden, the United Kingdom, and municipalities in Germany.
- The higher the share of sub-central governments in public investment, the more consequences a deterioration of their financial position may have in terms of pro-cyclical impact on unemployment and growth. In Belgium, Canada,

Switzerland, and the United States for example, sub-central governments represent above 80% of public investment.

- The impact of the crisis on public service delivery depends on the allocation of responsibilities between levels of government. Part II provides detailed information, whether on financial terms (Chapter 3) or functional terms (Chapter 4). Among sub-central governments' responsibilities, some fields emerge more strongly: public investment, education and health. But in this field, there is a variety of pictures, and averages do not mean much. This is why this report provides information on a country basis, and not just as OECD averages.
- Sub-central government debt represents on average 16% of public debt in OECD member countries. In Canada, this share is as high as 56%. In Austria, Estonia, Germany and Switzerland, it is above 30%.
- On average, sub-central government debt represents one year of revenues for states/regions, and half a year for municipalities. In Canada, state debts represent 2.3 year's of revenues, in Japan and Germany it is above 2 years. In most countries this ratio has increased since 2000, and in particular, after the beginning of the crisis.
- This situation generated a renewed interest in reforming fiscal relations across levels of government. The reforms studied in this report are mainly reforms which increase decentralisation and equity. For such reforms, the fact that they took place during good economic times was a facilitating factor in their implementation. The present tight fiscal environment may be more favourable reforms aiming at increasing efficiency, even if it also calls for equity preserving reforms. While central governments have less leeway to give financial compensations to potential losers, a shared feeling of economic urgency may facilitate reforms that otherwise would not have been possible.

Since each country has unique political, economic and social environments, it is hard to identify a generalised pattern in institutional and financial relations across levels of government. But the overall lesson that can be drawn from the studies in this report is that effective response of local governments in harmony with the policies of the central government to increasingly volatile and uncertain economic conditions is a crucial element for sustainable growth and sound fiscal outcomes. Among many factors that affect the effectiveness of sub-central governments, policy co-ordination between the central and sub-central governments is of profound importance. Without vertically co-ordinated fiscal policies, expansionary fiscal policy of the central government is neutralizsd by pro-cyclical nature of sub-central government budget constraints. Likewise, vertically uncoordinated fiscal consolidation may put sub-central governments in excessively tight fiscal conditions.

Failures to have fiscal institutions that facilitate vertical co-ordination therefore give rise to the need for fiscal reform. According to the study in this report, such reform can effectively take place during the times of good economic conditions. However, it is also noted that the need for fiscal reform is most strongly felt during economic and fiscal crisis. In this era of economic turmoil, identification of problems that cause ineffective policy co-ordination and pursuit of fiscal reform that remedy them seem to be ever more important policy tasks faced by countries around the world.

PART I

MANAGING INSTITUTIONAL AND FINANCIAL RELATIONS ACROSS LEVELS OF GOVERNMENT IN TIMES OF ECONOMIC AND FINANCIAL TURMOIL

Chapter 1

A sub-central government perspective on fiscal policy in a tight fiscal environment

by
Camila Vammalle,
Dorothée Allain-Dupré
and Norbert Gaillard

This chapter assesses the impact of the global financial crisis on sub-central governments' finances and describes how the relationship between central and sub-central governments has evolved, from a strong support during the crisis, to requesting their efforts in the present phase of consolidation. The first section shows that the crisis and stimulus measures have increased the levels of sub-central government debts and exacerbated the disparities between strong and weak sub-central governments. The financial markets are now putting pressure both on central governments and on sub-central governments to reduce their levels of debt. The second section shows that a credible commitment on the part of sub-central governments is necessary to achieve fiscal consolidation and describes the measures being taken to achieve this. The third section explores the need for all levels of government to make the most of reduced public investment in a tight national fiscal context and presents some guiding principles how to do better with less.

Introduction

In the present context of uncertainty in the global financial system, instability in sovereign debt markets, pressure on public sector budgets and persistently high levels of unemployment (8.2% for the OECD area in March 2011), OECD member countries and regions are facing a narrow path to long-term growth. After two years of fiscal stimulus policies in 2008/09 that helped sub-central governments (SCGs) sustain public investment to fight the crisis, central governments (CGs) are under pressure to consolidate their budgets and reduce their deficits. Given that low economic growth is expected for the foreseeable future, central governments are trying to reduce their deficits to reassure the markets about the sustainability of their debts. In 2011, gross government debt is expected to exceed 100% of GDP in the OECD area (OECD, 2011a). In many countries, sub-central governments have contributed to this increase. As stimulus packages were phased out in 2010/11, many countries and sub-central governments were planning some combination of tax increases and spending cuts, with public investment particularly targeted as an adjustment variable. Such pro-cyclical policies run the risk of undermining recovery efforts. The right policy mix and trade-offs are difficult to find, and there are no easy solutions.

This chapter assesses the impact of the global financial crisis on sub-central governments' finances and describes how the relationship between central and sub-central governments has evolved, from a strong support during the crisis, to requesting their efforts in the present phase of consolidation. The first section shows that the crisis and stimulus measures have increased the levels of sub-central government debts and exacerbated the disparities between strong and weak sub-central governments. The financial markets are now putting pressure both on central governments and on sub-central governments to reduce their levels of debt. The second section shows that a credible commitment on the part of sub-central governments is necessary to achieve fiscal consolidation and describes the measures being taken to achieve this. The third section explores the need for all levels of government to make the most of reduced public investment in a tight national fiscal context and presents some guiding principles how to do better with less.

From stimulus to consolidation: the sub-central perspective

The impact of the 2008-09 financial and economic crisis varied across countries and across regions within countries.

A global crisis with regional impacts

The impact of the crisis has not been uniform across regions. The severe contraction experienced across the OECD in 2008-09 had substantial but highly variable effects on labour-market outcomes (OECD, 2010d). The variation in unemployment rates across regions within the OECD in 2009 exceeded the variation across countries, and the variation in the rise in unemployment rates during 2008-09 was similarly greater across regions than across countries (Allain-Dupré, 2011; and OECD, 2011c).

The rise in unemployment has been greater in vulnerable regions and/or those specialised in vulnerable sectors, in particular in manufacturing regions (e.g. the automotive sector). A 2010 survey in France revealed that 63% of employment losses during the crisis were located in the industrial sector, largely concentrated in

Franche-Comté, Champagne-Ardenne, Picardie and Auvergne (INSEE, 2010). In the United States, job losses have been most severe in areas that experienced a big boom in housing, those that largely depend on manufacturing and those that had the highest unemployment rates before the crisis (New York Times, 2010).

Although all types of regions – rural, intermediate and urban – have been affected in different ways depending on their industrial mix, the shock in most countries seems to have been concentrated in and around urban areas (OECD, 2011b). For example, the impact was larger in urban regions in Canada and the United States. However, in Sweden and Spain, while urban regions suffered the largest absolute impact in terms of job losses, the relative impact appears much larger in intermediate and rural regions close to cities (Sweden) and in intermediate remote regions (Spain). In Spain and the United States, the more vulnerable regions (those with the highest initial unemployment rates) saw unemployment rise the most during the crisis; this was less true of Canada and Sweden (OECD, 2010e).

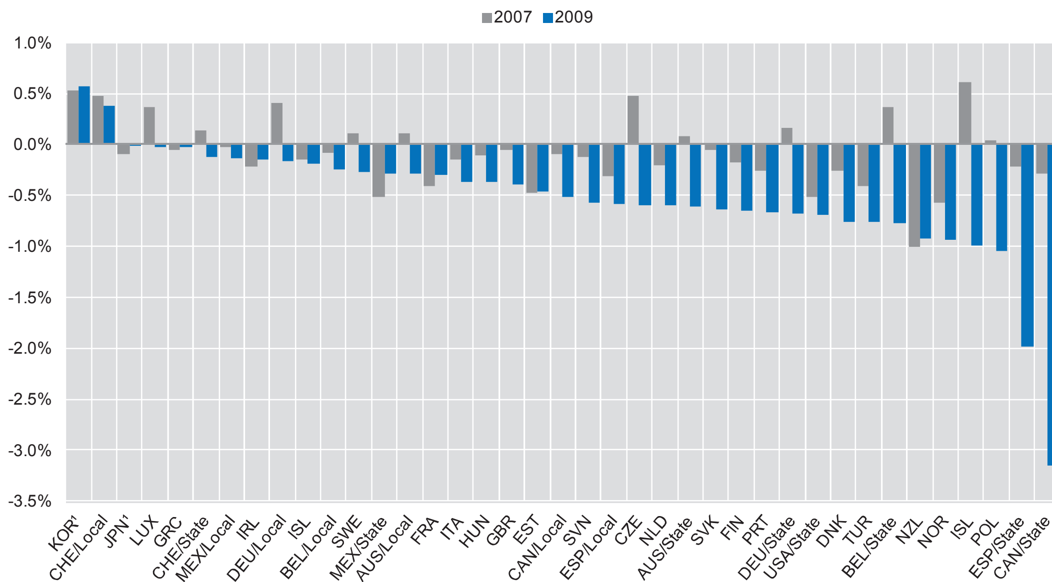
The crisis generated a strong "scissors effect" on sub-central governments' budgets

While the impact of the crisis on sub-central government finances varied across countries, most sub-central governments struggled with a "scissors effect" of decreasing tax revenues and rising expenditure (Bloechliger et al., 2010). Tax revenues fell sharply as a consequence of declining economic activity. In some cases, this was compounded by additional tax cuts planned for in national recovery packages. Sub-central governments that rely most on taxes faced the greatest deficit in 2009 (Canada-state, Iceland, New Zealand, Norway, Poland and Spain). The effect was even sharper in countries in which sub-central governments primarily rely on a pro-cyclical tax base, such as corporate or personal income taxes, (as in Spain and Canada, see Figures 1.1 and 3.16).

At the same time, the crisis led to higher spending on unemployment, social protection and social welfare more generally. In many OECD member countries, sub-central governments are responsible for welfare services and social transfers (see Figures 3.3, 3.4a, 3.4b and 3.4c). In EU countries, social protection spending by sub-central governments increased by 6.4% in 2009 and by 3.5% in 2010, as employment lagged behind economic activity (Dexia, 2011). As a result, sub-central government budget deficits have risen in countries where these are allowed, while spending cuts or tax increases have been required in countries where sub-central governments must follow balanced-budget rules (e.g. the United States). In Spain, for example, sub-central governments were severely hit by the recession, facing both a collapse of their revenues (-7.7%) and a surge in their expenditures (+15.5%) (OECD, 2010a). The unemployment rate, which soared from 8.7% in 2007 to 18% in 2009 and 20.7% in March 2011 (*OECD Labour Force Statistics*), prevented raising taxes and constrained sub-central governments to increase social protection spending (+34.1% between 2006 and 2009, *OECD National Accounts*).

As sub-central governments' revenues are often based on the previous year's activity (e.g. shared taxes, equalisation transfers, etc.), most sub-central governments saw the situation worsen in 2010 and 2011, despite a degree of recovery at the national level. In the United States, states consider fiscal year 2011 as one of the most difficult in modern times, with few improvements expected for 2012. According to the United States Center on Budget and Policy Priorities (CBPP), 44 states are projecting budget deficits totalling USD 112 billion for fiscal year 2012 (Johnson et al., 2011) (Box 1.1).

Figure 1.1. **Sub-central government net surplus (+) / deficit (-) as a share of GDP in OECD member countries**



Source: OECD National Accounts.

During the crisis, most central governments provided strong support to sub-central governments and public investment

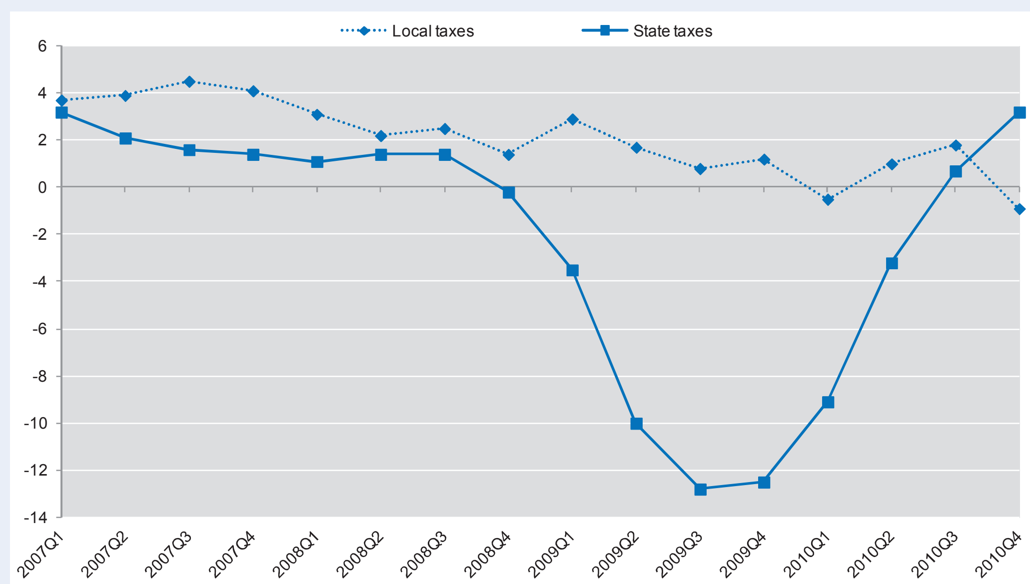
Support from national governments to sub-central governments was particularly needed, as sub-central governments were severely hit by the crisis. The situation of sub-central governments was important during the crisis, because they could have taken measures to balance their budgets that would have worked against national counter-cyclical efforts. Today, their financial difficulties may affect public service delivery and lead to a decrease in public investment (OECD, 2011b).

During the crisis and subsequent recession, central governments took active policy measures to support economic activity and employment. Many OECD member countries implemented stimulus packages, which in some cases amounted to 4% or more of GDP (Australia, Canada, Korea and the United States). These stimulus packages included both revenue-side measures (tax easing) and expenditure-side measures. On the expenditure side, the fiscal programmes typically focused on public investment. Given their large role in public investment in OECD member countries (Figure 3.2), sub-central governments have played an important role in implementing investment recovery strategies (Blöchliger et al., 2010). Some countries have specifically targeted their fiscal recovery packages towards sustaining public investment for sub-central governments. For example, one-quarter of investment funds have been administered by the *Länder* in Germany, one-third of the stimulus package has been managed by the states in the United States, half of the investment funding in Australia has been implemented by sub-central actors, and around 75% in Korea and Spain (Allain-Dupré, 2011) (see Annex 1.A1). By the end of 2010, most countries had already allocated more than 90% of the funds, in part through local governments (Australia, Canada, France, Germany, Korea, Spain and the United States) (OECD, 2011a).

Box 1.1. Evolution of sub-central government revenues in the United States

In the United States, the pattern of sub-central government revenues was quite particular. Sub-central government revenues (of state and local governments) grew 2.2% from 2007 to 2009, but this was mainly due to the increase in federal transfers. Indeed, state taxes decreased 4% in the last quarter of 2008, then dropped by more than 10% during the following three quarters. Local taxes were much more stable during this period (see figure below). It is relevant to note that only 18 states reported higher collections in the fourth quarter of 2010 than in the same quarter of 2007 (Boyd and Dadayan, 2011). As state revenue collections historically lag behind a national economic recovery, state revenues are expected to remain low throughout fiscal years 2011 and 2012.

Figure 1. Evolution of US state and local taxes (% change over four-quarter average)



Source: U.S. Census Bureau (tax revenue) and Bureau of Economic Analysis (GDP price index).

In the meantime, United States sub-central government spending increased by 7.1% between 2007 and 2009 (state and local governments combined). This “scissors effect” generated large budget gaps for state governments (USD 297 billion cumulated from fiscal year 2009 to fiscal year 2012). As most US states must follow balanced budget rules, these gaps were covered in part by USD 135 billion of federal funds received under stimulus legislation (also known as the American Recovery and Reinvestment Act of 2009, or ARRA), and in part by reducing expenditure (both investment and operational). But state governors must still close budget gaps of around USD 127 billion for the rest of fiscal years 2010, 2011 and 2012.

Source: OECD (2010), “The Impact of Consolidation at Sub-national Level: Where Do We Stand?”, GOV/TDPC/RD(2010)8, OECD, Paris.

Until early 2010, capital expenditure remained relatively high in most OECD member countries, as many sub-central governments adopted counter-cyclical measures to boost economic activities, in parallel with policies adopted by the various central governments (Blöchliger et al., 2010). For example, in 2009, the French central government advanced the reimbursement of the VAT to sub-central governments that agreed to maintain their capital expenditure above the 2004-07 average. This meant a total of more than

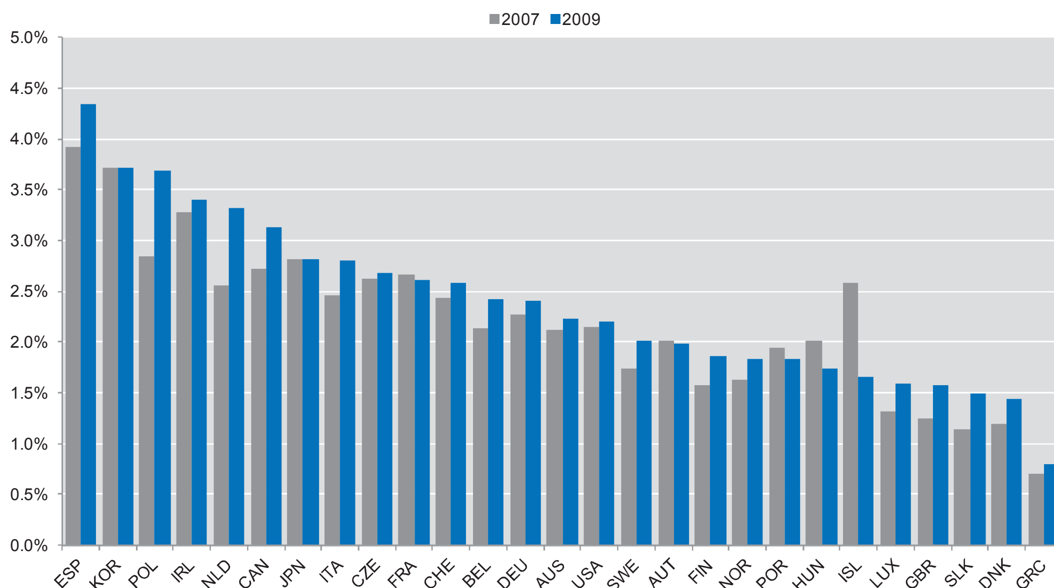
EUR 4 billion of expected VAT refund payments. Between 2008 and 2010, the capital expenditures of Polish sub-central governments increased 126% (Fitch, 2010a). German *Länder* and municipalities initiated additional infrastructure expenditure programmes (*Konjunkturprogramm 2*) in 2009-11, and the Austrian Government implemented a municipal infrastructure package. More globally, the increasing role of concessionary schemes – such as public-private partnerships – allowed sub-central governments to reduce the pace of capital expenditure, while maintaining infrastructure investments.

These measures contributed to prevent a massive drop in investment at the sub-central level in 2009. In Canada, Italy, Norway, Poland and Spain, there was even a significant increase in sub-central investment in 2009 (Figure 1.2). In France, Germany and the United States, national support essentially prevented a decline in investment that might otherwise have been significant (Allain-Dupré, 2011).

The crisis increased the level of sub-central government debts and raises questions about their sustainability

On average, sub-central government debt represents about 16% of total government debt in OECD member countries, but the variation is quite large: while in some countries it is close to zero (Greece, Korea), in most federal and quasi-federal countries, sub-central government debt represents above 25% of total government debt (except in Austria, Belgium and Mexico), and in Canada, it is over 50% (Figure 3.22). In nine countries, it is above 20%. This means that to achieve the objective of reducing the level of public debt, many countries have to co-ordinate with sub-central governments.

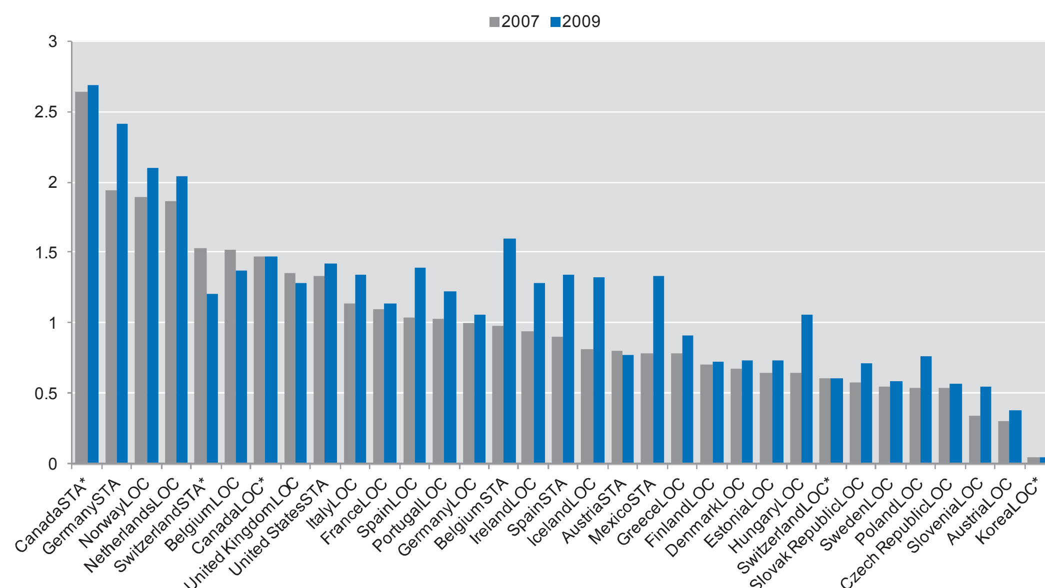
Figure 1.2. **Sub-central government capital expenditure as a % of GDP, 2009 compared to 2007**



Source: *OECD National Accounts*.

To avoid cutting public investment or increasing tax levels during the crisis, several countries have relaxed fiscal rules for sub-central governments to allow them to run higher deficits, thus leading to increased sub-central debt levels. Given the present context of reduced sub-central government revenues, in most OECD member countries there has been an substantial increase in the weight of debt in sub-central governments' budgets (Figures 1.3 and 3.28). On average, sub-central government debts represented about one year's revenue in 2007, and increased to 116% of a year's revenues in 2009. Of course, the weight of debts in sub-central government finances varies widely between countries: in four countries, outstanding debts represent more than two years' revenues in 2009 (Germany/states, Netherlands, Norway), and up to more than 2.5 years' revenues for Canadian provinces. In all but two countries, debt represents more than six months' revenues, with only Austrian municipalities below, and Korean municipalities close to zero. In all but five countries, the weight of debt in sub-central government finances increased from 2007 to 2009 (exceptions are the Swiss and Austrian states, and municipalities in Belgium, Canada and the United Kingdom). In some countries, the increase was quite significant. In Belgium, state debts grew from less than a year's worth to more than 1.5 year's worth of revenues. The increase in this share for the states in Germany, Mexico and Spain and for local governments in Hungary, Ireland and Spain was also equivalent to six additional months of revenues.

Figure 1.3. **Sub-central government debt as a share of sub-central government revenues**



Notes:

* Data for 2009 not yet available, numbers correspond to 2008 values.

Debt corresponds to total liabilities of each level of government, not consolidated, as they are defined in System of National Accounts (SNA). Liabilities include: currency and deposits, securities other than shares, loans, shares and other equity, insurance technical reserves, other accounts payable. This is a broader criterion than the Maastricht criteria, which do not consider shares and other equity, insurance technical reserves and other accounts payable. Data are presented non-consolidated, since in many cases, a large part of sub-central government debt is in the hands of higher levels of government, and would therefore disappear after consolidation.

Source: OECD National Accounts.

Sub-central government tend to have limited capacity to raise their revenues, given the often limited importance of own taxes in the revenue mix, and the fact that even in countries where own taxes represent a large share of sub-central government revenues, these are often constrained, and the capacity of sub-central governments to change rates and bases tend to be limited (Blöchliger and King, 2006) (Box 1.2). This therefore raises the question of whether sub-central governments' debts can be sustained, and where the funds to service their debt will come from: increased transfers from central governments, increased taxes, or cuts in other expenditure, such as capital investment.

Box 1.2. **Potential risks of sub-central government debt**

- Debt creates externalities across government levels, i.e. sustainability is determined by the joint actions of all governments. An individual government increasing its debt – even modestly – increases general government debt, thereby affecting interest rates and budget balances. The dynamics of this common pool problem are even more pertinent if discontinuities or threshold effects are present, i.e. if interest rates are suddenly rising or growth rates falling once a certain general government debt level is exceeded.
- The risk of contagion can disrupt financial markets. Financial problems in a few and even very small sub-central governments can have large repercussions on the functioning of markets for municipal bonds and lead to a rise in risk premia. Financial difficulties in a few sub-central governments may be contagious, spreading fear of a general malaise at the sub-central level.[1] Keeping debt thresholds relatively low for all sub-central governments reduce risk and uncertainty, making financial markets confident that local and regional governments are not a general case of concern.
- Flexibility (or fiscal space) to adapt fiscal policy is generally more restricted at the sub-central than at the central government level, making debt reduction difficult to achieve. With only 17% of general government tax revenue, space for sub-central government tax revenue increases is restricted. Tax competition may put additional limits on the scope for revenue rises. Many central governments put additional restrictions on tax autonomy, i.e. the right to introduce or abolish taxes or to change tax rates. Finally, sub-central government spending often concerns politically sensitive policy areas such as health care and education, where policy reforms are difficult. The lack of fiscal flexibility may suggest prudent debt levels since an increase in debt may be hard to reverse.
- Sub-central governments often own public enterprises whose debt is not accounted for in the *National Accounts* and which create contingent liabilities. In most countries, sub-central governments are owners or co-owners of infrastructure companies for water, energy, transport and the like. In several countries, states or regions are holders of public banks which also provide credit to public enterprises, municipalities, thus concentrating rather than spreading risks.[2] Sub-central governments owning public enterprises need to improve transparency, especially on the effective debt levels they are exposed to.
- Finally, in most countries central government is held responsible for sub-central government debt, often taking on the form of implicit or explicit bailout guarantees.[3] Sub-central governments expecting a bailout may then engage in unsustainable debt policy, thereby potentially increasing general government debt. The long-term implications with regards to the behaviour of sub-central governments facing a potential bailout have to be taken into account carefully when assessing maximum sub-central government debt levels.

Box 1.2. **Potential risks of sub-central government debt** *(cont'd)*

Notes:

1. Switzerland provides an interesting example for the small cause-big effect case. The default around the year 2000 of a small municipality – less than 0.05% of national GDP – caused the municipal bond market almost to collapse. Uncertainty about the fiscal situation of unaffected municipalities cut the municipalities from new liquidity and brought the body that managed municipal bonds into serious difficulties. It took municipal bond markets more than 1.5 years in order to return to normal. Also, fears of municipal defaults in summer 2011 led to rising interest rates for municipal bonds in the United States.

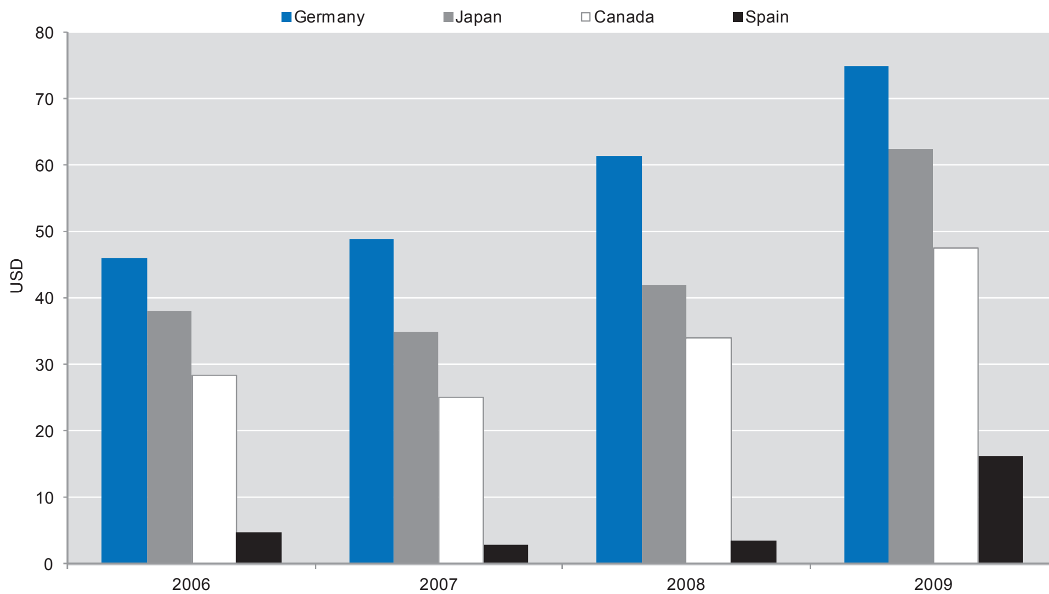
2. Defaults of state-owned banks have led to protracted financial difficulties for individual sub-central governments in Germany, Switzerland and the United States.

3. For example, Danish municipalities receive specific financial help from central government if they get into financial difficulties, and they are put under administrative control (Mau-Pedersen, 2011). In Germany, the constitutional court had ruled that the federal government had to help out two *Länder* (states) which were in financial distress.

Source: Blöchliger (forthcoming), "Fiscal Consolidation at Sub-national Level", working paper prepared for the November 2011 Fiscal Network meeting.

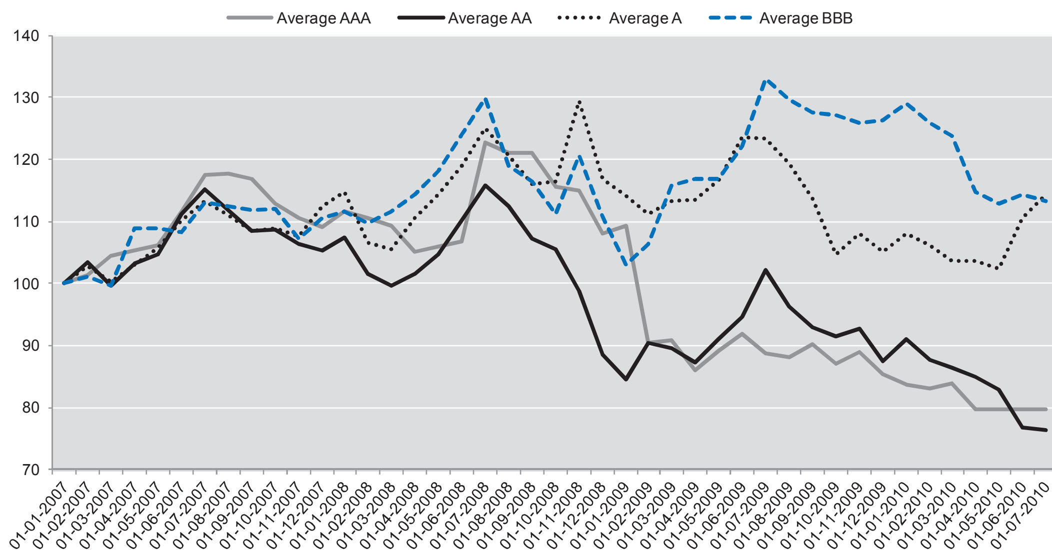
Sub-central governments resort more and more to capital markets to fund their needs: bonds currently make up about 70% of Western European[1] sub-central governments' total debt stock (Standard and Poor's, 2010). German states account for about two-thirds of the bonds issued by this group. Germany is the world's second-largest issuer of sub-central bonds after the United States (Figure 1.4). This increase in sub-central debt levels has come at a delicate moment in financial markets. The economic crisis led to the temporary disruption of sub-central credit flows in 2008, notably for bonds perceived as riskier (medium- to low-rated). In contrast, sub-central governments with top ratings benefited from a "flight to quality" and could tap international bond markets without much difficulty (except during the last quarter of 2008, in the wake of Lehman Brothers' collapse). Figure 1.5 shows the evolution of an index of yields[2] as a function of the creditworthiness of the borrowing sub-central government, as reflected in its credit rating (Box 1.3). Building an index of yields with the value 100 in January 2007, and distinguishing them by their ratings, makes it possible to analyse the performance of each type of bond during the crisis. Figure 1.5 shows that the negative impact of the crisis in October 2008 was disproportionately higher and lasted longer for medium- and low-rated sub-central governments (A and BBB) than for top-rated sub-central government borrowers (AA and AAA). The crisis therefore increased disparities between sub-central governments on financial markets as well as in economic terms.

Figure 1.4. **Top four OECD member countries in issuing sub-central bonds (excluding the United States)**



Source: *DCM Analogics* (database).

Figure 1.5. **Evolution of an index of yields of top- and medium- to low-rated bonds (2007-2010)**



Notes: Index of prices with 31/01/2007=100. Specific top-rated bonds are: Alberta 2005 4.43% 01/06/19; Oslo Kommune 2004 4% 06/12/12; Paris 2005 2% 24/11/14; Zurich Kantone 2002 2.75% 14/01/13; Nordrhein-Westfalen 2005 3.5% 16/11/15; Medium- to low-rated bonds are: Bucharest (city) 2005 4.125% 22/06/15; Valencia (gene.) 2005 3.25% 06/07/15; Lazio 1998 5.695% 23/06/28, Moscow (city) 2004 6.45% 12/10/11; Prague 2003 4.25% 19/03/13.

Source: Datastream (database).

Box 1.3. **Rating agencies and sovereign ratings**

A credit-rating agency is a private firm that assigns credit ratings to issuers of certain types of debt obligations, as well as the debt instruments themselves. In most cases, the rated issuers are national governments, sub-central governments, private companies or structured products.

A credit rating measures the issuer's credit-worthiness (i.e. its capacity to pay back its debts). Credit ratings affect the interest rate at which the issuer can issue bonds (i.e. borrow on the financial market). The higher the rating, the lower the return that investors will demand to hold the bond, as the probability of default (i.e. the risk of holding the bond) is lower.

There are three main rating agencies: Moody's, Fitch, and Standard and Poor's. They use similar types of ratings: the highest rating is "AAA" (assigned by Fitch and Standard and Poor's to issuers with the lowest credit risk), ahead of the "AA", "A", "BBB", "BB", "B", "CCC", "CC" and "D" categories. Moody's corresponding rating scale is as follows: "Aaa", "Aa", "A", "Baa", "Ba", "B", "Caa", "Ca" and "C".

The value of credit ratings was widely questioned after the 2007-09 financial crisis because the rating agencies failed to assess the risk of the subprime instruments correctly. Today, the importance given to ratings in international financial regulations is also coming in for criticism, because lowering the rating of a given country may trigger a multiplier effect and result in a self-fulfilling prophecy. Ratings are used to assess the risk of an investment portfolio. Therefore, when a rating falls below a certain threshold (known as "investment grade"), most pension funds and banks feel compelled to sell the security, contributing to the collapse of its price.

In some cases, sub-central government debt can even threaten the stability of central government debt on the financial markets. For example, the rating agency Moody's downgraded the rating of six Spanish regions in July 2011 (Le Nouvel Observateur, 2011) because they were not complying with their deficit targets. In October 2011, it also downgraded the sovereign rating of Spain, due among other reasons to doubts over the financial position of these regions. Recently, China published numbers on sub-central government debts, which represent 27% of GDP, i.e. more than the 17% official domestic debt (The Wall Street Journal, 2011).

Fiscal consolidation requires the credible commitment of sub-central governments

National budget deficits consist of the sum of the deficits of the central government, the sub-central governments and social security. Achieving a national target of deficit reduction requires co-ordination with sub-central governments, as reducing central government deficits will not be sufficient if sub-central governments offset these efforts by increasing their deficits. In Spain, for example, the budget deficit for 2010 was 9.2% of GDP. The central government has managed to cut its deficit to half that of the previous year, at 4.97% of GDP, but the deficit of the autonomous communities (ACs) rose to 3.39% of GDP, i.e. almost 0.30 percentage points above the forecasts. Local entities (consisting of more than 8 000 administrations) posted a 0.64% deficit, while the social security deficit amounted to 0.24% of GDP (La República, 2011). The deficit target for 2011 was 6%, but achieving this was likely to prove difficult, as several autonomous communities had already announced they would exceed their targets (Le Figaro Économie, 2011).

Central governments are requiring sub-central governments to participate in national consolidation efforts

Since the Greek crisis in the spring of 2010, both central governments and sub-central governments have been attempting to consolidate their budgets (Box 1.4). In most countries, national consolidation plans affect sub-central governments, which are often required to participate in consolidation efforts. Many central governments, fighting to reduce their deficits, are reducing or freezing their transfers to lower levels of government. If these were sustained during 2009 as part of the stimulus programme (+6.4% on average in EU countries), they were reduced by 1% in 2010 on average, with more than half of EU countries cutting transfers compared to the previous year (Dexia, 2011) (Table 1.1). This cut concerned mainly transfers for investment spending (-7.9%) (Dexia, 2011). In many countries, central governments also require sub-central governments to reduce their deficits (Germany and Portugal) or even to cut expenditure by given percentages (in Italy, for example, sub-central governments were required to reduce expenditure by 5% in 2010 and 2011 and by 13% in 2012).

Box 1.4. **Fiscal consolidation strategies at the national government level in OECD member countries**

Many OECD member countries are planning some combination of tax increases and spending cuts in 2011 and beyond, as their stimulus packages expire and budget consolidation begins. Fiscal challenges vary substantially across countries and regions; some face strong market pressure to reduce debt burdens while others have more room for maneuver. Countries in which financial markets have lost confidence have no choice and must undertake fiscal consolidation immediately.

Not surprisingly, countries with the largest economic imbalances and the most rapid deterioration in public finances require more extensive fiscal consolidation. For example, Greece and Ireland have introduced comprehensive fiscal consolidation plans, measured at around 22% and 17% of GDP respectively. Portugal, Spain and the United Kingdom have also announced large fiscal consolidation programmes that equal 6%-7% of GDP (OECD, 2011a).

A recent OECD analysis of 29 member countries' consolidation plans finds that in 2011-14, most governments will focus at the national level on expenditure cuts rather than revenue enhancement (OECD, 2011b). While almost all OECD member countries have deficit targets over the medium term, about half have announced consolidation plans that include measures over the 2010-13 period. For countries with consolidation plans, the size of the plan varies significantly, depending on the country's fiscal position and the current status and time frame of the consolidation plan. There is significant variation in the composition of consolidation measures. A number of countries have based consolidation mostly on expenditure-based measures. Fiscal consolidation is weighted on average two-thirds towards spending cuts and one-third towards increasing revenues (OECD, 2011a).

The largest expenditure reductions come from reducing programme expenditures, in particular programmes for welfare, health, infrastructure and pensions (OECD, 2011a). Cutting public investment is a priority for budget cuts in many countries, with 13 of the 29 responding countries scaling back public investments in their consolidation plans (OECD, 2011a). In Portugal and Spain, stopping or postponing infrastructure projects by downscaling investment expenditures is one of the most important contributions on the expenditure side (OECD, *ibid*).

Source: OECD (2011), *Making the Most of Public Investment in a Tight Fiscal Environment: Multi-level Governance Lessons from the Crisis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264114470-en*.

Table 1.1. **Reduced central government financial support to sub-central governments**

Country	Central government measures affecting sub-central government revenues (2009-2011)
France	The main transfer to sub-central governments, the *Dotation globale de fonctionnement*, is to be frozen at the 2010 level until 2013.
Germany	The federal government adopted a new fiscal rule in March 2009 that will limit the cyclically adjusted budget deficit of the federal government to a maximum of 0.35% of GDP and require balanced cyclically adjusted budgets for the *Länder*. It will become binding for the central government in 2016 and for the *Länder* in 2020. A longer transitional period has been agreed upon for the *Länder*, since some are experiencing serious consolidation problems. No borrowing limits have been specified for municipalities and social security funds. To comply with the new fiscal rule, the German Government has to reduce the structural deficit at the federal level by about 0.3% of GDP each year until 2016.
Greece	The government is planning a freeze in pay for all public sector workers, at all levels of government.
Italy	Italy adopted a EUR 25 billion austerity package for 2011/12, with a cut in EUR 8.5 billion in regions' budgets over the next two years. A new austerity package adopted in August 2011 further cuts transfers to sub-central governments by EUR 9.5 billion.
Korea	Significant spending reductions are planned for the environment (5.3%), general public administration (4.1%), and education (3.6%).
Mexico	The federal revenue sharing (FRS), the main federal revenue available for sub-central entities, decreased by more than 14% in 2009.
Portugal	Transfer payments from central to local government were reduced by EUR 100 million in 2010.
Spain	EUR 1.2 billion cut in transfers to local and regional governments in 2010. EUR 6 billion cut in public-sector investment in 2010.
United Kingdom	The United Kingdom adopted a severe austerity plan, with GBP 780 million (EUR 680 million) cuts in the Department for Communities and Local Government, a GBP 1.2 billion (EUR 1.05 billion) reduction in local authority grants, and the revocation of a GBP 1.7 billion (EUR 1.5 billion) earmarked grant to local governments.
United States	Many state governments are likely to pull back on transfers to municipalities.

Source: OECD (2011), *OECD Regional Outlook 2011*, First Edition, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264120983-en*.

In many countries, sub-central governments do not have much tax autonomy to increase their revenues (Figure 3.10), so pressure on them to reduce deficits may lead to cuts in public employment and spending on public services. The reduction of central government transfers can also generate a cascade effect, where each level of government replicates the reduction in their own transfers to lower levels. This is notably the case in the United States, where states are cutting transfers to local governments, and in Italy, where the regions are reducing their transfers to provinces and municipalities. In addition to an immediate reduction in spending on public services, this continued squeeze on local spending could hamper local and thus national recovery.

To support sub-central government public investment efforts, many countries have relaxed fiscal rules on sub-central governments during the crisis. This has led to higher sub-central government budget deficits and a surge in sub-central government debt (see next section). Today, many countries are strengthening fiscal rules on sub-central governments again. In 2009, the German Government adopted a new fiscal rule as part of a larger reform of the federal structure that will require the *Länder* to ensure balanced, cyclically adjusted budgets. In Italy, the 2010 update of the Domestic Stability Pact sets the burden sharing of regions and local governments. Accounting practices have been defined, and the harmonisation of the budget rules between central and sub-central governments is under way to enhance the transparency of public accounts and the accountability of sub-central governments. To increase budget transparency, the Spanish autonomous communities have agreed to present accounts quarterly instead of annually.

Sub-central governments often use capital expenditure as an adjustment variable

Given the increasing amounts of sub-central government debt and the difficult conditions in financial markets, many sub-central governments are taking measures to balance their budgets, as many face reduced own revenues and reduced support from central governments. One of the main adjustment variables seems to be capital expenditure: during 2008 and 2009, public investment by sub-central governments was often supported by central governments in the context of the stimulus measures, and increased by 4.2% and 4.7% respectively in EU countries (Dexia, 2011). Since 2010, investment spending is being sacrificed to balance budgets in 2010 and 2011, with an 8.3% decrease in 2010 on average in EU countries (Dexia, 2011). For example, more and more French *départements*[3] and municipalities have cut capital spending to counterbalance rising social expenditures (see Rapport Jamet, 2010). A recent OECD survey shows that nearly half of OECD member countries plan to scale back public investments in their consolidation plans (OECD, 2011b). According to Fitch (2010b), Spain's autonomous communities cut their capital expenditure budget to EUR 23 billion in 2011 from EUR 27.4 billion in 2010 and EUR 31.4 billion in 2009). Hopefully, some countries appear to be protected from this trend: German *Länder* and Scandinavian sub-central governments should be able to continue medium- and long-term investments thanks to their strong creditworthiness. To overcome economic downturns, Nordic municipalities can also rely on state-owned banks, whose mandate is to provide low-cost finance and debt management services to local governments: KommuneKredit in Denmark, Municipal Finance PLC in Finland, KBN Kommunalbanken in Norway, and Kommuninvest i Sverige AB in Sweden (Box 1.5). French local governments launched a new Local Government Financing Agency in September 2011 inspired by the Nordic model.

The most drastic examples of sub-central government capital spending cuts are in the United States. According to the National League of Cities' 2010 annual survey of city finance officers, 87% of city finance officers reported that their cities were less able to meet fiscal needs in 2010 than in 2009. When asked about the most common responses to prospective shortfalls, one of the most common responses was delaying or cancelling capital infrastructure projects (69%, up 7 points from 2009) (Figure 1.6). Capital spending cuts among US municipalities are much sharper than among European sub-central governments. These measures are the first step towards the fiscal austerity plans that were launched by many American mayors after 2009 (Hoene and Pagano, 2010).

Sub-central governments are seeking efficiency gains to reduce their deficits

Reacting to the transfer cuts and other revenue shortfalls, sub-central governments are attempting to improve efficiency in the provision of public services. This revives debates about territorial fragmentation, and possible economies of scale through amalgamation *vs*. inter-municipal co-operation solutions, as well as the potential benefits of contracting out, outsourcing and other forms of non-public sector involvement.

Box 1.5. **Municipal funding in Nordic countries**

For several decades, sub-central governments in Denmark, Finland, Norway and Sweden have employed an original instrument to satisfy their borrowing needs. In these four countries, municipal funding agencies were implemented to provide the sub-central government sector in their respective country with low-cost liquidity. As a result, Danish, Finnish, Norwegian and Swedish sub-central governments are less dependent on capital markets than other sub-central governments in the OECD.

The four main municipal funding vehicles are: KommuneKredit (Denmark), KBN Kommunalbanken (Norway), Kommuninvest i Sverige AB (Sweden), and Municipality Finance PLC (Finland). These vehicles were created at different times (in 1898, 1926, 1986 and 1989, respectively) and have different organisational structures, but they share many similarities:

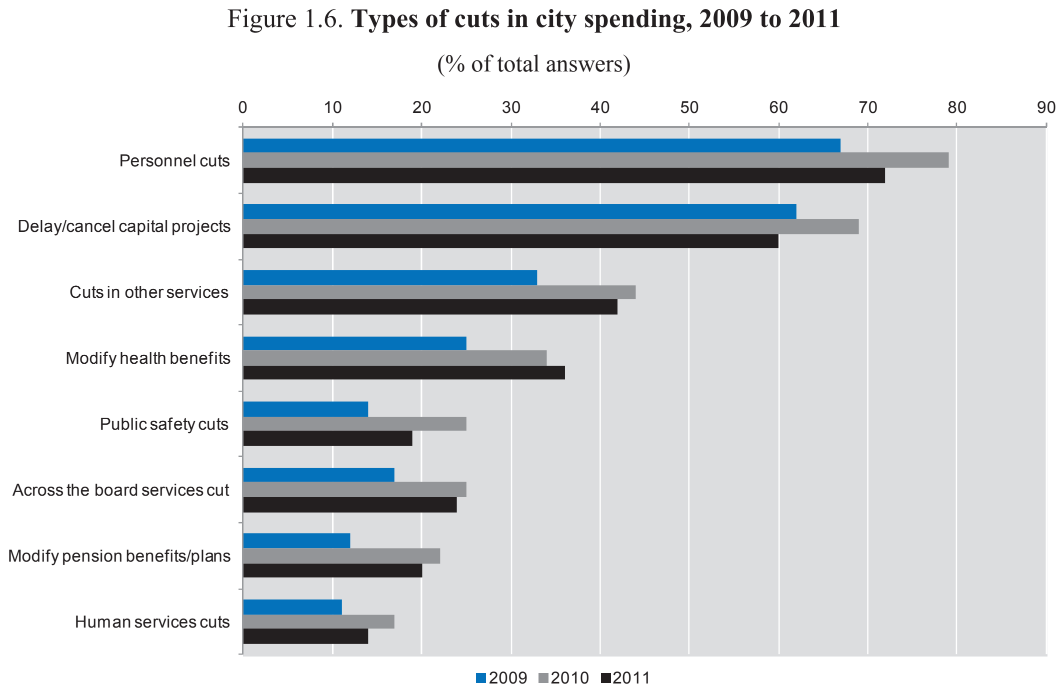
- They are not-for-profit entities with the sole purpose of providing competitive funding to sub-central governments.
- They hold big market shares in sub-central government lending in their respective countries: more than 90% for KommuneKredit in Denmark, around 50% for Municipality Finance PLC in Finland, 47% for KBN Kommunalbanken in Norway, and 40% for Kommuninvest i Sverige AB in Sweden.
- They are owned by the sub-central governments or the central government, and they benefit from various forms of “last resort” support mechanisms from their owners.
- They provide funding exclusively via the international bond markets, rather than via deposits.
- They have low-risk credit portfolios. Their 100% exposure to individual sub-central governments is mitigated by the strength of the Danish, Finnish, Norwegian and Swedish local government sectors.

Nordic municipal funding vehicles were particularly helpful during the recent financial turmoil, as they prevented disruption in the financing of sub-central governments. As of 31 December 2008, loans granted by Municipality PLC, Kommuninvest i Sverige AB, KBN Kommunalbanken Norway and KommuneKredit to their sub-central governments totalled EUR 7.57 billion, EUR 9.53 billion, EUR 12.18 billion and EUR 12.53 billion, accounting for 5.1%, 2.8%, 3.8% and 3.9% of GDP respectively.

Source: Standard and Poor’s.

Figure 1.6. **Types of cuts in city spending, 2009 to 2011**

(% of total answers)



Source: National League of Cities, National Association of Counties, and U.S. Conference of Mayors (2010), “Local Governments Cutting Jobs and Services”, *Research Brief*, July, Washington, D.C.

Spain’s economy was hit hard by the recent sovereign debt crisis, and the financial situation of the autonomous communities is particularly fragile. The autonomous communities have recently announced various measures to rationalise their public sector. For instance, they accepted a 5% reduction in wages across the public sector (which was decided by the central government but applies to all civil servants) and a promise to replace only one in ten retiring employees. Plans to concentrate the number of public agencies are also widespread, which contrasts with the previous period of 2003-09, when many such agencies were created.

In the United Kingdom, sub-central governments face challenging expenditure cuts. To encourage innovative solutions, they have been granted greater discretion on how to deliver public services, resulting in a series of original solutions, such as outsourcing local administration to major companies, wholesale contracting out of services, implementing an “Easy Council” model (based on the business model of low-cost airlines), where only the basic services are free, and extra payments are demanded for any additional service rendered, etc. Many councils are now considering creating joint departments, sharing joint chief executives, joint services, etc.

Renewed interest in structural reforms of relations across levels of government

Some OECD member countries are reconsidering long-term territorial and fiscal reforms to enhance the efficiency of sub-central actors, but the crisis has had divergent effects on these reforms. In some countries, the focus on urgent actions has delayed institutional reforms, which often require extensive negotiations before they are adopted (Blöchliger and Vammalle, 2011). This is was the case for Finland, where a planned reform of the regional grant system was largely scaled down. Other countries, on the

other hand, accelerated reforms. In Italy, sub-central governments accepted a greater reliance on own taxes, because the transfers from the centre are being cut in consolidation efforts.

Despite this mixed picture, fiscal consolidation is likely to trigger reforms aimed at increasing sub-central efficiency and tightening fiscal discipline (Blöchliger and Vammalle, 2011). In 2009, the German Government adopted a new fiscal rule as part of a larger reform of the federal structure that will require the *Länder* to ensure balanced cyclically adjusted budgets. In Italy, the 2010 update of the Domestic Stability Pact sets the burden-sharing of regions and local governments. Accounting practices have been defined and the harmonisation of the budget rules between central and sub-central governments is under way to enhance the transparency of public accounts and the accountability of sub-central governments. To increase budget transparency, the Spanish autonomous communities have agreed to present accounts quarterly instead of annually. Territorial reforms, aimed at achieving economies of scale in public service delivery and investment, are also high on the agenda of certain countries, such as Finland, France, Greece and Korea. Following the "Kallikrates" Law adopted in May 2010, the Greek Government launched a reform of the local and regional public administration to enhance transparency, productivity and efficiency. So far, the number of municipalities and regions has been reduced by 68% and 83% respectively (Les Echos, 2011). Overall, local government employees should be reduced by 50%, from 50 000 to 25 000, and the reform is expected to generate savings of about EUR 1.5 billion at the local administration level (Ministry of Finance of the Hellenic Republic, 2010). Italy adopted a new austerity plan in August 2011 that includes a territorial reform to reduce administrative costs. Rome plans to eliminate the less populous provinces (of less than 300 000 inhabitants), and to merge municipalities of less than 1 000 inhabitants. The government has announced that 50 000 local official positions should be eliminated (Les Echos, 2011).

Making the most of reduced public investment in a tight fiscal context

Better governance of public investment has become a pre-condition for making better use of scarcer fiscal resources. Confronted with the challenge of supporting growth in a tight fiscal environment, national and sub-central governments face the imperative of "doing better with less." Investment decisions are usually highly complex, involve long-term operational costs that need to be fully assessed, and shape regional and national economies for the future. The crisis has highlighted the challenges of investment decisions taken in situations of emergency, when speed becomes the only selection criteria. If, before the crisis, favourable fiscal conditions allowed some governments to mitigate the consequences of poor governance arrangements, now, in a climate of intense consolidation, better governance has become a priority and a pre-condition for making better use of scarce fiscal resources. Sub-central governments have a critical role to play in this respect.

Lessons drawn from the management of stimulus investment packages during the crisis

Investment strategies launched during the recession had a daunting task: like other stimulus measures, they had to be timely, temporary and targeted. While they had to be implemented quickly, they also had to correspond to strategic priorities and be transparent and subject to rigorous scrutiny. These demands are difficult to reconcile. Overall, the

focus has been on spreading resources across the territory rather than targeting for territorial impact.[4] Speed has mainly determined the selection of investment projects. Micro-scale infrastructure projects conducted at the municipal level could easily meet the criteria for eligibility. The emphasis on speed in committing funds, although understandable as a goal, has probably come at the expense of planning for maximum economic impact.[5]

Four challenges have been particularly important when implementing investment strategies across levels of government: *i)* the fiscal challenge, and the difficulty of co-financing investment; *ii)* the capacity challenge, associated with inadequate resources, staffing or processes for rapid, efficient and transparent implementation of investment funding; *iii)* the policy challenge, and the difficulty of exploiting synergies across different sectors and policy fields; and *iv)* the administrative challenge, and the fragmentation of investment projects at the local/municipal level. These issues can complicate the implementation of investment schemes, or result in unintended consequences, potentially undermining the plans' impact.

Co-ordination across levels of government and multi-level governance instruments have helped to overcome these challenges and target both short-term and long-term development objectives. While some countries were able to mobilise existing co-ordination mechanisms, others had to create them in the midst of the crisis. For example, the responsiveness of the Australian Government during the crisis was facilitated by a well-developed multi-level governance body, the Council of Australian Governments (COAG), which provided a forum for decision making and prioritisation of investment. In Sweden, "regional co-ordinators" were created to co-ordinate policies and resources from different levels of government. In the United States, both the federal government and states have created new institutions to co-ordinate the federal, state and agency levels. Horizontal co-ordination across jurisdictions has also been essential to target the relevant scale for investment effectively. In Germany, for example, implementation of the sub-central investment package was entirely decentralised, and there were some good practices of inter-municipal co-operation, for example in Nordrhein-Westfalen, where an agreement was reached across municipalities for the allocation of funds.

In responding to the crisis, regional policy and related governance instruments have also been valuable for prioritising investment and exploiting complementarities across programmes. In France, for example, regional policy tools such as inter-governmental contractual agreements helped to identify better targets quickly and to channel new central investment funding more effectively. Regional development strategies, defined for the EU Cohesion Policy, have been mobilised in several European countries to speed up decision making for the allocation of investment.

Overall, the effectiveness of recovery strategies based on public investment depends largely on the arrangements between levels of government to design and implement the investment mix. They are critical in particular for bridging the policy and financial gaps across levels of government, enhancing complementarities across programmes, facilitating public-private co-operation and fostering transparency in the use of funding at all levels (see Box 1.6).

Box 1.6. **Ten broad guidelines for multi-level governance of public investment**

Learning from the crisis, it is possible to identify a set of good practices for the design and implementation of public investment strategies across levels of government. These guidelines are interdependent, as the isolated effect of each of these principles may be significantly reduced if they are not implemented in a whole-of-government approach:

- **Combine investments in physical infrastructure with investments in "soft" infrastructure**, such as in human capital and other innovation-related assets, to maximise impact in terms of long-term productivity growth. Infrastructure policy needs to be closely integrated with other sectoral policies such as human capital and innovation, as part of a coherent development strategy. Investment funds are likely to work best as part of a multi-faceted policy package that makes use of other policy instruments.

- **Exploit the value added of place-based investment policies.** Investment should be prioritised to address the specific potential and impediments to growth in each region. In addition to national ministries/agencies, regional and local actors have a critical role to play in identifying policy complementarities and trade-offs in investment priorities. The social or growth objectives of investment projects must be clarified, and if growth is the aim, selection of projects through competitive procedures should be encouraged. Calls for tenders should allow local actors to reveal their specific knowledge and development potential. This is particularly important in times of tight budget constraints.

- **Improve co-ordination mechanisms for the design and implementation of investment strategies across levels of government.** The management of the crisis has shown that co-ordination is critical for designing well-informed investment strategies, better targeting them and ensuring policy and fiscal coherence across levels of government. Since the relationship among levels of government is characterised by mutual dependence, countries need to develop co-ordination arrangements to reduce potential gaps or contradictions between policy objectives, fiscal arrangements and regulations across levels of government, which can undermine national strategies for growth. This may imply setting up mechanisms to enhance dialogue across levels of government or specific instruments such as contractual arrangements. Co-ordination takes time, involves a learning curve and involves different types of costs (transaction, opportunity and monitoring costs). However, when properly designed and implemented, the long-term benefits of co-ordination should outweigh its costs.

- **Build a transparent management process to improve the selection and implementation of investment projects at all levels of government.** Prevent waste and corruption in investment projects starting from the selection process, throughout the tendering and right through contract management and payment. Maximise transparency at all stages of the procurement cycle, and establish clear accountability and control mechanisms. Given the complexity of investment decisions and their governance, institutional oversight mechanisms need to be well developed, not only for the audit function but also for the relevance of investment choices. Accountability processes should encompass the views of different stakeholders (citizens, NGOs, technical experts, etc.) regarding the use of funding, without compromising reactivity in the investment decision.

Box 1.6. **Ten broad guidelines for multi-level governance of public investment** *(cont'd)*

- **Enhance horizontal co-ordination across local jurisdictions** (municipalities in particular) to achieve greater critical mass at functional level and increase economies of scale in investment projects. Fragmented or poorly integrated investment may fail to capture the full benefits. This helps to avoid a proliferation of small-scale projects with low economic returns.
- **Rely on cost-benefit analysis and strategic environmental analysis to help inform and prioritise investment decisions.** Cost-benefit analyses should state whether the decision is made on the basis of economic benefits or qualitative goals. Because infrastructural investment tends to involve large-scale, frequently irreversible projects, it is crucial to ensure that existing stocks are being used efficiently before investing in new capacity. Operational costs of maintaining an investment over the long term, which are often under-estimated, should be fully assessed at an early stage in the decision-making process. Assessments of the long-term consequences of investment decisions need to be incorporated into budget systems at all levels of government.
- **Diversify sources of financing for infrastructure investment,** by making more and better use of user fees and creating mechanisms for securing long-term financing for infrastructure. Carefully assess the benefits of public-private partnerships (PPPs), as compared to traditional procurement. Consider setting up joint investment pools across public agencies/ministries, to help prioritise investment and overcome any tendency by spending agencies/ministries to consider only a limited set of investment options. Special attention is needed in the financing of such funds, as they risk becoming pro-cyclical.
- **Conduct regular reviews of regulations with potential impact on public investment decisions and strengthen regulatory coherence across different levels of government**. Conflicting regulations across government levels, as well as obsolete and excessive regulations, may impede public investment. Enhance coherence across sectors in regulation targeting cross-cutting outcomes such as green growth, innovation and risk management. Ensure the independence of regulators, which helps to establish a stable, credible and transparent framework for public investment.
- **Focus on capacity building at all levels of government.** Investment projects may fail, or create significant waste or corruption, in the absence of adequate or sufficient support services and credible leadership. Robust local public employment systems are called for, with transparent recruitment and remuneration rules. Developing the ability to manage relations with banks and private actors is crucial for the implementation of public investment. Local capacities to design appropriate investment strategies must be adequately developed, in particular regions' capacity to diagnose their competitive advantages and challenges.
- **Bridge information gaps across levels of government.** More work is needed in most countries to track investment at regional and local levels, in terms of spending and overall impact. Extend the efforts made during the crisis to enhance the use of e-government tools for performance monitoring of investment funding and the access of citizens, private firms and government services to shared databases.

Source: OECD (2011), Making the Most of Public Investment in a Tight Fiscal Environment: Multi-level Governance Lessons from the Crisis, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264114470-en*.

Making the most of reduced public investment

As stimulus packages are phased out, many countries (and SNGs) are planning some combination of tax increases and spending cuts in 2011 and beyond, and public investment is particularly targeted as an adjustment variable at all levels of government, as explained in Part II. Policy co-ordination, transparency and information sharing across levels of government are as crucial during the consolidation as during the management of the stimulus. It is all the more important to enforce strategies since budget cuts are by nature more difficult to implement than budget increases.

Multi-level governance challenges may in fact be amplified in the current context if appropriate co-ordination measures are not mobilised and if the focus is only on the short term. Urgency is also a key dimension of fiscal consolidation, given the scale of deficits and the pressure of financial markets. More than 70% of total consolidation efforts will take place between 2011 and 2012 (OECD, 2011a). Not only the fiscal gap, but also the policy and information gaps, run significant risks of becoming more acute if appropriate co-ordination efforts are not mobilised at all levels of government.

Risks include a cascading effect, where each level of government transmits the cuts in its budgets to lower levels of government. Other risks include trying to impose a one-size-fits-all fiscal consolidation strategy for all territories (despite the fact that fiscal and economic challenges vary considerably across regions) and across-the-board cuts in capital expenditures at the sub-central level, without distinguishing how important each programme is. To avoid shifting the problem from the centre to the regions, co-ordinated efforts by all levels of government are required to accommodate appropriate budget cuts for fiscal consolidation and to better prioritise investment in what unlocks each region's potential to restore growth.

Place-based approaches as levers to promote growth

The crisis has increased disparities across regions. The differentiated impacts of unemployment, ageing, immigration, financial situation, etc., call for differentiated responses that take into account a region's specific problems and the instruments available to it. In the current context of uncertainty, sub-central governments need to ensure access to welfare services to preserve social cohesion and trust at the territorial level, and to formulate a clear vision for local development strategies. Structural unemployment will continue to be concentrated in certain geographical areas, and the demand for social services will intensify the fiscal challenges faced by sub-central governments. Long-term recovery and fiscal consolidation strategies require national and regional policies tailored to local needs.

In a tight fiscal environment, where budgetary and monetary policies are no longer an option, place-based approaches and multi-level governance instruments to support them are amongst the remaining levers for promoting aggregate growth (OECD, 2011c). Such a policy approach consists mainly in exploiting policy complementarities that mutually reinforce the impact of different actions on a given policy outcome.[6] In itself, this approach does not add costs, but new co-ordination mechanisms need to be put in place to manage these complementarities.

The current context has renewed the debate and interest in some countries in regional and place-based policies. While some are reducing their regional focus in an austerity context, others have expressed renewed interest in integrated territorial policy approaches. Australia is moving towards a greater focus on place-based policies and has created a new ministry responsible for regional policy. In the United States, policies geared towards generating and supporting economic clusters have received increased attention. The United States administration outlined clear principles in July 2009 for a more integrated regional policy and called for a streamlining of redundant federal programmes.

Use of conditionalities

In the tight fiscal context, higher level funding authorities (whether national governments or a supra-national entity like the European Commission) must also ensure that their funds are used efficiently and effectively[7] when implementation is in the hands of regional or local bodies. EU member countries and the European Commission are currently discussing a range of proposals for "conditionality" in connection with the future of Cohesion Policy; the current US administration is engaged in trying to design (and incentivise) new forms of inter-governmental or public-private co-operation in conjunction with place-based initiatives, especially to promote innovation, and many OECD member countries are wrestling with the need to find more efficient and effective mechanisms for the management of policies involving a substantial inter-governmental dimension (OECD, 2011b).

There are also some indications that discretionary earmarked grants have come back into vogue in the last few years, after an extended period in which OECD member country governments seemed to be moving away from them. While one might expect a reversion to block grants in the context of fiscal consolidation (since lower levels of transfers to subordinate governments have often gone hand in hand with greater freedom in the use of these), earmarking may be seen as a way to protect growth-enhancing expenditure from broader budget cuts. The most growth-enhancing investments are likely to generate positive spillovers, i.e. benefits that extend beyond the spending jurisdiction. There may be a case for such grants to prevent sub-central governments from succumbing to the temptation to cut such spending, and investment spending in particular. This may help sustain expenditure on consumption and services, where spillovers are likely to be limited or non-existent.[8]

Territorial reforms

Territorial reforms intended to achieve economies of scale for public service delivery and investment are also high on the agenda of certain countries, such as Finland, France, Greece or Korea, as mentioned in Part II. Care is needed not to lose sight of the broad strategic picture when designing reforms affecting relations across levels of government. Reforms should not focus too narrowly on fiscal consolidation, but need to focus on long-term growth. If properly designed, reforms such as enhanced inter-municipal co-ordination have the potential to combine objectives of improved public service delivery and better governance of public investment.

Conclusion

This chapter showed that the crisis hit sub-central governments very hard, both by reducing their revenues and increasing their expenditure. This not only degraded their fiscal position but (when allowed) increased their debts. As for the implementation of stimulus measures during the global financial crisis, central governments now need to co-ordinate their actions with sub-central governments to achieve fiscal consolidation objectives. Some countries do not allow sub-central governments to borrow, but where this is permitted, debts have increased rapidly since 2007. The inability of sub-central governments to balance their budgets and reduce their debts may have negative consequences for the credibility of central governments' debts.

As a high-level official once put it, one should "never let a serious crisis go to waste". Although the crisis does not appear to have run its course, in a context of high uncertainty, some lessons from the 2008-10 period can already be drawn, with a forward-looking perspective on how to manage the current fiscal consolidation. A risk in the current context is to focus exclusively on short-term budget cuts and lose sight of the long-term strategic vision, at all levels of government. The pace of recovery and fiscal challenges differ significantly across regions, calling for differentiated strategies. Synergies and complementarities should be used to enhance the impact of individual policies. Managing fiscal consolidation and optimising public expenditures requires moving back to the structural reform agenda, in particular fiscal decentralisation and territorial reforms, as well as redefining the public-private interface in the aftermath of the financial crisis.

Notes

1. Western European countries included in the sample are: Austria, Belgium, Denmark, Finland, Germany, Italy, France, Norway, Spain, Sweden, Switzerland and the United Kingdom.
2. Bond yields measure the returns for investors who hold the bond (the interest they receive, corrected for the maturity and coupon of the bond). Yields therefore reflect financial investors' willingness to buy sub-central government bonds, and therefore, the facility with which sub-central governments can finance their expenditure needs and investments on the financial markets. A high/rising yield indicates that investors demand higher returns for holding the bond, which means that borrowing is more expensive for sub-central governments. A low/decreasing yield reflects investors' confidence in the security, since they are willing to hold onto it despite the lower returns.
3. An intermediary sub-central government level between municipalities and regions.
4. In a context of nationally launched strategies, priorities have been built vertically along existing sectors and programmes; and there has been little differentiation among territories in terms of allocation of funds. National governments have focused mostly on sectoral priorities for investment, in particular infrastructure (roads, railways, ICT, public transports, schools). Many countries have also sought a balance with "soft" investment, in particular to support R&D and innovation, green technologies and investment in human capital.
5. Recent OECD analysis (OECD, 2009b) has shown that the complementarities across the different types of investment in a place-based approach are essential, since infrastructure investment alone has little impact on regional growth. If a region is to benefit from a new road, school or any other type of public investment, certain conditions must be met in terms of complementary local infrastructure or services. Since this co-ordination does not take place spontaneously, multi-level governance (MLG) arrangements are needed to promote effective co-ordination across programmes and levels of government.
6. The concept of policy complementarities refers to the mutually reinforcing impact of different actions on a given policy outcome.
7. These two dimensions of performance are related but distinct. "Effectiveness" is concerned with performance relative to the objectives set, without regard to cost. Effectiveness reforms may increase or decrease cost, or be cost-neutral. "Efficiency" refers to the relationship between cost and outcome: efficiency reforms aim at better outcomes for any given level of expenditure.
8. In fact, the evidence suggests that such spillovers are likely to be modest in most cases; see Blöchliger and Petzold (2009), but in an environment of consolidation, central governments may still wish to use them to protect spending that they believe to be particularly important for growth.

Annex 1.A1

Measures adopted by central governments to support sub-central public investment (2008-09)

	Share of investment spending that transits through SNGs as a % of total national investment stimulus	Grants to SNGs	Other types of measures to support local investment
Australia	56%	Investment programmes funded by the Nation Building Plan were largely implemented by Australian states and territories through their agencies, as well as through commercial contracts they put in place.	
Canada	30%	Through the federal stimulus plan, sub-central governments are expected to contribute at least CAD 14.0 billion in stimulus, in addition to federal contributions of CAD 48.1 billion. They are to contribute, at a minimum, an additional CAD 7.3 billion to support infrastructure investments (federal funds are only supposed to cover part of the cost of infrastructure projects). Sub-central governments will also provide CAD 2.2 billion to federal investments in educational and knowledge infrastructure.	Acceleration of investment funds for local governments.
France	27%		In addition to additional national investment funding, local governments have been able to accelerate planned investment through a one-year advance of VAT reimbursements, for an expected total of EUR 3.6 billion in VAT refund payments.
Germany	26%	The sub-central investment scheme accounts for about 26% of the funds provided by the stimulus package II.	
Korea	75.2%	About 75.2% of the investment package is targeted to sub-central governments (KRW 7.6 trillion out of KRW 10.1 trillion).	
Spain	73%	The EUR 8 billion state fund for local investments accounts for the lion's share of the Spanish stimulus measures and focuses on infrastructure investments.	
United States	One-third of total ARRA funding administered by states	Of the USD 787 billion recovery package, USD 275 billion was allocated for contracts, grants and loans to support public investment measures, which amount to 35% of the recovery package. Of the USD 787 billion of the stimulus plan, USD 286 billion is administered by states and municipalities.	Non-replacement rule for infrastructure investment.

Source: Results of the 2010 OECD questionnaire and updated from OECD (2010), "OECD Economic Outlook No. 87", *OECD Economic Outlook: Statistics and Projections (database),* Vol. 2010/1Vol. 1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/data-00492-en*.

Bibliography

Allain-Dupré, Dorothée (2011), “Multi-level Governance of Public Investment: Lessons from the Crisis”, *OECD Regional Development Working Papers*, 2011/05, OECD Publishing, Paris.

Blöchliger, H., C. Charbit, J.-M. Piñero Campos and C. Vammalle (2010), “Sub-central Governments and the Economic Crisis: Impact and Policy Responses, *OECD Economics Department Working Paper No. 752*, 18 February, OECD Publishing, Paris.

Blöchliger, H. and D. King (2006), “Fiscal Autonomy of Sub-central Governments”, *OECD Network on Fiscal Relations across Levels of Government Working Paper No. 2*, COM/CTPA/ECO/GOV/WP(2006)2, OECD Publishing, Paris.

Blöchliger (forthcoming), “Fiscal Consolidation at Sub-national Level”, working paper prepared for the November 2011 Fiscal Network meeting

Blöchliger H. and O. Petzold (2009), “Taxes and Grants: On the Revenue Mix of Sub-central Governments”, COM/CTPA/ECO/GOV/WP(2009)7, OECD, Paris.

Blöchliger, H. and C. Vammalle (2011) *Reforming Fiscal Federalism and Local Governments: Beyond a Zero Sum Game*, OECD Publishing, Paris.

Boyd, D.J. and L. Dadayan (2011), “Tax Revenues Finished 2010 Strong: Growth Continues in Early 2011”, *State Revenue Report No.83*, April, Nelson A. Rockefeller Institute of Government, Albany, NY.

Financial Times (2010), “Obama Unveils New Stimulus Plans”, Washington, D.C., 8 September.

Dexia (2011), “Sub-national Public Finances in the European Union”, July, Paris.

Fitch Ratings (2010a), *2011 Outlook: Fiscal and Operational Challenges Remain for European Sub-nationals*, 13 December, London.

Fitch Ratings (2010b), *Spanish Autonomous Communities’ 2011 Draft Budgets*, 23 December, London.

Hoene, C.W. and M.A. Pagano (2010), “City Fiscal Conditions in 2010”, *Research Brief on America’s Cities,* National League of Cities, October, Washington, D.C.

INSEE (2010), *Les conséquences de la crise sur l’emploi dans les régions*, Insee Première No. 1 295, Stève Lacroix, Division statistiques régionales, locales et urbaines, mai 2010, INSEE, Paris.

Johnson, N., E. McNichol and P. Oliff (2011), *States Continue to Feel Recession’s Impact*, Center on Budget and Policy Priorities, 9 March, Washington, D.C.

Ministry of Finance of the Hellenic Republic (2010), "The Economic Adjustment Programme for Greece", *Report submitted in accordance with Council Decision 9443/10 (ECOFIN 250, UEM 171)*, July, Athens.

National League of Cities, National Association of Counties, and U.S. Conference of Mayors (2010), "Local Governments Cutting Jobs and Services", *Research Brief*, July, Washington, D.C.

New York Times (2010), "Geography of a Recession", 3 May, *www.nytimes.com/interactive/2009/03/03/us/20090303_LEONHARDT.html?src=tp*.

OECD (2009a), "Bridging the Gaps Between Levels of Government", *OECD Policy Brief*, OECD Publishing, Paris, *www.oecd.org/dataoecd/43/8/43901550.pdf.*

OECD (2009b), *How Regions Grow: Trends and Analysis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264039469-en.*

OECD (2010a), "The Impact of Consolidation at Sub-national Level: Where Do We Stand?", GOV/TDPC/RD(2010)8, OECD, Paris.

OECD (2010b), "OECD Economic Outlook No. 87*", OECD Economic Outlook: Statistics and Projections (database),* Vol. 2010, OECD Publishing, Paris, *http://dx.doi.org/10.1787/data-00492-en*.

OECD (2010c), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*.

OECD (2010d), "Regional Labour Markets and the Crisis", note by the Secretariat for the 24th Meeting of the OECD Territorial Development Policy Committee, GOV/TDPC/RD(2010)7, OECD, Paris.

OECD (2011a), *Making the Most of Public Investment in a Tight Fiscal Environment. Multi-Level Governance Lessons from the Crisis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264114470-en*.

OECD (2011b), *Regional Outlook*, First Edition, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264120983-en*.

OECD (2011c), *Regions at a Glance*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/reg_glance-2011-en*.

Rapport Jamet (2010), *Rapport à Monsieur le Premier Ministre sur les finances départementales*, April.

Standard & Poor's (2010), "Western European Local and Regional Governments' Borrowing Likely to Reach a New High in 2010", 11 May, Standard and Poor's.

Chapter 2

The political economy of fiscal decentralisation

by
Hansjörg Blöchliger
and Camila Vammalle

In the present tight fiscal environment, many countries may seek to reform their fiscal relations across levels of government to try to find efficiency gains. Although fiscal federalism reforms are meant to make intergovernmental fiscal relations more efficient, more equitable and more stable, experience shows that they usually face stiff political resistance. Little analysis has been done so far on the political economy of fiscal federalism and local government reforms. The present chapter summarises the main conclusions of the study carried out by the OECD Network on Fiscal Relations across Levels of Government. The first section analyses why governments undertake fiscal federalism reforms, and the methodology used in the study. The second section focuses on the context for the reform, i.e. on the factors that shape and influence reforms and reform processes, but that lie largely beyond the control of policy makers, such as the general economic situation or electoral mandates. The third section discusses the issues of the timing and scope of the reforms, and in particular, underlines the importance of bundling several reforms together. The last section deals with the design of the reform process.

Introduction and summary

Efficient and effective fiscal relations across levels of government are key ingredients for sound fiscal management, especially in times when fiscal consolidation is among the top policy priorities. Although fiscal federalism reforms are meant to make intergovernmental fiscal relations more efficient, more equitable and more stable, experience shows that they usually face stiff political resistance. But the need for reform is not likely to fade: the importance of reforming fiscal relations and of raising the efficiency of sub-central governments has become even more urgent in the face of the need to consolidate after the crisis.

Little analysis has been done so far on the political economy of fiscal federalism and local government reforms. The effective management of intergovernmental fiscal reforms in a challenging political economy environment is at the heart of a recent study carried out by the OECD Network on Fiscal Relations across Levels of Government (Blöchliger and Vammalle, 2011). To better understand the conditions that underpin successful reforms, this study analysed cases of reform in ten countries from the perspective of the political economy, using a uniform approach. The aim was to identify the elements that helped to overcome earlier barriers to reform in order to provide guidance to policy makers as they design reforms that are both effective and politically palatable. The present chapter summarises this study and presents its main conclusions and policy recommendations.

Some factors that determine the success of reforms are outside the scope of policy makers. Fiscal relations are shaped by country-specific frameworks and reforms often touch upon constitutional arrangements that demand a strong mandate for change. Economic and fiscal conditions may evolve during a reform episode, influencing the direction of the reform and indeed whether it is passed at all. Immediate distributional effects are highly visible and often result in a focus on the short term, which makes it difficult to pass long-term reforms that genuinely enhance efficiency. But within this context, policy makers have scope to help a reform succeed. They may be able to influence the timing, the scope and the sequencing of the reform. Political leaders may help secure support for it, and the administration and external experts can help in developing credible proposals for reform. Finally, by fine-tuning the design of a reform, policy makers may be able to head off opposition and help to ensure its final passage.

The main lessons from the study are as follows:

- **Good economic and fiscal conditions can help.** One of the most salient findings is that the success of a reform is strongly associated with a healthy economic situation and sound fiscal positions. While a few reforms were initiated when the economic situation was weak or driven by the need for consolidation, implementation of virtually all the reforms studied were carried through when central and – to a lesser extent – sub-central public finances were in good shape. A sound fiscal position makes it possible for the central government to compensate sub-central governments, and resistance tends to be stiffer and failure more likely without central government support. The legacy of the crisis is likely to change the role of economic and fiscal conditions for reform. Weak growth and a lack of financial resources will change reform objectives as well as central government's role as paymaster.

- **Different levels of government do not always have antagonistic interests.** Central and sub-central governments are the main stakeholders in fiscal relation reforms, and in many instances, they do not have strongly opposed stakes and interests. The dividing line instead separates individual sub-central governments, often (if not always) wealthy and poor ones.
- **Electoral mandates are important but not crucial.** Electoral mandates are an important driver for reforms, although fiscal federalism and local government issues rarely figure prominently in election campaigns. The stronger an electoral mandate, the more comprehensive a reform tends to be. Campaigns tend to focus on generic objectives such as "more autonomy", "better public services", "a fair regional distribution" and less on the intergovernmental mechanics that are needed to achieve them. However, fiscal relation reforms can be achieved without explicit mandates. Given their often technical and non-ideological nature, governments have some scope to negotiate a reform without an explicit mandate.
- **Political leadership tends to accelerate a reform.** Political leadership – i.e. the presence of a person or a political group committed to the reform process – proved to be a significant factor for reform success. In several cases, a few determined politicians helped push through a reform where earlier attempts had failed. Political credibility was increased if politicians driving the reform process had no direct stake in the reform.
- **Reforms often build on earlier reform attempts, pilot programmes and experiments.** Fiscal federalism and local government reform often touch on the founding institutions of a country, and reforms sometimes require constitutional amendments. Reform success is often preceded by several failed attempts or even reversals. Such attempts build up expectations and pressure for more comprehensive reforms later. Moreover, experiments and pilot programmes, which tend to be easier to implement in fiscal relations than in other policy areas, can demonstrate the effectiveness of reforms and pave the way for change on a grander scale.
- **Bundling is required to bring majorities on board.** Most successful reforms of fiscal relations consist of comprehensive packages offering benefits to a large array of actors. Bundling of various elements makes it possible to spread the benefits more evenly across various types of jurisdictions and stakeholders. Bundling also allows more emphasis to be placed on long-term considerations, with reforms often bundling efficiency-enhancing elements with distributional objectives. Indeed, wide-ranging fiscal federalism and local government reforms try to strike a balance between efficiency and equity objectives.
- **Transitional compensation is almost always necessary.** Transitional arrangements are a frequent expedient that help to ensure that no jurisdictions and stakeholders lose out in the short run. Transitional arrangements have their benefits beyond securing reform success as they help preserve reform consistency, with necessary political compromises being relegated to a transitional period. On the other hand, they usually come at the expense of the central government. In certain cases, and in order to deflect categorical opposition by a few jurisdictions, opt-out clauses might be provided.

- **External expertise creates credibility.** Many fiscal federalism and local government reforms are both overtly "political" and highly technical. Independent experts can help here on both fronts. By providing impartial and unbiased scrutiny, independent experts lend credibility to the reform. In addition, experts can help set up specific technical support as the reform is being designed. In some instances, expert panels and reports were considered the crucial element in the success of a reform.
- **Communication creates ownership among stakeholders.** Wide and open communication not only creates support among dispersed winners, who may often not be aware of the potential gains involved, but also helps identify potential problems with individual elements of a reform. Successful communication emphasises the long-term benefits without concealing the negative impacts for certain jurisdictions. Keeping the details from the public tends to undermine the credibility of the government.
- **Consultation and involvement should concentrate on principles.** Consultation and involvement create ownership of the reform. The reforms that were the most successful appeared to be those where the central government clearly presented and discussed the overall and long-term objectives.

The present chapter summarises the main conclusions of the study carried out by the OECD Network in Fiscal Relations across Levels of Government.[1] The first section analyses why governments undertake fiscal federalism reforms and the methodology used in the study. The second section focuses on the context for the reform, i.e. on the factors that shape and influence reforms and reform processes, but that lie largely beyond the control of policy makers, such as the general economic situation or electoral mandates. The third section discusses the issues of the timing and scope of the reforms, and in particular, underlines the importance of bundling several reforms together. The last section deals with the design of the reform process.

Methodology of the study

Using the lens of the political economy to analyse fiscal relations reform

One of the salient features of fiscal federalism in OECD member countries during the past decade has been a trend towards decentralisation, as policy reforms increased the power of state and local governments. From 1995 to 2008, the average share of sub-central governments in general government spending rose from less than 31% to more than 33%, while the sub-central share of general government tax revenues rose from 16% to 17%. Some countries have embarked on a comprehensive shift to decentralisation involving wide-ranging changes to their institutional arrangements (Box 2.1). However, many attempts to reform fiscal relations have encountered difficulties. Various reforms – including the territorial reorganisation of public service delivery, changes to the sub-central tax structure, and the tightening of sub-central fiscal rules – have stalled or been introduced only partially and after several unsuccessful attempts. The technical and political obstacles to wide-ranging reforms of fiscal arrangements are formidable. The challenge is to resolve how they may be overcome and the benefits of decentralised policy making fully realised, especially in a context where sub-central governments have to participate in fiscal consolidation.

Box 2.1. **Why reform fiscal relations?**

Fiscal relations reforms in most OECD member countries are driven by a multitude of factors, whether structural, macroeconomic or political. Sub-central entities are integrated into inter-regional and international trade and are vulnerable to globalisation pressures, requiring changes to sub-central taxation, more productive public spending and better intergovernmental transfer systems. Responsibilities across government levels are often opaque, raising demands for a more efficient division of tasks between levels of government. Technical progress changes the way public services are provided and consumed, calling for the administrative reorganisation of service delivery. Demographic change, spatial mobility and widening interregional disparities – often the consequence of economic agglomeration and the attraction of metropolitan areas – increase pressure to introduce or amend fiscal equalisation systems. Deficit bias and the need for fiscal adjustments call for amended sub-central fiscal rules or other forms of enhanced fiscal co-ordination. In some cases, the need for reform is a consequence of earlier reforms: decentralisation of spending can lead to unfunded mandates, and other revenue-side imbalances can require improvements to sub-central tax systems or intergovernmental grants. Finally, the emergence of political movements such as communitarianism leads to demands for local and regional empowerment.

In an effort to help governments understand the obstacles to reform and the best ways to overcome them, the OECD Network on Fiscal Relations across Levels of Government studied a series of reforms from the perspective of the political economy of reform. The objective was to analyse how political, economic and institutional factors influence the design, adoption and implementation of policy changes, and how policy design and the reform process are intertwined. Given the idiosyncrasies of fiscal federalism institutions, such reforms would at first appear to be highly country-specific, with little scope for cross-country comparison, as shown by the wide variations of the fiscal federalism framework between countries that are underlined in Part II. But within this context of diversity, policy makers face similar challenges and opportunities to make fiscal relations more efficient, equitable and stable. They may be able to influence the timing, the scope and the sequencing of the reform process and thus change the balance between winners and losers or between short- and long-term effects. By adapting the design of the reform, they may be able to reduce opposition and to secure a majority in favour of the reform. The study summarised in this chapter is based on episodes of reform in ten OECD member countries (Table 2.1 and Annex 2.A1), which show that despite the wide differences in institutional backgrounds, the challenges are similar.

The stakes in fiscal relations reforms

The problem for policy makers aiming to reform fiscal federalism and local government is that benefits do not accrue equally to all citizens and jurisdictions. While reforms are supposed to benefit the economy and the society as a whole, their costs and benefits are unevenly distributed, and some individuals and groups are bound to be net losers, particularly in the short run. These losers, whose numbers may not be large, often have well-identified stakes and interests, which they tend to defend vigorously. The benefits of reform are often thinly spread over a large and dispersed group of beneficiaries who are often not aware of the potential gains of reform. In addition, the cost of the reform tends to become apparent immediately, while the benefits, whose extent is uncertain, tend to emerge later. The asymmetry between winners and losers in

the reform process and uncertainty over the size and distribution of the future benefits may weaken the support for reform. A bias toward the status quo, and resistance to reform, may result, even if potential winners are likely to outweigh the losers in the long run. Only under certain circumstances can uncertainty about the outcome of a reform create a "veil of ignorance", i.e. a situation where stakeholders, unaware of how they will be affected individually, may be ready to agree to social contracts that increase the overall effectiveness of fiscal federalism arrangements.[2]

Table 2.1. **The ten case studies**

Country	Name of the reform, year of adoption
Australia	Intergovernmental Agreement on Federal Financial Relations, 2008
Austria	Reform of the Financial Equalisation Law, 2007
Belgium	Lambermont Agreement on Tax Autonomy and Community Refinancing, 2001
Canada	Equalisation Reform, 2007
Denmark	Local Government Reform, 2007
Finland	Restructuring of Local Government and Services, 2008
Italy	Law 42 on Fiscal Federalism, 2009
Portugal	Local Finance Reform, 2007
Spain	Reform of the Autonomous Community Funding System, 2009
Switzerland	Reform of Fiscal Equalisation and of Responsibility Assignment, 2004

Source: Blöchliger, H. and C. Vammalle (2011), *Reforming Fiscal Federalism and Local Government: Beyond a Zero-Sum Game*, OECD Publishing, Paris.

Fiscal federalism and local government reforms can be seen as a blend of structural reforms, including tax reforms and public administration reforms, and they can be analysed using the appropriate political economy framework.[3] Fiscal relations reforms have their peculiarities, however:

- The main actors and interests in fiscal relations reforms are government levels and individual governments, rather than interest groups outside the public sphere. The fact that governments will be dealing mainly with each other is likely to shape the reform and the reform process.
- The impact of fiscal relations reforms is highly visible, especially in the short run. Governments and administrations are often obliged to quantify short-term effects with great accuracy, leaving both winners and losers with a precise idea of how reforms to the tax system, intergovernmental grants or fiscal rules affect them individually.
- Fiscal federalism reforms tend to be a zero-sum game in the short run, where one level of government or group of sub-central governments is going to lose what the other level of government or other sub-central governments will win. As a result, such reforms are plagued by a strong bias towards the status quo. The political discussion revolves around short-term distributional effects, and stakeholders will concentrate their efforts on ending up on the "right" side.

Methodology

The study presented in this chapter is based on ten country case studies, and applies "focused comparison" methodology (Box 2.2). In order to make reform experiences

comparable, all country experiences have been analysed within the same structure and methodological framework. The analysis focused on issues such as reform outcomes, the reform context and the issue history, the actors and interests involved, the reform process, the design of the reform, and finally the adoption and implementation of the reform. The reforms studied were adopted between 2001 and 2009, although some were initiated many years earlier. They include the introduction or amendment of fiscal equalisation programmes; the upgrading of (non-equalising) intergovernmental grant systems, particularly a move from earmarked to non-earmarked grants; the introduction or tightening of sub-central fiscal rules; a sub-central sales tax reform; the territorial restructuring of public service delivery, including the merger of municipalities; enhanced inter-jurisdictional co-operation and the introduction of a new regional layer; and the reorganisation of power and competences across ministries with respect to fiscal relations (Annex 2.A1 provides a short description of the ten reforms studied). In most cases, a reform covers more than one of the topics mentioned.

Box 2.2. **The "focused comparison" methodology**

The method of "focused comparison" basically entails asking the same questions across a substantial number of cases in order to discern similarities among them. Findings generated in this way do not enjoy the level of formal verification that may be achieved via quantitative analyses of very large numbers of cases. However, the method of focused comparison offers significant advantages, chiefly by facilitating a more detailed study of the context-dependent nature of certain relationships among variables. In particular, it permits a greater degree of "process-tracing" – i.e. tracing the links between possible causes and observed outcomes in order to assess whether the causal relationships implied by a hypothesis are evident in the sequence of events as they unfold. Because it examines specific cases in depth, rather than simply comparing data across cases, a focused case-study approach is better able to explore the policy process, to take account of institutional and political complexities and to explore more complex causal relationships, such as path dependence or the issues that arise when, for example, a given factor may favour adoption of a reform but hinder its implementation. A case study approach also permits exploration of variables that can be extremely difficult to quantify or code for inclusion in regression analyses.

Source: Tompson, W. (2009), *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264073111-en*.

While the study might give a comprehensive picture of the reforms recently on the agenda in member countries, the case studies could be said to suffer from a selection bias, in the sense that all reforms under scrutiny were adopted and can hence be considered "successful". Moreover, all reforms, except for the Canadian Equalisation Reform, some of whose elements became fiscally untenable after the 2008 crisis, were implemented in a sustained fashion. Once adopted, the reforms were not reversed or watered down. The ten country case studies do not cover reforms that eventually stalled, do not analyse the factors that lie behind aborted reforms, nor do they cover situations where the government considers reforms urgent but has so far made no serious attempts to carry them out. Given this selection bias, it is clear that this study has more to say on the factors that promote comprehensive fiscal federal reforms than on the obstacles that impede them.

The reform context

This section describes the factors that shape and influence the reforms and the reform process but that are largely outside the control of policy makers.

Favourable economic and fiscal conditions can help reforms succeed

One of the most salient conclusions of the country studies is that a sound economic and fiscal position is strongly linked to the success of a reform. While some reforms were initiated during times of economic slack, or driven by the need to consolidate, implementation of literally all the reforms studied in this report took place when central and, to a lesser extent, sub-central public finances were robust. For example, when the Australian Intergovernmental Agreement was discussed in 2007 and early 2008, the economy was in healthy shape, with real GDP growth rates above 3% per year. Fiscal positions were excellent, especially at the Commonwealth level, with consistent surpluses netted since 2004. These favourable economic and fiscal conditions helped the Commonwealth to bundle the structural grant reform with a considerable increase in transfer funding, by up to 50% in some policy areas, leaving all states winners of the reform. This was also the case in the 2001 Lambermont reforms in Belgium: during the 1990s, Belgium had undergone considerable fiscal consolidation, reducing the general government deficit from almost 7% of GDP to virtually a balanced budget. This sound budget position allowed the federal government some leeway to embrace reform and to increase transfer funding for education, which was one of the main requests of one of the stakeholders involved.

Favourable economic conditions and sound fiscal positions help central governments to "buy" reforms and to grant a reform dividend on the spot. The role of a sound fiscal position is most obvious in equalisation reforms, whose explicit distributional objectives inevitably create short-term winners and losers among sub-central governments (a zero-sum game). In Canada after the turn of the millennium, for example, the economy was growing solidly, with rates around 4%, and the fiscal position had improved significantly after the sharp consolidation of the mid-1990s. In the ten years leading up to 2007, the federal government boasted uninterrupted budget surpluses, although some provinces struggled to restore their fiscal balances. Buoyant revenues allowed the federal government to increase equalisation payments considerably in terms of total federal spending.

Good economic conditions also reduce the opposition to reform, because the prospect of sustained growth may convince sub-central governments to accept an increase in the volatility or uncertainty of their revenues. For example, in the 2007 Austrian reform, buoyant tax revenues made it easier for the states to switch from a (stable) intergovernmental grant to (cyclically fluctuating) shared taxes. In Portugal, higher municipal property taxes after the 2003 reform, and growth prospects during the reform period, reduced opposition from potential losers from the transfer reform. In contrast, the global financial crisis severely scaled down a planned reform in Finland: the 2007 election campaign included a broad grants reform. The existing three different block grants were to be merged into one general purpose grant managed by the Ministry of Finance, and new allocation criteria had been developed by the Government Institute for Economic Research (VATT). But after the global crisis reduced sub-central government revenue shortfalls, the allocation formula was not revised so as not to increase revenue uncertainty, and municipalities were given a guarantee that they would not lose revenues

due to this reform. The reform was finally limited to merging the three previous grants into a single grant of the same amount.

The recent economic and financial market crisis and its dire fiscal implications are likely to change the economic and fiscal environment for reform for some time. Most of the reforms studied were adopted before central governments had embarked on fiscal consolidation. Few reforms have been adopted during the crisis, although Ontario's tax harmonisation in Canada, which had been delayed for years, was prompted by the crisis and by the need to help the economy out of recession. The state of Ontario's economy was particularly hard hit by the global crisis, and in 2009, was projected to contract by around 3%. The tax reform implemented in 2009 was considered to be the single most important policy for promoting long-term growth. Portugal's local government reform, part of a strategy of fiscal retrenchment, was the only reform studied that was fiscally "neutral" for the central government, i.e. where the central government did not put additional resources on the table, thus implying that there were net losers among sub-central governments. Weak growth and a lack of financial resources will now limit the prospects for reform and the central government's role as paymaster. Fiscal positions will shape the outcome of reforms: while good economic and fiscal conditions appear to favour reforms that increase equalisation and more generous hand-outs to sub-central governments, economic and fiscal crises will probably result in reforms that increase sub-central government efficiency and tighten fiscal discipline. The coming years will show what type of reform can be initiated, adopted and sustained under conditions where central governments can no longer afford to pay.

Electoral mandates are useful but not crucial for success

Electoral mandates are an important driver in fiscal federalism reforms, although intergovernmental fiscal relations rarely attract much interest in election campaigns. When a new government is elected on a platform that includes a fiscal relations reform, it tends to facilitate a rapid adoption of the reform. In Australia for example, the Labor government elected in 2008 had a clear mandate for reform. The party obtained a majority at both the Commonwealth level and in all states, and the federal election campaign had been strongly focused on a reform of the public sector and service delivery, which in turn necessitated a reform of fiscal relations between the federal and state levels. In Italy, the 2008 electoral campaign had focused on federalism issues (as the implementation of the 2001 constitutional reform, which called for a reform of fiscal relations towards a more federal model), and several regions were pressing for more autonomy. When the new government came into power in 2008, it therefore had a clear electoral mandate to reform, and political pressure was strong: the government was a coalition of a center-right party (*Popolo della Libertà*) and a regionalist party (*Lega Nord*), which claimed more autonomy for the regional level.

Governments without a mandate tend to engage in small and often piecemeal attempts at reform. Acting against electoral promises can create strong opposition to a reform by special interest groups and the public at large, even if the reform is financially supported by the central government. Compulsory mandates – e.g. the obligation to amend fiscal relations every four years, as is the case in Austria – may create a positive climate for reform, but again, the scope and outcome depends on the electoral mandate. The more convincing the mandate, the more comprehensive the result of the reform tends to be. Electoral mandates to increase the efficiency of public services, to reduce fiscal disparities or to increase sub-central fiscal autonomy are stronger than mandates for

sub-central fiscal consolidation and tighter sub-central fiscal rules, and the respective reforms also tend to be bolder.

Electoral mandates are not always necessary, however. Fiscal federalism itself is a technical topic that arouses few political emotions, except in a few instances where voters are strongly attached to "their" jurisdiction or "their" local service, as was the case in Finland, where the reform was promoted to secure local provision of public goods. But in most countries, interest in which government level provides a public service is slight; voters are usually more interested that it be tailored to their needs and delivered at a reasonable cost. In the reform cases under scrutiny, campaigns tended to focus on generic objectives such as "more autonomy", "better public services" and "fair regional distribution" and less on the intergovernmental mechanisms that were necessary to achieve them. Only with time did governments become aware that fiscal relations played a pivotal role in their endeavour to reform the public sector, public finances or tax systems. Moreover, it was generally expert or administrative groups rather than politicians that drove reform, which kept the discussion at the technical level and below the radar of party politics. Since fiscal relations are rarely viewed through an ideological prism, governments have some scope to negotiate a reform that was not initially on the political agenda. For example, the Finnish PARAS reform was launched after a mid-term government review in 2005, i.e. without a clear electoral mandate.

Clear majorities and political alignment between levels of government help reforms succeed

Even when a reform of fiscal relations is not an issue during election campaigns, and no explicit electoral mandate for reform exists, a clear majority in Parliament helps government push reforms through. For example, in Portugal, the 2005 elections gave an absolute majority to the Socialist party in Parliament. The reformers seized this particularly favourable political moment, and implemented the reform soon after the general elections, to benefit from the legitimacy of a newly elected government and their majority.

Political alignment between different levels of government is also a facilitating factor in adopting fiscal relations reforms. This was the case for example in Australia, where the Australian Labor party enjoyed a majority both at the Commonwealth and in all states during the reform process. It was also the case in Belgium: after the 1999 federal elections, the same parties held power at both the federal and regional level. Although Belgium has no "national" parties, since all its parties reflect regional interests, the coalition government facilitated co-ordination across government levels. Federalist issues had played a minor role during the election campaign, but the new government considered state reform an important priority and wanted to prove that it was able to resolve federalist disputes. For a reform to be strong and sustainable, it can be helpful if the same parties or a party coalition command a majority at both levels of government, as many elements of a reform depend on political tenets reflected in party ideology.

Some arrangements provide sub-central governments with considerable leverage

Constitutions and electoral systems may give local and regional governments considerable power to shape the reform or veto undesired outcomes. Put simply, members of a national parliament will represent the interests of their jurisdiction. In several federal

countries, reforms have to be approved by two parliamentary chambers, with the second chamber representing the states or regions. In some unitary countries, especially those in Scandinavia, municipalities enjoy the right to fiscal and administrative self-governance, putting limits on the central government's ability to change acquired rights against their will. In sum, an institutional bias toward the status quo can be an obstacle to radical overhauls if they do not benefit a large majority of sub-central governments.

Certain forms of collaborative federalism and comprehensive consultation across government levels and with other social groups add to the constraints. The distribution of sub-central governments in terms of size or economic wealth across the country also has a strong impact on the outcome of reform, often favouring small and/or economically lagging sub-central governments. The Canadian equalisation formula, with its strict reliance on tax-raising capacity, strongly favours poorer provinces with a lower cost of living (Albouy, 2010). The Austrian reform of 2007 has reduced the equalisation premium for large urban areas, and the new Swiss equalisation formula does not include such a factor at all. A system of many small electoral districts is likely to favour redistribution and the interests of certain groups over considerations of efficiency.[4] Finally, sub-central governments with strong regionalist ambitions and the ability to deliver crucial swing votes can strongly influence reforms of fiscal relations. For example, in Spain, some autonomous communities (ACs) complained that the old system was too redistributive, and pushed for increased tax autonomy and reduced redistribution. In 2006, six autonomous communities changed their statutes (constitutions), increasing the need to reform the law for financing autonomous communities (LOFCA). The leadership of these autonomous communities became particularly important because Spain was governed by a minority government during the negotiation process, which gave the autonomous communities increased leverage.

Another complication is the fact that reforms of fiscal relations require an administration to reform itself. The public administration at one or more government levels must design and implement measures that may negatively affect part of its own constituency (Charbit and Vammalle, 2010). While an internal distribution of power between ministries may increase administrative efficiency, it may also create resistance within the administration, particularly when the power to oversee fiscal relations is shifted from the line ministries and concentrated in the hands of the Ministry of Finance. Country cases suggest that ministries such as those for education or health care – often closely linked to their respective constituencies, such as the medical or educational sector – may provide impetus for a reform, but they also often slow down the reform process or tilt it towards their own interests. Certain reforms – e.g. the move from earmarked to non-earmarked grants – had an impact on special interests within and outside the administration and met with tacit resistance that could often be only partially overcome. In Denmark, for example, some special interest groups, such as the handicapped, opposed the reform because they feared that service levels would be reduced if the responsibility for them was decentralised, and that services would be cut in the most remote areas. Widening the scope of fiscal federalism reform by an internal market reform (e.g. removing trade barriers between sub-central governments) and incorporating the interests of the business sector can help overcome this type of status quo bias, but it can also create additional opposition from businesses in protected markets.

The central government must often mediate between diverging sub-central government interests

Government levels and individual jurisdictions are the main actors and interest groups in fiscal federalism reforms. The objectives of the central government include: *i)* increasing the efficiency of public service delivery or economic growth; *ii)* creating fiscal frameworks that reduce cyclical fluctuations of intergovernmental grants and sub-central budgets; *iii)* providing fiscal equalisation that reduces differences in tax-raising capacity and/or service costs across jurisdictions, without compromising sub-central governments' incentives to develop their own fiscal base; *iv)* clarifying the allocation of responsibilities across levels of government; and *v)* simplifying regulation and administration of intergovernmental grants. Moreover, central governments generally aimed to harden sub-central budget constraints, usually by tightening sub-central fiscal rules or by granting more tax autonomy to sub-central governments in order to reduce sub-central deficit bias. In most cases, the various rationales for reform overlap, particularly in their mix of efficiency and equity objectives. Sub-central governments rarely oppose such demands, and in some cases even act as early promoters. Indeed, during several of the case studies, the central government was merely reacting to sub-central demands rather than pushing its own agenda.

Opinions on reform often diverge more between sub-central governments than across government levels, leaving the central government to balance diverging sub-central government interests. Sub-central governments with an efficient public sector usually prefer tax autonomy over grants and subsidies, while less efficient jurisdictions tend to oppose it. Poorer sub-central governments, often in a majority, claim more equalisation, while wealthy sub-central governments try to put limits on redistribution. Sub-central governments with high debt and deficit levels oppose tighter fiscal rules, while those with robust fiscal positions take them more lightly. In some cases, conflicts between sub-central governments were swept under the carpet in order not to weaken negotiations with the central government. Summing up, most fiscal federalism reforms tend to entail stronger conflicts among sub-central governments than between the central and the sub-central level, especially when, at an early stage of the reform, the central government aligns with a few reform-minded sub-central governments.

The case of Portugal and Switzerland illustrate this point. In Portugal, the 2007 Local Finance Law changed the distribution formula of the grants, and because it had to be neutral for the central government's finances, it created net losers. Municipalities were therefore divided according to whether they stood to lose or gain from the reform. In general, large, dynamic municipalities with a growing population and education needs, and extended protected areas (*pro natura* municipalities) gained from the new distribution criteria that took these factors into account. Benefits were somewhat attenuated by the fact that after the reform, richer municipalities had to contribute to the Social Cohesion Fund. Opposing the reform were small municipalities, especially those losing population and those that had previously benefited from automatic increases in transfers which were to be cancelled, as the new formula no longer guaranteed an increase in their revenues independently of how their population or their spending needs evolved. In Switzerland, the main divide was not between the two levels of government but between the cantons themselves. While the reform had to be "fiscally neutral" between the federal level and the cantons as a whole, the reform – particularly fiscal equalisation – was certain to have considerable consequences in terms of redistribution. The reform would produce winning and losing cantons, and the net fiscal effects for each canton were easy to calculate and hence visible to politicians and the public. Some cantons were not too unhappy with the

old system, and for the cantons to find a concerted position in favour of specific reform proposals and reform steps took a relatively long time.

The division between sub-central governments is also clear for merging reforms: while poor sub-central governments tend to favour mergers with those better off, richer ones lobby hard against such mergers because they fear that average service levels will go down or tax rates up. This was notably the case in the 2007 Local Government Reform in Denmark. During periods of strong economic growth, this issue may be less important, but it may be an obstacle for mergers in more difficult economic times. For example, municipal mergers have become more difficult in Finland after the global financial crisis, because many municipalities are facing financial difficulties and neighbouring municipalities refuse to merge with those in greater difficulty as this would imply sharing part of the financial burden.

Finally, the interests of individual jurisdictions or government levels have a stronger impact on the outcome of a reform than party ideologies. In the case studies, political party members often took a different position depending on whether they were acting at the central or the sub-central level. Conversely, parties of different ideological stripes aligned across levels of government to pursue a reform. In some cases, especially in reforms concerning tax autonomy or fiscal equalisation, the same political party held different views across sub-central jurisdictions, although this was not explicitly acknowledged. The Spanish case is particularly interesting, as the multi-polarity of interests among autonomous communities reduced opposition to the reform. Autonomous communities were divided into at least four different interest groups, resulting from the possible combinations between economic and political variables. From an economic perspective, strong and dynamic autonomous communities would benefit from the new criteria, and less dynamic autonomous communities with above-average per capita revenues would lose in relative terms. From a political perspective, some autonomous communities were governed by the majority party and some by opposition parties. There were autonomous communities in all four groups. The combination of self-interest and party discipline therefore reduced opposition to the reform.

Timing and scope

Policy makers can decide or influence elements such as the timing, scope and sequencing of a reform, and must be able to identify and seize appropriate moments and windows of opportunity, as well as to shape the reform content to put all the chances on their side.

Reform often results from earlier failures, a shared diagnosis of the need to reform, and pilot programmes

Successful reforms of fiscal relations tend to be preceded by one or several aborted attempts or even reversals. Fiscal federalism and the framework in which local governments operate are often part of the founding principles of a country. Moreover, they are very country specific, so that a blueprint for reform is rarely available. A widely shared perception that fiscal relations are not functioning properly is likely to evolve slowly. But early reform failures may raise awareness of the shortcomings of the status quo and give policy makers guidance for approaching reform. In several of the cases examined, failed attempts had built up expectations and pressure for change, until the established system had become so inefficient or inequitable that governments were

ready to act quickly and comprehensively. The propitious moment for reform is to some extent endogenous, and policy makers can create a climate for reforms by pushing for them even if the initial attempts are likely to end nowhere.

In Switzerland, for example, the former system of fiscal relations, dating from 1959, could neither deal with recurring issues, such as disparities between wealthy and poor cantons, nor with emerging ones, such as the specific needs of urban areas. Cantons repeatedly complained about a reduction in their spending autonomy, but attempts in the late 1980s to change the indicators determining grant allocation, which restrained spending flexibility, led nowhere. In the mid-1990s, several federal-cantonal financial management pilot programmes were set up, showing both the desirability and feasibility of a wide-ranging reform. In Italy, the period after the constitutional reform of 2001 (which called for a fiscal federalism reform) saw a number of failed attempts to implement the constitutional amendment. Despite mounting pressure, particularly from the northern regions, various governments failed to push a reform agenda. In the meantime, fiscal relations had become ever more inefficient and prone to deficit bias. Experts had repeatedly criticised the shortcomings of the system, and the economic crisis of 2008 exacerbated the risk that the system might become unsustainable. In 2009, when Law 42 was passed, reform was ripe. Canada is yet another example where a large-scale reform has matured over several years. A thorough reform of equalisation had been on the agenda since the 1990s, when various weaknesses of the system had become apparent. Finally, the Intergovernmental Relations Reform in Australia benefited from the experience of earlier reform attempts, and a broad awareness that the system of intergovernmental fiscal relations had become untenable. At the beginning of the 1980s, some grant reforms were instigated, but they were reversed in 1988. After 2000 and the introduction of the goods and services tax, government commissions and expert groups had repeatedly noted the inefficiencies of transfer spending. Several states had begun to reform their own system of public service funding, but demanded action at the federal level. When the new government was elected in 2008, the time for reform had come.

A shared diagnosis of the need to reform helps to disrupt the status quo. In Denmark, for example, there was consensus that provision of public services should be carried out by local governments, and awareness that the existing system was unsustainable. This included a shared diagnosis that the main problem was linked to the size of municipalities, and that reforming the existing system was necessary to guarantee local provision of public services. Spain also had a shared diagnosis of the need to reform: About 7 million migrants entered the country between 1999 and 2009, which generated asymmetrical impacts among autonomous communities. As the 2001 AC Finance Law (LOFCA) was based on a population census taken in 1999, it could not adapt to these changes, and the evolution of transfers was partially decoupled from the evolution of population and costs. It quickly became obvious that some autonomous communities with low population growth were receiving above average per capita revenues, while other autonomous communities with large migrant inflows were being under-financed. This shared diagnosis on the need to reform helped push the reform through.

Finally, pilot programmes can help prepare the way for comprehensive reforms. The municipal reorganisation in several Nordic countries was successful because policy makers could point to successful experiments with a subset of local governments. In Finland, for example, a "regional model" has been experimented since 2005 in the remote Kainuu region, assigning the Regional Council responsibility for about 60% of the municipal services, including those previously under the regional central government administration. In spite of the positive evaluations of the results of the model, it was

considered a specific solution intended to secure the provision of public services in this remote area, and was not chosen in the subsequent PARAS reform. Still, this experiment showed the feasibility of a new approach and helped to overcome resistance to change. In Canada, the tax accords between the federal government and three small provinces helped pave the way for sales tax harmonisation in the larger and economically more important provinces such as Ontario. In Australia, successful public sector reforms in individual states showed the need for reform at the central level, especially in the realm of service funding and delivery.

Pilot programmes may concern a subset of sub-central governments, but they may also consist of new management techniques used in selected policy areas, before they become the rule for the rest of the intergovernmental framework. Finally, "asymmetric federalism", i.e. an institutional setup in which one or a few sub-central governments have more prerogatives with respect to tax or spending powers than other sub-central governments – a common feature in OECD member countries on a secular decentralisation path such as Italy or Spain – can also help start reforms. Once a reform covering selected sub-central governments is implemented, other sub-central governments may ask for equal treatment, resulting in further reforms that encompass all sub-central governments. In time, symmetric fiscal relations, under which all sub-central governments are subject to the same rules, can be restored.

Bundling may be necessary to forge majorities

Most fiscal federalism reforms explored in the OECD study consisted of comprehensive bundles offering benefits to a large array of actors and interests. Although the inertia of fiscal federalism frameworks may compound the difficulty of engineering a wide-ranging reform, a big-bang approach may prove easier to pursue than a gradual, sequential approach.[5] Comprehensive reforms may be necessary if there are many veto players whose support is crucial for success. In many of the cases under scrutiny, different reform elements, each addressing a subset of actors, were bundled in order to obtain the majority needed to pass the reform. In the Lambermont Agreement in Belgium, for example, the most crucial factor in the success of the reform was probably the bundling of two elements: tax autonomy for the regions and additional transfer funding for education. Indeed, the Flemish Region had essentially asked for more taxing power, and the Walloon Region for more education funding, and neither region was particularly opposed to the other region's demands. But while bundling helped secure the necessary majorities at both the federal and regional level, it put considerable strain on the federal budget.

Bundling also makes it possible to distribute the benefits of reform more evenly across various sub-central governments and stakeholders. It has the additional advantage of providing governments an opportunity to offer individual actors a "take it or leave it" package. Bundling locks in veto players: no single actor can expect to renegotiate reform amendments once the reform proposal is anchored, because that would threaten the position of other actors, and hence the outcome of the entire reform. Bundling also allows more emphasis to be placed on long-term efficiency. Indeed, while wide-ranging fiscal federalism reforms attempt to strike a balance between efficiency and inter-jurisdictional equity, small-scale reforms are largely perceived as distributional.

In the reform cases under scrutiny, elements that enhanced efficiency, such as granting more tax autonomy, tightening sub-central fiscal rules, moving from specific to general purpose grants or merging small municipalities, were often bundled together with

distributional objectives, such as more grants for sub-central governments, a strengthened fiscal equalisation system, tax credits for low-income earners, service guarantees in remote areas and the like. In Italy, the link between "taxing power" and "equalisation" held the reform together: an extension of taxing power appealed to the wealthier regions and the regions in the north, while equalisation was attractive to the poorer regions. In parallel and by amending the Internal Stability Pact, the central government succeeded in imposing stricter fiscal rules while allowing the regions more flexibility in implementing them.

Bundling was also a key element in the Swiss Fiscal Equalisation Reform, reflecting both the need to tackle unwarranted distributional conflicts as well as the desire to offer clearly visible long-term benefits to selected jurisdictions. As such, the reform package comprised four elements that benefited different stakeholders. *i)* Fiscal equalisation appealed to the cantons with low tax-raising capacity. To bring the richer and more urbanised cantons on board, an equalisation fund for specific socio-demographic burdens was added towards the end of the reform process. This fund eased budget pressures associated with high social welfare spending. *ii)* To tackle fears of ever-growing demands for fiscal equalisation, upper and lower limits on the size of the horizontal equalisation fund were set. This constitutional rule is supposed to forge a link between the federal level and rich cantons against strong demands for equalisation from poorer cantons. *iii)* Disentangling competences brought on board fiscally strong cantons interested in more spending autonomy. The federal level was also interested in disentanglement and grant reduction, as it reduced the administrative burden. *iv)* Finally, the rule on horizontal collaboration (the right of federal government to coerce cantons into horizontal collaboration and joint funding in selected policy areas) offered a net gain to the urbanised cantons, because it would ensure that at least part of their territorial spillovers (services provided across jurisdictional borders) would be funded by adjacent cantons. Taken separately, these four elements would not have generated a sufficient majority in favour of the reform. But together, the cumulative support allowed the reform to succeed.

In several cases, grant reforms, especially the move towards general-purpose grants, were balanced by an increase in transfers from the central government. Territorial reforms such as mergers gave the municipal level more power and responsibilities – sometimes at the expense of another territorial level – and benefited both rural and urban areas of varying economic circumstances. In Denmark, the Local Government Reform bundled together three reform areas: a territorial reform (merging of municipalities), a re-allocation of tasks across levels of government, and a financing and equalisation system reform. A tighter sub-central fiscal rule was sometimes coupled with extra funding for highly indebted or poor jurisdictions. In Austria, for example, new spending regulations were attached to increased budget flexibility for sub-central governments, minimising changes to public spending patterns and leaving vested interests relatively unscathed. In some cases, the scope of the reform was widened to include other policy areas. For example, Australia's fiscal federalism reform provided incentives to reduce barriers to interstate trade, while Denmark's was coupled with a health care reform.

One important problem with bundling is that if it goes too far and tries to satisfy too many stakeholders, the distributional aspects can detract from the efficiency-enhancing aspects of the reform. Bundling may turn into log-rolling, i.e. special interests joining forces at the expense of other, less well-organised groups.[6] As mentioned above, bundling often ends up with the central government "buying" the support of opponents of reform. Although some additional transfers could be justified on the grounds that efficiency gains – such as internalised externalities or lower administrative cost – accrue to the country as

a whole, the country studies suggest that fiscal relations reforms are often costly for the central government. And even strong bundling may not achieve all the desired objectives: further sub-central tax autonomy, which is sometimes on the agenda when a reform is initiated, may be scaled back or dropped completely during the reform process. In several cases, neither the central government, reluctant to lose central budget oversight, nor sub-central governments, fearing higher uncertainty over revenue, showed sufficient interest in greater tax autonomy. In Australia, for example, the large vertical fiscal imbalances of the states were one of the drivers of the reform. *Ex post*, this issue was not solved; moreover, as the grants increased, vertical fiscal imbalances were actually increased rather than reduced.

Sequencing may be an alternative strategy for some reforms

Sequencing may be an option if demands for institutional change and decentralisation are persistent and if decentralisation can be partitioned into phases. A sufficient majority must then be mustered at each stage. Countries in a secular decentralisation process, such as Belgium, Italy or Spain, follow such a pattern. Reforms often start with the decentralisation of spending responsibilities, while sub-central government funding is ensured through a set of corresponding earmarked grants. This is followed by a move from earmarked grants to general purpose grants and to an increase in spending autonomy, sometimes linked to more results-based regulation. At the next stage, grants tend to be replaced by tax-sharing systems and finally by autonomous taxes, thereby increasing sub-central tax autonomy. Such sequencing allows time to test the gains obtained by decentralisation, which, if considered satisfactory, create impetus for further reforms. However, further phases of reform are only successful as long as the efficiency gains of decentralisation outweigh the associated distributional conflicts (Rodrik, 1999). In this respect, spending decentralisation is easier to engineer than tax decentralisation, which can arouse fears of increasing inter-regional disparities. In several countries, plans to devolve taxing powers to sub-central governments were scaled back or abandoned. In other cases, distorting sub-central government autonomous taxes were replaced by tax-sharing systems or intergovernmental grants, supposedly increasing the efficiency of the tax system, but reducing sub-central government tax autonomy. For example, in 2000, the Australian goods and services tax replaced a set of inefficient state consumption taxes. Although all tax proceeds are transferred to the states, the latter have no discretion over the tax base or tax rates. Similarly, at the beginning of the 1980s, Mexico replaced a set of inefficient autonomous state taxes by a tax-sharing system that stripped the states of taxing power.

In designing reforms of fiscal relations, policy makers may have to consider some trade-offs between sequencing and a big bang approach, i.e. between adopting a comprehensive reform as opposed to pursuing an incremental strategy. As described above, the fiscal federalism reforms studied tended to follow the big bang approach. Most reforms studied were wide-ranging, with little relation to former reforms or reforms in adjacent policy domains, and implemented in a short period of time. Exceptions were the Italian and Swiss reforms, which had a sequential pattern, i.e. constitutional amendments were implemented before lower level laws and decrees were adopted or amended. Given the importance of the Swiss reform and the specific institutional requirements, the federal government decided to pass it in stages. In 2001, the government presented the 27 constitutional amendments needed to obtain the green light in Parliament for the 4 main reform elements, and the popular vote was held in 2003. Simultaneously, the federal government presented the new Fiscal Equalisation Law, which was also passed by

Parliament in 2004. The constitutional vote passed with a majority of 65% of the population, and only three cantons objected. In 2005, the government presented Parliament with a set of 37 laws, which had to be adapted following adoption of the constitutional amendments, and the parliamentary vote was held in 2006. Finally, in 2006, the government presented the size of the horizontal and vertical equalisation funds, for which the parliamentary vote was held in 2007. At each stage, the federal government aimed for maximum transparency. For instance, when voting on the constitutional reforms in 2003, and when voting on the laws, information on the subsequent steps was made available. The constitutional and legal reforms, including executive decrees, were implemented from 2007 onwards, without particular delays. The Italian reform was also pursued in several stages. The constitutional reform of 2001 was followed by a framework law, which itself was followed by a set of legislative decrees. This strategy was used because sequencing could force all the actors involved to agree on reform principles (lock-in) without knowing their individual and short-term consequences. It could also allow for agreement on the less problematic aspects of the reform before the more contentious ones were taken on.

Speed may help, but reforms take time

Speed can provide the momentum to bring a reform to fruition and shows that a government is taking an electoral mandate seriously. Opposition may not be well organised after an electoral defeat, and policy makers can take advantage of the moment before vested interests intervene. In Australia, the Commonwealth government acted quickly after the election, bringing the reform to conclusion within one year. If a reform is adopted soon after an election, its effects have time to unfold before the next election. In Denmark, the tight calendar was considered an important element in the success of the Local Government Reform. In this case, the constraint was exogenous, as the time schedule for implementation was strongly influenced by the local elections due in November 2005: new municipal borders had to be drawn up before the elections took place, and the new division of tasks had to be decided before the merger process could begin. This created a very tight schedule, giving municipalities only about six months to carry out the negotiations and agree on the mergers, which left them little time or means to oppose the reform.

Speed may also briefly create a "veil of ignorance" that allows stakeholders a general view of the potential effects of a reform but does not leave them time to assess how they will be affected individually. However, speed may discourage debate. The fact that fiscal relations reforms are often highly visible makes it difficult to maintain the "veil of ignorance" for long. Wide consultation with potential veto powers and fine-tuning to adapt reforms to obtain a majority may be needed. Well-prepared reform proposals that are considered impartial can sometimes even be implemented by a new government of a different political persuasion, as shown by the Canadian Equalisation Reform, where the new government embraced the recommendations of the expert committee set up by the previous government. The trade-off between speed and inclusion depends on the electoral mandate, the number of potential veto powers and the institutional framework to address them, but in general, the specific character of fiscal relations reforms calls for wide inclusion.

Designing the reform process

Political leaders have an important role to play in the design of the reform process, and some instruments may help them secure the needed support.

Political leadership tends to accelerate a reform

Political leadership – i.e. a person or a political group closely committed to the reform process – can be a significant driver of reform. In the end, it is politicians and political parties that must pass a reform and be persuaded that it is in the country's wider interest. In some of the reforms studied, the involvement of a few determined individuals and political heavyweights helped the reform to succeed where earlier attempts had failed. In Denmark, for example, the Minister of the Interior and Health was highly motivated to carry out a local government reform. The aim was to reform the health care system by transferring responsibilities to larger municipalities, and thus to ensure the local provision of high-quality health care services. In Finland, the personal commitment of the Minister of Regional and Municipal Affairs (Ministry of the Interior) was all the more important, in that he was a member of a political party that traditionally opposed municipal mergers. In Portugal, the Prime Minister, the Finance and the Interior Ministers were personally committed to the success of the reform, and in Belgium, the new Prime Minister was anxious to prove that he was able to solve federalist disputes that the former government had supposedly been unwilling to resolve. Significantly, the name under which the reform came to be known, "the Lambermont Agreement", derives from the name of the Prime Minister's residence.

Conversely, a lack of strong political leadership can explain setbacks that blocked some reform attempts and the inability of stakeholders to reach consensus on controversial elements. The credibility of political leadership may be enhanced if lead politicians or jurisdictions don't have any direct stake in the reform and can help build support across government levels or between individual sub-central governments, as exemplified in the Italian and Swiss cases. An important element during the Italian reform process, for example, was that a few regions – both in the north and the south – emerged as "bridge regions" able to mediate between opposing positions. The fact that these regions had no strong individual stakes in the reform proposals and embraced the views of both the north and the south increased their credibility. In Switzerland, the reform proposals produced winning and losing cantons. While the actual winners of the reform remained relatively silent, the strongest proponents of the reform were cantons with an intermediate fiscal capacity that had stakes neither in the status quo nor in renewed fiscal equalisation but which could benefit from the efficiencies that the reform made possible. These intermediate cantons, acting as the honest brokers of cantonal interests, were able to overcome reform fatigue within the administration and to push for a common cantonal stance towards the federal level. The political leadership of cantons whose fiscal position after the reform was not immediately obvious probably helped substantially to overcome opposition to the reform.

If political leadership was an important element in most of the reforms studied, in some cases, the government did not take the initiative but was passively following the advice of its administration and external experts, while maintaining a low political profile. Such "de-politicisation", as exemplified by the Canadian Equalisation Reform (which followed the advice of a committee of experts and survived a change in government), can be an alternative route to reform, and it may help avoid reversals once a

government of a different political affiliation is elected. In Switzerland, leadership was more administrative than political: administration, rather than political, officials instigated the reform and claimed ownership of it. External experts were asked to report to the administration and were relatively tightly controlled.

Using financial incentives and compensations helps reduce opposition to the reform

In most cases studied, the central government provided additional transfers to the sub-central level so as to make almost every sub-central government a net reform winner (Portugal being the only exception). In Austria, for example, transitional compensation by the federal government made sure that no single state would lose out either as a result of the new population statistics or of the new fiscal equalisation formula. Even in Switzerland, where the principle of fiscal neutrality for the federal government was clearly stated from the beginning, the federal government was forced towards the end of the reform process to introduce a transitional cohesion fund (*fond de rigueur*), in partial compensation for all cantons whose fiscal balance would be negatively affected by the reform.

Even territorial reorganisation and tax reforms, whose distributional impacts are weaker, are also often bankrolled with additional resources from the central government. Financial incentives seem to be particularly important for merging municipalities. For example, Finland used time-varying financial incentives to push for municipal mergers (the culture of consensus in Finland did not allow the mergers to be imposed, as they were in Denmark): the earlier the merger took place, the greater the financial reward to merging municipalities. The financial reward also depended positively on the total number of municipalities merging as well as the final population of the merged municipality. Financial compensations can also be used to cover the costs implied by the reform. In Canada, for example, the federal government was ready to pay a transitional transfer equal to 1.5 percentage points of total gross goods and services tax revenue in the province to any province that adopted a harmonised sales tax. For Ontario, this transfer meant around CAD 4 billion.

Australia designed a sophisticated system of incentive payments to maintain momentum for reform, which consists of several elements: National partnership agreements outline mutually agreed policy objectives in areas of nationally significant reform or to achieve the service delivery improvements, and define the outputs and performance benchmarks. National partnership payments support the implementation of the agreed reform agenda by providing three types of payments: *i)* project payments, to support *ex ante* specific projects; *ii)* facilitation payments, to initiate reform in a specific area and improve standards of service delivery; and *iii)* reward payments, based on the achievement of agreed performance benchmarks and which can be freely used in any area (not necessarily related to the reform). The evaluation of the achievements against the predetermined benchmarks that trigger the reward payments is carried out by the independent COAG Reform Council (CRC) (Box 2.3).

Finally, some reforms were implemented as part of a fiscal stimulus programme, as in the case of Australia, and in other cases, the increase in transfers to sub-central governments in the context of the reform turned out to be timed well to support them in the context of the global financial crisis. In Spain, for example, the 2009 reform provided a significant increase in the total revenues assigned to the autonomous communities.

Without considerable financial help from the central government, resistance to reform tends to be much stiffer and failure is more likely.[7]

External and independent expertise lends credibility to reforms

Experts and expert panels operating outside the direct influence of the administration usually play a significant role in the reform process, and they can be considered a precondition for success. Given that fiscal federalism and tax reforms are often highly complex, experts provide technical expertise to assess both the status quo and the impact of reform proposals. Moreover, by providing impartial and unbiased scrutiny, independent experts are able to create and sustain political credibility among the public. Particularly in polarised political environments, when the central government are at odds with the sub-central level or when sub-central governments or political parties strongly disagree among each other on the scope of a reform or even the need for it, external experts can help defuse the situation.

In several countries, expert panels laid out the strategic reform issues, helped to consolidate and streamline the reform proposals, and designed and shaped central pillars of the reform. In Portugal, a working group comprised of five experts was charged with elaborating a proposal to reform the Local Finance Law. The fact that this working group was composed of well-known and respected experts gave its recommendations credibility and an aura of neutrality. Moreover, these experts were active in defending the proposal in the media and in academic circles. As a result, only a few minor changes distinguish the draft law proposed by the working group and the law adopted in Parliament. Canadian Equalisation Reform was also largely based on a report prepared by five high-ranking senior officials. This expert group consulted extensively with academics, politicians and the public at large and put strong pressure on politicians to adopt a global and “neutral” view on equalisation. The report was considered well documented and unbiased and was highly regarded by the public. It even survived a change in government: when it was published, a new government of a different political complexion had come to power and nevertheless endorsed the report’s recommendations with only minor modifications.

Government research institutions can play a similar role, for example when their publications launch a reform or accompany the reform process. Independent commissions can provide additional input from outside the traditional realm of fiscal federalism. For example, in Portugal, the Court of Accounts also played an important role, by publishing reports demonstrating the inefficiencies of the previous system, thus justifying the need to reform it. The Bank of Italy, together with other institutions and research centres, played a similar role, by preparing several reports pointing out the flaws of the old system. In Finland, the Government Institute of Economic Research (VATT) had carried out considerable research prior to the reform, showing the unsustainability of public finances under the existing model, including projections of the rise in municipal expenditure and deficits due to the ageing of the population. This helped create broad consensus on the need for reform, and on the view that the municipalities were too small to provide the required public services effectively and on a sustainable basis.

Consultation creates ownership among stakeholders

Given the largely institutional character of fiscal federalism reforms, consultation and involvement of the main stakeholders is unavoidable. Comprehensive consultation can raise awareness of the reform and help build up the necessary majorities, creating a feeling of ownership. Once stakeholders feel they have participated in the design of the

reform, they are more likely to defend its outcome. Consultation and involvement can also help to lock in the steps for implementing a reform. Once the different stakeholders have agreed to reform proposals in principle after extensive consultation, it is more difficult for them to contest the reform once individual impacts become more apparent, as exemplified by the sequential approach of the Italian reform. In Finland, the working groups in charge of making proposals for reform were made up of members from the two coalition government parties, as well as from opposition parties and members from the Finnish Association of Local and Regional Governments. This broad composition allowed the reform to succeed despite a change of government during the reform process. In Denmark, the decision to include as many stakeholders as possible in the design and negotiation process was seen as a way of reducing opposition to the reform, by giving the different parties the feeling that their interests had been taken into account. Stakeholders represented in the negotiation process could not easily vote against or oppose the reform subsequently. A public hearing was organised after the publication of the conclusions of the Commission on Administrative Structure. Almost 500 organisations, counties, municipalities, associations and individuals were invited to express their opinion on the commission's conclusions. This hearing was considered a turning point: before the meeting, nobody believed any concrete action would follow the publication of the report. After the meeting, it was clear to all participants that the question was not whether something would happen, but what it would involve and when it would happen.

In the reform cases under scrutiny, the scope of consultation largely depended on the number of stakeholders involved. In some countries, the reform concerned mostly government levels. In other cases, however, involving stakeholders outside government complicated consultation, especially when sub-central tax systems or frameworks underlying the funding of earmarked grants were to be reformed.

While wide-ranging consultation is often considered necessary to bring the main stakeholders on board, it can also jeopardise reform efforts. Too much consultation can inflame opposition. From the various country studies, it appears that the most successful consultation and involvement processes were those where the government was generally parsimonious with numbers – i.e. rejecting a precise assessment of the short-term impact of reform for individual sub-central governments – but insisted on presenting and discussing the overall objectives of the reform. In this way, governments hoped to shift the discussion away from distributional effects and onto the long-term efficiency goal. It is true that this "veil of ignorance" is difficult to maintain in a policy environment where short-term distributional impacts are easier to quantify than long-term effects.

Transitional arrangements, guarantees and opt out clauses reduce opposition to the reform

Transitional arrangements are a frequent expedient for reducing opposition while maintaining the fundamentals of a reform. In many cases, they can be the ultimate resort for securing a majority. This said, transitional arrangements are usually introduced late in the day. Transitional "cohesion funds", as in the Swiss case, and other entitlements, ensured that hardly any sub-central government lost in financial terms over an extended period of time. The Swiss reform provides for a transition period of up to 28 years during which no canton will lose in net terms. In Germany, the new sub-central fiscal rule forbidding the *Länder* from running structural deficits, which was inserted into the Constitution in 2009, will be fully applicable only after 2020. Job guarantees for civil

servants for a limited period can reduce opposition from the public administration, as was the case in the Danish reform.

In several countries, a gradual phasing-in of new arrangements helped to reduce sudden breaks and discontinuities in transfer flows. In Australia, for example, a transition period of five years was allowed for the move from the old intergovernmental transfer system based on numerous earmarked and narrowly defined specific-purpose payments, to a new funding system based on a few broad-based per capita grants. "Grandfathering" rights (entitlements) and similar compensation mechanisms kept to a minimum short-term change in the sub-central governments' revenue-ranking position – e.g. in terms of tax capacity or transfer size. In Spain, for example, the autonomous communities that were receiving above-average per capita funding agreed to be brought closer to the average, as long as their position in the overall ranking did not change significantly.

Transitional arrangements can yield benefits, beyond securing the success of a reform: distinguishing between permanent and transitional arrangements can help ensure the overall consistency of a reform, since all messy political compromises can be confined to the transitional arrangement. In Portugal, for example, a "maximum variation clause" was introduced to mitigate the effects of the change in the redistribution criteria, and to guarantee that no municipality would face destabilising revenue losses. This clause stipulated that central government transfers flowing to any municipality would be reduced by no more than 5% in comparison with the previous year.[8] However, and in most cases, transitional arrangements put a considerable burden on the central government. As many observers interviewed during the study lamented: "central government always pays".

In cases where a small number of stakeholders with considerable veto power – especially specific sub-central governments – categorically reject a reform, the right to opt out may be granted. Some case studies suggest that allowing a few sub-central governments to opt out can help reduce opposition to reform without much cost and without threatening the principal elements of a reform, provided that these arrangements have little impact on economic sub-central government fiscal outcomes and that they do not incur resentment among other sub-central governments. In Denmark, the government used both the stick and the carrot: municipalities that did not reach the population targets could be forced to merge by the Parliament, thus creating an incentive to enter into voluntary mergers. An opt-out clause allowed municipalities to refuse to merge under some conditions, but they would not receive the new tasks transferred to municipalities and would have to conclude compulsory service agreements, buying these services from neighbouring municipalities. This allowed the reform to succeed in the vast majority of cases, reducing the opposition from the fiercest opponents.

Co-ordination bodies can help the administration speak with one voice

Organising an efficient process that structures and oversees the reforms is crucial for success. In general, fiscal relations reforms are overseen and managed by a single ministry, usually the central government's Ministry of Finance, the Interior Ministry or a body that comprises all government levels. Given that fiscal relations reforms often have a distinct horizontal character and cut across several policy areas, various line ministries are involved, especially in cases where the allocation of intergovernmental grants is traditionally shared across ministries. Reforms tend to advance more rapidly if the administration speaks with one voice, i.e. if one ministry takes the lead and relegates the other ministries to heading a working or project group. In some countries studied, administrative leadership was aided by the creation of new vertical and horizontal

intergovernmental bodies that helped select and bundle reform elements. Other countries explicitly pulled back from creating additional bodies on the grounds that they would procrastinate and develop their own agenda. In Australia, the Council of Australian Government (COAG) was revived (Box 2.3), and played a crucial role in the negotiation and design of the intergovernmental reform.

If administrative leadership is weak or shared between ministries, reforms are more likely to stall. Inter-ministerial infighting tends to weaken a reform. This is why several of the fiscal federalism reforms studied were enacted in conjunction with a reform of inter-ministerial financial management, or the reallocation of administrative powers and responsibilities was made part of the reform. In several cases, tasks such as the responsibility for disbursing intergovernmental grants, previously carried out by a range of different administrations, was concentrated in a single ministry (as in the grants reform in Finland, or in the case of Australia, where the Commonwealth Treasury became responsible for transferring the funds to the states). Indeed, many reforms may have resulted in a power shift from line ministries to the Ministry of Finance.

Box 2.3. **The Australian Federation and COAG co-ordination**

The **Council of Australian Governments (COAG)** is the main forum for the development and implementation of inter-jurisdictional policy, with the Australian Prime Minister as its chair, and includes state premiers, territory chief ministers and the president of the Australian Local Government Association.

Prior to the introduction of the COAG in 1992, the **Financial Premiers' Conferences** served as the peak intergovernmental forum through which the Commonwealth, the states and territories discussed issues of national concern, but these were mainly driven by the Commonwealth, with limited opportunity for the states to have input. In contrast, COAG meetings have been characterised by a high degree of collaborative efforts by state, territory and Commonwealth political leadership as well as agency officials, who participate in COAG decision making through heads of government meetings, ministerial councils and working groups.

The COAG was established in May 1992, but since 2007, the implementation of the COAG reform agenda has been boosted by new Commonwealth leadership and new working arrangements at COAG, including the use of **working groups** of senior state officials chaired by a Commonwealth minister, to identify areas for reform and develop implementation plans. Under the auspices of the COAG, **ministerial councils** facilitate consultation and co-operation between the Australian Government and state and territory governments in specific policy areas, and take joint action in the resolution of issues that arise between governments. In particular, ministerial councils develop policy reforms for consideration by COAG and oversee the implementation of policy reforms agreed by COAG.

In 2006, the states established a **Council for the Australian Federation (CAF)**, comprising all the states' premiers and territory chief ministers. The CAF aims to facilitate COAG-based agreements with the Commonwealth by working towards a common position among the states, as well as common learning and sharing of experiences across states.

The **COAG Reform Council (CRC)** is an independent body established by a COAG decision in 2006. It is meant to assist the COAG to drive its national reform agenda by strengthening accountability for the achievement of results through independent and evidence-based monitoring, assessment and reporting of the performance of governments. The CRC is independent of individual governments and reports directly to the COAG.

Source: OECD (2010), *OECD Reviews of Regulatory Reform: Australia 2010: Towards a Seamless National Economy*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264067189-en*.

Communication should present the policy behind the numbers

Governments tend to make considerable efforts to “sell” a reform. Efforts to highlight the long-term efficiency gains help create support from dispersed winners, who are often not fully aware of the potential gains. Communication with the public also helps identify potential problems with individual elements of a reform. In several of the cases studied, reports by expert panels were widely disseminated and discussed at public hearings, bringing the main stakeholders on board. In other cases, special seminars were held for the media to provide journalists with the broad outlines of the reform. In Portugal, the members of the expert group in charge of making a proposal for reform were active in presenting and defending it in the media. A major TV show organised a confrontation between those in favour and those against the reform, in which both the Minister of the Interior and the president of the National Association of Portuguese Municipalities participated. “Stealth” reforms in which the attention of the public is not drawn to the reform may at first appear expedient, but they should be weighed against how visible the short-term impacts of the reform may be, and how such an approach could undermine a government’s credibility. The case studies indicate that the most successful efforts at communication were those emphasising the long-term benefits.

A strategy for presenting the reform to the public is equally important. Fiscal federalism issues are abstract, highly technical and often accessible only to experts. Voters usually care little about who is responsible for a given public service or who taxes their income and property. However, they are interested in decent services, low taxes and sustainable public finances. Reformers thus have to clearly convey the policy intentions behind the formulas and numbers. In the case studies, such promotional slogans as “better services”, “more autonomy”, “save federalism”, “save the country” were invoked, or in some instances “save the reform”. Tighter sub-central fiscal rules were communicated as part of a fiscal consolidation strategy and the need for different government levels to co-ordinate their efforts in order to restore a sound fiscal position. Finally, in most cases, public relations campaigns pointed out that the reform allows both for more efficiency and for a more equitable distribution of fiscal resources across sub-central governments.

Conclusion

The study presented in this chapter aimed at filling a gap in the knowledge about the political economy of fiscal federalism reforms, which had hitherto received little attention. It shows that such reforms are particularly challenging, since in the short run, they result in a zero-sum game, with highly visible and quantifiable individual gains and losses. Most of the reforms studied for this report were carried out under favourable economic and fiscal conditions, and this seems to have played an important role. If most of the lessons learnt from these episodes should be useful for today’s reformers, it is probably that in the present tight economic environment, the nature of the reforms will change, from reforms towards more decentralisation and local autonomy to reforms aiming for efficiency and increasing policy coherence across levels of government. If healthy economic conditions helped governments “buy” reforms and reduce opposition to the uncertainty they entail, the present pressure to achieve efficiency gains and reduce costs may act as a powerful lever in the up-coming reforms.

Notes

1. For more information on this network, see www.oecd.org/ctp/federalism.
2. The "veil of ignorance" is a concept originating in political philosophy that explains how productive arrangements and social contracts evolve (Rawls, 1971). The "veil of ignorance" and the "status quo bias" are opposite outcomes of the same underlying fact, namely uncertainty. Somewhat simplified, the "veil of ignorance" assumes that overall efficiency gains will help to pass a reform because the average gains are assumed to be positive, while the "status quo bias" assumes that uncertainty about individual outcomes will block the reform because risk aversion puts a negative value on the stakeholders' expected average outcomes.
3. Political economy of reform issues in selected areas are reviewed in the OECD publication *Making Reform Happen* (OECD, 2010a), with contributions, among others, by Price on fiscal consolidation, by Brys on fundamental tax reform and by Charbit and Vammalle on public administration reform. Tompson (2009) scrutinises pension, product and labour market reforms in ten OECD member countries.
4. See Rodden (2009). This is why constitutional economists have suggested at least partially abandoning electoral districts and running elections at the national level (national election districts). Given that members of a national Parliament would need votes from the entire country, they would be more inclined to adopt a "national" and aggregate view of reforms rather than defend special sub-central government interests (see, for example, for Switzerland: Eichenberger, 2010).
5. In this respect, the political economy of comprehensive fiscal federalism reforms tends to be akin to fundamental tax reforms (Brys, 2010).
6. Log-rolling is an exchange of votes in a legislative process whereby two parties, who each need a partner to push its priorities through, create a common platform. One group supports the demands of another group with which it has little common ground or that it mildly opposes, in exchange for obtaining the other group's support for its own aims. Log-rolling works if the interests of other parties are relatively weak and dispersed. The benefits of log-rolling are controversial in the economic literature: while some see it as efficiency-enhancing during a reform process, others see it as rent-extracting (Crombez, 2000).
7. Indeed, one of the most robust findings to emerge from econometric work in the field of the political economy of structural reforms is that sound public finances are associated with more comprehensive reforms (Tompson, 2009).
8. Initially, this clause was conceived of as a temporary measure that would expire in five years (2007-2011), but since the final law passed by Parliament does not mention this sunset clause, in practice, this measure became permanent.

Annex 2.A1
Summary of the reforms analysed

Australia: the Intergovernmental Agreement on Federal Financial Relations, 2009

In 2008, the Council of Australian Governments (COAG) agreed to a new Intergovernmental Agreement on Federal Financial Relations (IGA). This agreement increased the financial autonomy of the states, moving from input control to the monitoring of outputs, and rationalising the payments made to the state into five broad areas (health, affordable housing, early childhood and schools, vocational educational and training and disability services). Each of these payment areas is funded by a special purpose payment (SPP), distributed to the states on an equal per capita basis (there is no need to adapt the amounts to the needs and costs of each state, as this is done by the Commonwealth Grants Commission). For each of these payment areas, a mutually agreed national agreement clarifies the roles and responsibilities that will guide the Commonwealth and the states in the delivery of services across the relevant sectors and covers the objectives, outcomes, outputs and performance indicators for each SPP. The performance of all governments in achieving mutually agreed outcomes and benchmarks specified in each SPP is then monitored by the independent COAG Reform Council and publicly reported on an annual basis.

The reform consisted of the following elements:

- **A new over-arching framework:** the Intergovernmental Agreement provides the framework for collaboration between the Commonwealth and the states through two types of agreements: national agreements, which set out policy objectives and performance indicators for key service areas; and national partnerships, to achieve more specific policy objectives across a wider range of government activities.
- **Moving from narrowly defined earmarked payments to more unconditional funding:** on the financial side, the agreement changed the intergovernmental transfer system, replacing the former numerous earmarked and narrowly defined specific-purpose payments with a few broad-based per capita grants. The grants must be spent in the sector for which they are provided.
- **Greater accountability to the public:** the framework defines more clearly the roles and responsibilities between the Commonwealth and the states and provides for simpler, standardised and more transparent public performance reporting through the Council of Australian Governments' Reform Council.
- **An increase in Commonwealth funding for state core policy areas:** the Commonwealth government increased funding for core areas such as education and health care by around 30%, compared to the former SPP funding. Moreover,

incentive payments are disbursed to states that deliver on national reforms or achieve service delivery improvements.

- **A reform of funding administration:** at the Commonwealth level, policy formulation and service funding were administratively separated. While policy formulation remained with line ministries (health care, education, etc.), funding and associated tasks (allocation formulas, etc.) were transferred to the Commonwealth Treasury.

The Intergovernmental Agreement was a political statement, with only the new payment arrangements requiring legislation at the Commonwealth level. While the reform did not affect fiscal equalisation – which in Australia is achieved through the redistribution of the goods and services tax – the transition towards per capita payments separated equalisation objectives more clearly from joint service delivery. Although the reforms did not reduce the vertical fiscal imbalance, i.e. the gap between state spending and state own tax revenues, they potentially moderated some of its disadvantages by increasing spending autonomy at the state level.

Austria: the reform of the Fiscal Equalisation Law, 2008

The Austrian Law on Fiscal Equalisation stipulates that the federal and sub-federal levels should periodically evaluate and, if necessary, renegotiate fiscal equalisation and intergovernmental fiscal relations. The 2008 reform followed a set of earlier reforms in 2001 and 2005. The Fiscal Equalisation Reform adopted by the national Parliament in 2008 was a fiscal and administrative reform aimed at increasing the states' budget flexibility, improving service delivery at the state level and tightening the states' budget constraints. The reform consisted of several elements:

- **The transformation of a set of intergovernmental, partially earmarked grants into a higher sub-central share in federal government tax revenue**. The amount of transfers decreased by around 40%, while the states' share in total tax revenue rose from around 16% to 19%.
- **An increase in federal funding of social benefits and health care spending by the states**, particularly hospital funding, welfare benefits and child care, thereby increasing earmarked grants to the state level. States and municipalities were committed to spending similar additional resources.
- **The amendment of the tax-sharing-*cum*-equalisation formula that allocates fiscal resources between large and small sub-central governments**, thereby slightly reducing the higher per capita payments allocated to large sub-central governments.
- **A change in population statistics, i.e. a move from census data to registry data that are updated annually**, in order to better reflect demographic change and internal cross-border migration in tax sharing and intergovernmental grant allocation formulas.
- **Harmonisation of tax legislation for autonomous taxes** – which make up around 4% of state government tax revenue – across the nine states.

While the move from transfers to tax sharing was considered fiscally neutral, the increase in hospital and child care funding and the compensation for the change in population statistics was not, entailing additional expenses of around EUR 180 million

per year at the federal level. The issue of greater tax autonomy and of performance-oriented transfers was briefly discussed at the beginning of the reforms but later dropped.

Belgium: the Lambermont Agreement, 2001

The Lambermont Agreement (*accord du Lambermont*), concluded between the parties of the governing coalition in 2000 and adopted by the national Parliament in 2001, substantially changed the revenue structure of Belgium's regional entities and the financial balance between the federal and the regional level. The agreement consisted of two distinct elements: *i)* the reassignment of several taxes to the regions and further tax autonomy for them; and *ii)* a considerable increase of federal transfers to the communities. The reform also included minor institutional aspects, with new tasks transferred to the regions. The Lambermont Agreement was the latest in a succession of fiscal decentralisation reforms and the widest-reaching tax assignment reform since Belgium had started to decentralise in the 1970s.

The reform consisted of:

- **More taxing power for the regions:** several taxes, such as the registration duties, the TV tax, the vehicle tax and some "green" taxes, were reassigned to the regions. Moreover, the regions were allowed to adapt personal income tax rates within the limit of 6.75% of total regional personal income tax revenue, without, however, reducing progressivity.
- **Less tax sharing:** the regional share in the personal income tax was reduced to compensate for the new taxing powers and higher revenue from the newly assigned taxes.
- **More transfers for the communities:** the communities received a permanent increase in VAT transfers, mainly for education, according to a distribution formula that reflected the cost of education and which was linked to GDP growth as of 2007.
- **More regulatory tasks to the regions:** the regions were granted more responsibilities in areas like agriculture and fishery, foreign trade policy, supervision of local authorities and development co-operation.

The decentralisation of taxing power raised the share of autonomous taxes in total regional revenue from 10% to around 20%, reducing tax sharing accordingly. The refinancing of the communities increased federal transfers by around 10% of total value-added tax revenue. While the taxing power pillar was thought to be "fiscally neutral" – i.e. not entailing an additional burden for either government level, the transfer and refinancing pillar was not, since the higher regional share of value-added tax reduced the resources available for the federation.

Canada: the Equalisation Reform, 2007

In 2007, the Canadian Parliament endorsed a wide-ranging reform of fiscal equalisation, making the system more principle- and formula-based and injecting additional federal resources for the provinces. The reform overhauled a system that had become pro-cyclical, opaque and prone to the influence of special interests. Equalisation

was simplified, the distribution formula overhauled, and total equalisation payments were no longer subject to a cap. The reform also changed the allocation formula for provincial resource revenue, a much contested issue. The national fiscal capacity standard was redefined, including a new assessment of provincial revenues from natural resources. The reform, considered one of the farthest reaching since the inception of the scheme in 1957, was meant to put an end to chronic disagreements between the federal government and the provinces as well as among the provinces. Overall, it led to considerable spending increases for the federal government, in large part driven by the interaction of the new formula with record oil prices. After the financial and economic crisis struck in 2008, the reform was revisited and total federal equalisation payments were again made subject to a ceiling.

The reform consisted of the following elements:

- **A new equalisation standard was developed:** equalisation entitlements were based on an average defined by a subset of the Canadian provinces. The reform introduced the ten-province standard, i.e. the national average, replacing the five-province standard that had been in operation since the early 1980s.
- **The Representative Tax System (RTS) was simplified:** the RTS, which defines the fiscal capacity of a province, was simplified, combining revenue sources so that the number of tax bases that determined fiscal capacity declined from 33 to 5.
- **Equalisation became open-ended:** the overall size of the programme was no longer subject to any federal ceiling provisions. The reform thus reverted to the system that existed prior to 2004.
- **Resource revenues are partially taken into account:** resource revenue – royalties and fees, etc., from the exploitation of oil, gas, coal, water, and so on – would henceforth contribute 50% to the definition of provincial fiscal capacity. Actual resource revenues are used to estimate fiscal capacity.
- **Some ceilings were set:** a cap was set to ensure that no province could have a higher post-equalisation fiscal capacity than the lowest non-receiving province. This provision ensured equitable treatment of the provinces and reduced total federal payments.

The new standard was higher than the old five-province standard, since it included high-revenue and oil-rich provinces such as Alberta, which had formerly been excluded from the five-province-standard. Since the reform moved from a closed-ended to an open-ended approach – i.e. total equalisation payments were no longer subject to a ceiling – the new standard means considerably higher expenses for the federal government, especially when resource prices are high. The limits on resource-rich provinces were a relatively weak measure to contain pressure on the federal budget. After gradually receding in terms of GDP or total federal spending, equalisation payments rose sharply after the reform. After the financial and economic crisis contributed to a sharp deterioration in fiscal balances, the federal government again imposed a cap on total equalisation payments for the period 2009-10 and beyond.

Canada: the provincial sales tax harmonisations, 2010

In July 2010, the governments of the two provinces of Ontario and British Columbia introduced the "Harmonised Sales Tax" (HST) framework, i.e. submitted their sales taxes to federal legislation, federal administration, a common definition of the tax base and a federally administered formula for allocating tax revenues across provinces. In Ontario, "harmonisation" was embedded in a wider-reaching tax reform, while in British Columbia it was not. As part of the Ontario and British Columbia reforms, the federal government modernised the HST framework accords – previously concluded with three Atlantic provinces only – to give the provinces the autonomy for the first time to set their own individual tax rates. After the reforms, the share of activity in Canada for which there is no tax on business inputs is now around 94%. This note concentrates on the reform in Ontario.

The Ontario Sales Tax Harmonisation consisted of a comprehensive reform package that modernised the province's tax system and harmonised it with the federal goods and services tax. The reform consisted of the following elements:

- **Harmonisation of the provincial sales tax:** the reform replaced the provincial sales tax with a value-added tax that was combined with the federal goods and services tax. The tax was federally legislated and administered with a common definition of the tax base and a federally defined formula for allocating tax revenues across provinces.
- **Corporate income tax reductions:** the general corporate income tax rate will be reduced incrementally from 14% in 2009 to 10% in 2013, with the small business rate reduced from 5.5% to 4.5% in 2010. The capital tax and some other surtaxes were eliminated.
- **Personal income tax reductions:** the personal income tax rate of the first tax bracket was lowered from 6% to 5%, thereby reducing the tax bills for around 90% of households.
- **Sales tax and property tax relief:** two tax credit schemes were replaced and existing tax relief broadened to help low-income households.

The reform was adopted in July 2010 following the severe global crisis in the fall of 2008. In order to provide tax relief for households and to support economic growth, the government reduced the total tax burden by around CAD 5.2 billion for the 2010-12 budget period or by around 4% of total provincial tax revenue. Around 40% of the total tax relief was compensated for by a federal transfer.

Denmark: the Local Government Reform, 2007

On 1 January 2007, a new administrative map of Denmark was created, as the Danish Local Government Reform came into force. The number of municipalities was reduced from 271 to 98 by mergers, and the 13 counties were abolished and replaced by 5 regions. A process of "controlled voluntary mergers" resulting from a political agreement between the main political parties forced municipalities to merge until they reached a minimum size of 20 000 inhabitants, while leaving them freedom to negotiate with their neighbours to create the new boundaries. The main objective of the reform was to adapt public service delivery to technological change and increasing demand, while leaving the Danish

public sector decentralised. The public sector and service levels had grown over the years, and small municipalities could no longer provide the level of services that was now required. Municipal mergers were therefore seen as an alternative to recentralisation.

The Danish Local Government Reform consisted of three main elements.

1. A new map of Denmark:

- The number of municipalities was reduced from 270 to 98 by mergers, resulting in an average size of 56 000 inhabitants per municipality. Fourteen counties were eliminated and replaced by 5 new regions.

2. A new distribution of tasks between levels of government:

- A number of tasks were transferred from the counties, leaving the municipalities responsible for handling most welfare tasks. Municipal responsibilities include: social services, child care, compulsory education, special education for adults, rehabilitation and long-term care for the elderly, preventive health care, nature and environmental planning, local business services, promotion of tourism, participation in regional transport companies, maintenance of the local road network, libraries, music schools, local sports and cultural facilities, and a responsibility for employment, shared with the central government.
- The new regions took over responsibility for health care from the counties, including hospitals and public health insurance covering general practitioners and specialists, pharmaceuticals, etc. The regions also have a number of tasks involving regional development.
- The central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services. Employment services became a responsibility that it shares with municipalities, and responsibility for upper secondary schools was reallocated to the central government to ensure more coherence in secondary education. Tax collection was also transferred to the central government, as well as part of collective transport and road maintenance, and it assumed an increased role in nature and environmental planning (especially as regards compliance with international obligations and complex matters of major national importance). Finally, responsibility for culture was transferred to the central government (in practice, subsidising a number of private cultural institutions of national stature), and the central government administration took over regional official authority from the office of the governor of the county.

3. A new financing and equalisation system:

- The number of taxation levels was reduced from three to two, since the regions, unlike the counties, no longer have the authority to impose taxes. Their revenues consist of block grants and activity-based funding from the central government and the municipalities. In addition, in order to ensure that the local government reform does not result in changes in the distribution of the cost burden between the municipalities, a reform of the grant and equalisation system was carried out, which takes into account the new distribution of tasks.

Finland: Restructuring Local Government and Services, 2008

In 2007, Finland started implementing the Act on Restructuring Local Government and Services (also known under its acronym as the "PARAS Reform"), which aims at creating economies of scale by encouraging voluntary municipal mergers and municipal co-operation areas for public service delivery. Given the high degree of municipal autonomy in Finland and the country's tradition of consensual decision making, it was not possible to use threats or sanctions to force municipalities into implementing the reform (as was the case in Denmark, where municipalities were given one year to merge voluntarily; if they did not comply, the central government could impose the merger). Municipalities could therefore choose between merging and joining larger co-operation areas, but financial incentives were used to encourage municipalities to merge. Municipal mergers were already on the agenda before this reform, and in 2002, a substantial increase in merger subsidies was granted to municipalities wishing to merge. This led to a reduction of the number of municipalities from 452 in 2001, to 432 in 2005. The PARAS Reform further reduced the number of municipalities to 348 in 2009, and municipalities have until 2013 to benefit from financial incentives under the current framework.

The PARAS reform consists of two main elements: the payment of grants for voluntary mergers of municipalities, and the restructuring of public service delivery. The reform is currently being implemented.

- **To promote municipal mergers, grants are offered to merging municipalities.** Municipalities are free to choose whether to merge or not, as well as to select their merging partners. The amount of the grant depends on the number of municipalities merging, the size of the municipality after the merger, and the initial size of the merging municipalities.
- **The reform also aims at restructuring public service delivery by creating larger units that deliver public services.** Different population requirements were thus established for different public services (for example, a minimum population base of 20 000 had to be reached to provide primary health care and associated social services, and a population base of 50 000 was required for vocational basic education). Municipalities can reach these population targets either by merging, or by co-operating with other municipalities in the delivery of these services. In cases where a partnership area is formed, a new joint municipal body must be established for the management of the relevant tasks.
- Some flexibility is allowed based on whether municipalities are located on an island of the archipelago or in a remote location, and on linguistic and cultural features.
- The biggest urban regions – i.e. the four local authorities in the Helsinki Metropolitan Area as well as 16 other cities in other parts of Finland with their neighbouring municipalities (altogether 102 municipalities) – had to draw up co-operation plans by 31 August 2007. These plans had to resolve matters such as land use, housing and transportation and provision of services across municipal boundaries.

The Finnish Grant System Reform: an unfinished task, 2010

The Finnish intergovernmental grant system has been repeatedly criticised for its excessive complexity and lack of transparency, and for not providing enough incentives for productivity improvements at the municipal level. It was established in the 1960s, together with the welfare state, and has seen periodic reforms. Initially, the public services linked to the welfare state were provided by the municipalities, but financed by the central government through earmarked grants (central government financing of new responsibilities ranged from 50% to 86%, compared to 34% today). But this system grew increasingly complex, as new grants were created for each new responsibility transferred, with different calculation formulas, different ministries in charge, different steering systems, etc. In 1993, after the Finnish financial crisis, the grant system was overhauled, moving away from earmarked matching grants towards a simpler system of three block grants managed by the Ministry of Social Affairs and Health, the Ministry of Education and the Ministry of Finance.

In 2010, as part of a broader reform process called the “Basic Services Programme” (initiated in 2003), the grant system was revised: the three different block grants were merged into one general purpose grant managed by the Ministry of Finance. This grant reform was included in the 2007 election programme, and a detailed study was conducted by the Government Institute for Economic Research (*Valtion Taloudellinen Tutkimuskeskus*, or VATT) to provide new criteria for allocating the funds. But finally, as the global financial crisis led to revenue shortfalls, the allocation formula was not revised and the municipalities were given a guarantee that they would not lose revenues due to this reform.

This reform project was supported by state officials, not the political leadership, and was welcomed by the municipalities and their association. They preferred to have the Ministry of Finance as their sole counterpart, since they believed that it is more likely to take their interests and long-term sustainability into account. The main opponents of the reform were the line ministries whose budgets were reduced. In 2009, the year prior to the reform, grants from the Ministry of Social Affairs and Health amounted to EUR 5.5 billion, those from the Ministry of Education represented EUR 3.8 billion, while the Ministry of Finance funded only EUR 0.2 billion. The loss of these funds represents almost 40% of the Ministry of Social Affairs and Health budget, and about 20% of the Ministry of Education’s budget. Strong lobbying from the education sector and the Minister of Education allowed this ministry to keep control over the grants for upper secondary schools and vocational training.

The reform ended up involving a shift of power from the Ministry of Social Affairs and Health and the Ministry of Education to the Ministry of Finance, with only minor changes made to the allocation formula. This shift reinforces the central role of the Ministry of Finance in municipal affairs, which was already boosted in 2008, with the transfer of the Ministry of Regional and Municipal Affairs from the Ministry of the Interior to the Ministry of Finance. The transfer creates favourable conditions for the next step of the reform, which will consist in renegotiating the grant formula. Future negotiations will involve two interest groups only: the association of municipalities and the Ministry of Finance.

Italy: Law 42 on Fiscal Federalism, 2009

In 2009, the Italian Parliament passed a framework law that thoroughly reshaped fiscal relations between central, regional, provincial and municipal governments. The law, based on a constitutional amendment dating back to 2001, aims to increase both the efficiency and accountability of sub-central governments (sub-central governments) and to guarantee adequate levels of sub-central public services across the country. The reform replaces a sub-central funding system that had become opaque, inequitable with respect to public service levels and prone to spending excesses. The reform consisted of the following elements:

- **Spending responsibilities to be covered by own taxes:** in line with the constitutional principle of fiscal autonomy, sub-central governments will be entitled to a set of own taxes or shares in national taxes sufficient to cover their spending needs. Regions are entitled to the tax on productive activities (a regional business-*cum*-value-added tax) and the personal income tax; and they are entitled, within limits, to change the rates on these taxes. Regions are also entitled to a share in the national value-added tax. Municipalities will receive a share of the value-added tax and the personal income tax and will be allowed to levy a property tax on non-owner-occupied houses. The increase in taxing power will be fully offset by a reduction in intergovernmental grants. Only equalising grants and some special-purpose grants will remain.
- **Clarification of spending obligations:** responsibilities for public services at the sub-central government level will be divided into compulsory services (health care, education, social protection and local transport) and all other public services. While the central government will define minimum standards for compulsory services, sub-central governments are free to define standards and spending levels for the other services. All services not explicitly allocated to the central government level will be the region's responsibility.
- **Equalisation of tax-raising capacity and standard cost:** two different equalisation systems will be introduced, funded through a share of the national value-added tax: *i)* equalisation of the cost for essential and compulsory services, to be fully equalised and based on standard cost instead of historical cost; *ii*) equalisation of tax-raising capacity, for which the equalisation rate would be less than 100%, leaving sub-central governments an incentive to develop their economic and fiscal base.
- **Harmonisation of accounting principles:** accounting principles for regional and local levels of government (such as accounting and budget rules, the treatment of publicly owned enterprises, depreciation rules, etc.), are being harmonised, so that regional and local accounts will be truly comparable and "creative accounting" avoided.

Law 42 is a framework law that sets down the principles for reform but leaves their implementation to a set of legislative decrees. These decrees also have to be passed by Parliament, and only five were in force as of mid-2011. Pending issues include the functioning of the equalisation scheme and the tax shares allocated to each government level. There is some uncertainty as to whether the reform will be fiscally neutral for the central government. At the time it adopted Law 42, the central government tightened fiscal rules in the Internal Stability Pact and instituted sanctions for non-complying

sub-central governments. To mitigate the strictness of the rules, regions are given some flexibility in dividing up overall deficits and debt among their provinces and municipalities.

Portugal: the Reform of the Local Finance Law, 2007

In January 2007, a new Local Finance Law came into force in Portugal, with the objective of increasing the equity and efficiency of sub-central public finances, while remaining financially neutral for the central government. One of the main aims of this reform was to tighten budget constraints and to reduce the revenue dependence of municipalities on immoveable property. Municipalities had relied heavily on housing transaction fees as a revenue source, which gave local governments an incentive to grant building licenses that led to urban sprawl. Another objective was to reduce corruption and other illegal practices at the local level. Finally, the reform aimed at increasing equity by correcting flaws in the previous 1998 Local Finance Law, which were seen as favouring small municipalities over larger ones.

The reform consisted of four elements:

1. **A reform of municipalities' revenue mix:**

- **An increased municipal share in the personal income tax and more tax autonomy.** Of the personal income tax revenues collected, 5% is ceded to the municipalities. They are free to reimburse all or a part of this to their residents, on the condition that they maintain the constitutional principle of uniformity and progressivity of the tax.
- **A reform of the general-purpose grant system.** The reform reinforced equalisation and created a component of horizontal equalisation that did not exist previously. The allocation criteria were changed by increasing the weight of population and environmentally protected areas, reducing the lump-sum transfer to municipalities and reducing the weight of the number of parishes in the allocation formula, thus penalising municipal fragmentation. A new "social municipal fund" was created, disbursing earmarked grants to compensate for the cost of the responsibilities transferred to municipal governments in the areas of education, health care and social assistance. The "minimum guaranteed growth" clause was abolished, under which municipalities were guaranteed that they would not receive less than in the previous year in real terms. Finally, the tax-sharing apportionment was reduced to compensate for the increase of the municipalities' share in the personal income tax, to ensure fiscal neutrality for the central government.

2. **New fiscal rules:**

- **The new fiscal rules set out two limits.** The level of a municipality's debt was limited to 125% of its annual total tax and transfer revenue; short-term borrowing was limited to 10% of these same resources; and an annual limit of 100% of those resources was imposed for medium- and long-term loans. Loans and amortisation for financing urban rehabilitation programmes were excluded from the limit on indebtedness. The law states that if a municipality breaches these debt limits, transfers from the central government shall be reduced by a corresponding amount.

3. **Reform of statutory reporting and auditing of accounts:**

- **Municipal accounts must be consolidated** with those of their local public enterprises and submitted to external audit.

4. **Two institutional reforms:**

- **Harmonising the rules on fees and prices for local public services.** This regulates the imposition of fees by municipalities and parishes, establishing the criteria under which they can be charged, and the principle that the fees should cover the costs of providing the services.
- **A reform of the law governing municipal-owned companies.** A broad definition of local government businesses was adopted, covering municipal, inter-municipal and metropolitan companies. The aim of the law is to better regulate their activity and increase transparency. The law covers the criteria for creating a local company; requires the drafting of a management contract that specifies the company's intended objectives, need, purpose and proposed gains in efficiency and effectiveness; prohibits the granting of allowances and subsidies; makes it unlawful to exercise remunerated executive functions in both local government and local enterprises at the same time; and imposes limits on the remuneration of local public managers.

Spain: reforming the funding of autonomous communities, 2009

When it was created in the 1980s, the Spanish system of financing autonomous communities (AC) provided for renegotiation every five years. Each round of negotiation raised political tensions and subjected the central government to additional costs for reaching an agreement. The AC Finance Law (*LOFCA: Ley Orgánica de Financiación de las Comunidades Autónomas*) adopted in 2001 was supposed to remain in force indefinitely and thus to avoid such problems. However, since it did not include mechanisms to adapt to asymmetrical shocks (such as uneven population increases across regions), it was criticised for generating inefficiencies and inequities in revenue allocations. After only a couple of years, the need to reform the system became apparent. Preliminary studies were undertaken between 2006 and 2008, negotiations were carried out in 2008 and 2009 between the central government and the autonomous communities, and in December 2009, a new LOFCA was passed by the national Parliament and subsequently ratified by all the autonomous communities.

1. **The share of the autonomous communities in shared taxes was raised:**

- personal income tax: from 33% to 50%;
- value-added tax: from 35% to 50%;
- excise: from 40% to 58%;
- of these taxes, 75% are allocated to the fund to guarantee public services, which is divided among the autonomous communities according to adjusted population criteria. The remaining 25% are allocated to the autonomous community where they were generated. If an autonomous community increases its tax effort, it can keep the resources that are generated.

2. **Several specific funds were created for different purposes** (the fund to guarantee public services, the global sufficiency fund and two convergence funds: the competitiveness fund and the co-operation fund).

3. **The equalisation scheme was reformed.** The previous system of total equalisation, based on a static assessment of relative needs, was changed to a system that only equalises partially, but is frequently adjusted.

- Under the previous system, needs were calculated based on the 1999 census, and thereafter increased following the national tax receipts index (ITEn), which is identical for all autonomous communities. This meant that it did not take into account relative changes in needs between autonomous communities.

- The new system provides partial equalisation (of 80% of needs). These needs, however, are now re-evaluated and adjusted yearly, following the evolution of actual needs (mainly in response to population changes), and thus ultimately adjusting the autonomous communities' relative shares.

4. **The criteria for allocating funds to autonomous communities were changed.** About 80% of the autonomous communities' revenues (75% of ceded taxes plus about 5% additional transfers from the central government) are allocated to the fund to guarantee public services, according to an "adjusted population" criterion, i.e. population weighted by age group, area of the autonomous communities, dispersion of the population in the autonomous communities, island status, etc. This fund is adjusted yearly, taking into account the evolution of these variables. Additionally, a global sufficiency fund provides sufficient resources for the rest of the responsibilities devolved, and guarantees that there are no net losers due to the reform.

5. **Finally, two new convergence funds were created:**

- A competitiveness fund was created to satisfy the autonomous communities whose financing was clearly below the national average in the previous system (richer autonomous communities with steep population growth). It aims to reduce per capita financing disparities.

- A co-operation fund was created to help the less dynamic autonomous communities (which had fallen behind either economically or in population growth), thus helping to reduce growth discrepancies among autonomous communities.

Switzerland: the "New Fiscal Equalisation" Framework, 2004

Switzerland's fiscal federalism reforms, whose beginnings date back to the late 1980s, were passed in successive parliamentary and popular votes in 2003, 2006 and 2007. The 2003 vote concerned the constitutional amendments necessary to implement the reform, the 2006 vote concerned legal amendments to intergovernmental co-operation in various policy areas, and the 2007 vote concerned the size of and rules applied to the equalisation funds introduced in 2003. The government presented the reform package to voters in the form of four "pillars":

- **Disentanglement:** responsibility for a number of tasks in policy areas such as education, social security and transport infrastructure – previously funded and regulated jointly by the federation and the cantons – were allocated either entirely

to the federal or to the cantonal level. Since the federal level was funding its share of joint tasks through a set of intergovernmental grants, disentangling resulted in a decrease of grants by about 40% from their pre-reform level.

- **Fiscal equalisation:** a new fiscal equalisation system was introduced, consisting of three elements: *i)* a horizontal equalisation fund financed by cantons with above average tax-raising capacity and granting payments to cantons with below average tax-raising capacity, *ii)* an equalisation fund financed by the federation for cantons with below average tax-raising capacity, and *iii)* a federal equalisation fund for cantons with high geographic-topographic or socio-demographic spending. To compensate for the additional federal spending linked to the vertical equalisation fund, the federal government reduced the cantons' share in the federal income tax from 30% to 17%.
- **Horizontal collaboration:** the federal level obtained the right to coerce cantons into horizontal collaboration and joint funding in selected policy areas, such as higher education and health care, in order to reduce externalities and free-riding of cantons and to improve collaboration on service provision across cantons. However, the federal level may only intervene if a certain number of cantons call for it.
- **New fiscal management:** a number of public finance and new public management techniques were introduced into the remaining joint policy areas where formal collaboration is still required, such as standard and norm cost accounting or performance contracting. In the latter case, policy objectives (e.g. on environmental protection) were established jointly between the federation and the cantons, and implementation was left to the cantons.

In addition, a transitional "cohesion fund", to be phased out over the next 28 years, was created, aimed at compensating cantons that were net losers of the reform. Also, a new budget rule stipulated that the size of the horizontal equalisation fund should be between two-thirds and 80% of the size of vertical equalisation. After several changes to the substance as well as to the title of the reform, the official name became "Reform of Fiscal Equalisation and of Task Allocation between the Confederation and the Cantons". Every four years, Parliament will have to decide on the size of the three elements of equalisation. While the reform covered the spending side of the federal budget – and grant revenues for the cantons – the federal tax system, tax assignment across government levels and cantonal taxing power remained untouched, except for the lower cantonal share in the federal income tax.

Bibliography

Albouy, D. (2010), "Evaluating the Efficiency and Equity of Federal Fiscal Equalization", *NBER Working Paper,* No. 16 144, National Bureau of Economic Research (NBER), Cambridge, MA., *www.nber.org/papers/w16144.*

Brosio, G. and G. Pola (1989), "A Survey of Various Attempts to Explain the Distribution of Tax Revenues among Levels of Government", Proceedings of the 42nd Congress of the International Institute of Public Finance, Athens.

Blöchliger, H. and C. Vammalle (2011), *Reforming Fiscal Federalism and Local Governments: Beyond a Zero Sum Game*, OECD Publishing, Paris.

Crombez, C. (2000), "Spatial Models of Log-Rolling in the European Union", *European Journal of Political Economy*, No. 16.

Charbit, C. and C. Vammalle (2010), "Modernising Government", in *Making Reform Happen: Lessons from OECD Countries,* OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264086296-9-en*.

Eichenberger, R. (2010), "Bessere Politik für die Schweiz: Fünf Reformvorschläge für mehr Effizienz und weniger Sonderinteressen", *Schweizer Monatshefte,* No. 980, Zurich, September.

OECD (2010a), *Making Reform Happen, Lessons from OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264086296-en*.

OECD (2010b), *OECD Reviews of Regulatory Reform: Australia 2010: Towards a Seamless National Economy*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264067189-en*.

Olofsgard, A. (2003), "The Political Economy of Reform: Institutional Change as a Tool for Credibility", background paper to the World Bank Development Report, Washington, D.C.

Rawls, J. (1971), *A Theory of Justice*, Harvard University Press, Cambridge, MA.

Rawls, J. (2001), *Justice as Fairness: A Restatement*, Belknap Press, Cambridge, MA.

Rodden, J. (2009), "Representation and Regional Redistribution in Federations", in *IEB's World Report on Fiscal Federalism*, Institut d'Economia de Barcelona, Barcelona.

Rodrik, D. (1999), "The Rush to Free Trade in the World", in F. Sturzenegger and M. Tommasi (eds.), *The Political Economy of Reform*, MIT Press, Cambridge, MA.

Tompson, W. (2009), *The Political Economy of Reform: Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264073111-en*.

PART II

INSTITUTIONAL AND FINANCIAL RELATIONS ACROSS LEVELS OF GOVERNMENT: INFORMATION ON COUNTRIES

Chapter 3

Financial resources, expenditures and debt of sub-central governments

by
José María Piñero Campos
and Camila Vammalle

The design of intergovernmental fiscal relations varies widely across countries, as they necessarily incorporate local economic, but also political, social and cultural factors. This chapter aims to give some insight to policy makers about the relative importance in OECD member countries of sub-central governments (SCGs) in different policy fields, the spending responsibilities of sub-central governments, and the composition and autonomy of the revenues of sub-central governments with which they must finance these expenditures. This chapter draws on data from the OECD Fiscal Decentralisation Database*, a new database developed by the OECD Network on Fiscal Relations across Levels of Government, based on information provided by the* OECD National Accounts *and* OECD Revenue Statistics*. The first section focuses on the spending responsibilities and weight of sub-central governments. The second section analyses sub-central governments' own revenues, such as taxes and user fees. The third section looks at the grants in sub-central governments' revenues and, finally, the fourth section deals with sub-central government debt.*

Spending responsibilities of sub-central governments

Using the common classification of functions of government in redistribution, allocation and stabilisation (Musgrave, 1959), the theory suggests that stabilisation and redistribution functions should be assigned to the central government, while sub-central governments should concentrate on the allocation function for certain types of public goods (Musgrave and Oates, 1972). Indeed, macroeconomic stabilisation depends on monetary and fiscal policies that normally reside at the central level of government, and it would be very difficult for sub-central governments to carry out redistribution in a world of mobile resources. Indeed, any attempt by a sub-central government to tax a mobile resource in order to redistribute it to poorer mobile factors would result in the flight of the wealthy to avoid paying for the redistribution, and an influx of the poor in order to benefit from it. Finally, with respect to allocation, it is generally admitted that pure national public goods with high economies of scale and goods that produce large externalities are better allocated to higher levels of government, while public goods subject to congestion and whose benefits are limited geographically are best provided by sub-central governments, which typically have more information on local preferences. Actual allocation of competences, however, does not always match these principles, as the result of historical, cultural, institutional and political factors.

Looking at the fiscal weight of sub-central governments in each function of government gives an indication of the multi-level governance complexity of the country's institutional framework. The higher the weight of sub-central governments in functions of national interest, such as education, health or social protection, the more important it is to co-ordinate actions between central governments' national strategies and goals, and sub-central governments' policy making. The importance of different functions of government in sub-central government budgets also gives an indication of the room for manoeuvre they have to reduce expenditure in an effort to reduce deficits, as some areas may be more incompressible than others, and some expenditure may even be pro-cyclical (for example, social protection).

This section gives information both on the relative importance of different functions of government in sub-central government budgets, and the relative weight of sub-central governments in total public spending by government function.

Sub-central governments represent a significant share of total public spending

The relative share of sub-central government spending in total public spending varies greatly across countries, ranging from 6% in Greece to more than 60% in Denmark and Canada (Figure 3.1a and Box 3.1). On average in 2010, sub-central government expenditure represented about 30% of total public spending, or 14% of GDP (Figure 3.1b), but in three countries, sub-central governments account for more than half of public spending (Canada, Denmark[1] and Switzerland). Spending decentralisation (the share of sub-central government expenditure in total public spending and in GDP) is higher in countries with three levels of government (federal and quasi-federal) and in North European countries than in unitary countries. Korea is the only non-North European country with two tiers of government to have above-average sub-central government spending.

On average, the share of sub-central governments in total public spending have remained quite stable since 2000 (0.4 percentage points increase) (Figure 3.1c). But this average hides country variations: some countries have decentralised spending (Slovak Republic) while others have re-centralised (Ireland). The initial level of decentralisation does not explain the direction of the change: some countries with initial above average decentralisation of spending have further increased the share of sub-central governments (Canada), while some countries with below average decentralisation of spending have re-centralised (Portugal).

On average, sub-central governments represent a large share of total public spending. This does not necessarily imply that spending decisions are actually taken by sub-central governments, as central governments may impose standards, regulations, earmarking, staff and wage policy, etc. that constrain sub-central governments' choices. The commonly used measure of the relative share of sub-central spending to total government spending does not take this fact into account (the most drastic illustration of this is the case of Denmark[2]). There is no set of internationally comparable indicators of spending power (defined as the extent of the control sub-central governments exert over their budget). A pilot study was carried out by the OECD Network on Fiscal Relations across Levels of Government in four policy areas (education, public transport, child care and elderly care) in five countries (Denmark, Germany, Ireland, Portugal and the Slovak Republic) (Bach et al., 2009).

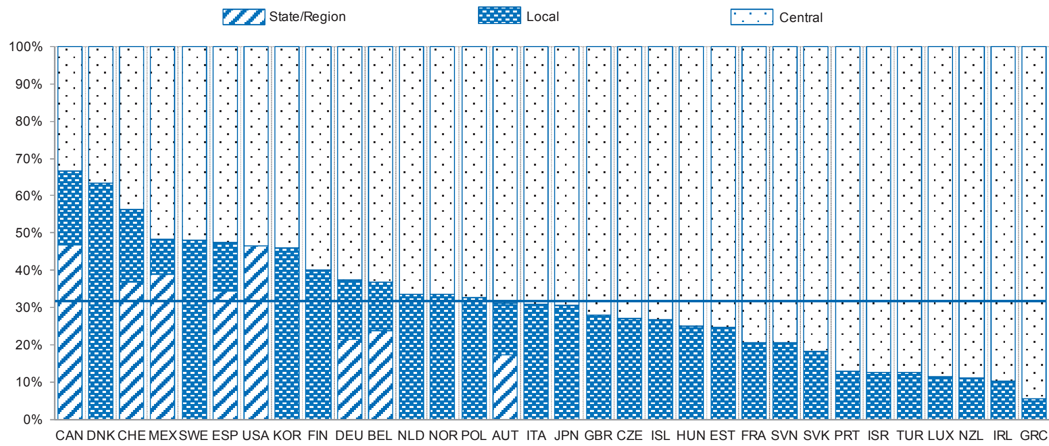
Box 3.1. **Methodology and definitions: spending by level of government**

Spending data from the National Accounts must be consolidated before use. The amount of intergovernmental transfers is usually significant and makes the sum of central (including social security), state/region and local spending larger in general than general government spending. To solve this issue, the *OECD Fiscal Decentralisation database* consolidated expenditure of each level of government by calculating total spending minus the intergovernmental transfer spending of that government level. Consolidated total general government expenditure is defined as global total expenditure at general government level plus total intergovernmental property expenditure. This addition is made because the latter represents payments by one level of government for a service provided by another government level and it essentially avoids consolidation of property expenditure at the general government level.

For total expenditure in recent years, almost all OECD member countries provide sufficient data in the *National Accounts database* to allow this consolidation.

Figure 3.1. **Spending by level of government (2010)**

a) In % of total public spending



b) In % of GDP

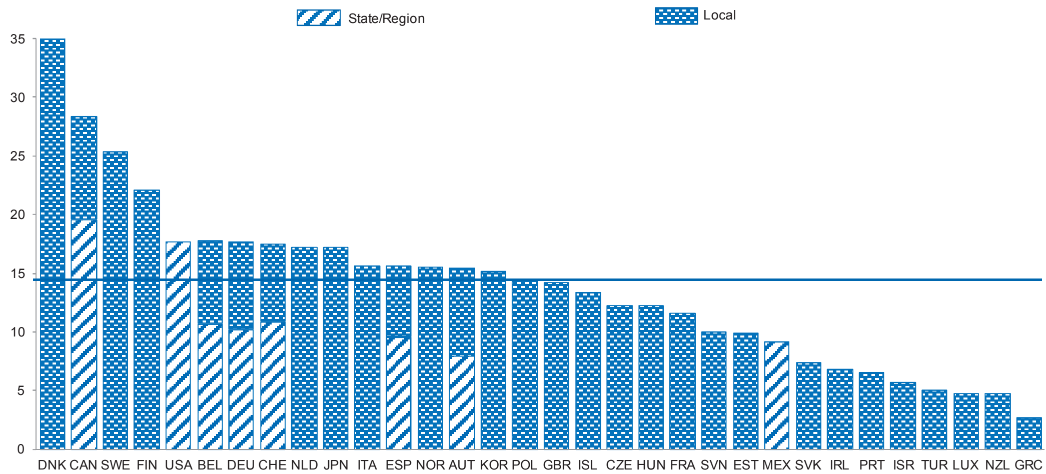
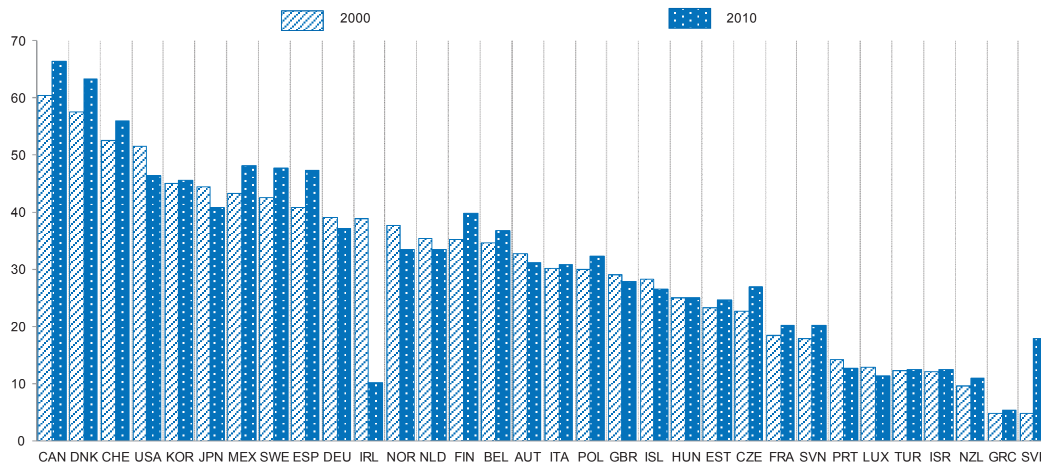


Figure 3.1. **Spending by level of government (2010)** *(cont'd)*

c) 2000-2010 variation (in percent points of total public spending)



Notes: Data for Japan and Turkey are non-consolidated. Data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and the United States correspond to 2009 instead of 2010. Data for Mexico for 2003, Poland for 2005 and Turkey for 2006 data instead of 2000. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and *OECD Fiscal Decentralisation database*.

Sub-central governments are the main actors in public investment

Sub-central governments represent a large share of public spending, and in particular in public investment (Box 3.2). On average, they represent more than 60% of public investment, with only four countries registering below 40% (Estonia, Greece, Luxembourg and Portugal) (Figure 3.2a). In general, federal and quasi-federal countries tend to have the highest participation of sub-central governments in public investment, with sub-central governments in Belgium, Canada, Switzerland and the United States representing more than 80%. The key role of sub-central governments in public investment was well understood by governments during the recent global financial crisis, as many stimulus measures taken by central governments aimed at supporting sub-central governments and their investment capacity, in order to prevent them from cutting investment expenditure because of their falling revenues (Blöchliger et al., 2010; and OECD, 2011b). The role of sub-central governments in public investment and the challenges this creates for multi-level governance was explored in Chapter 1 of this report.

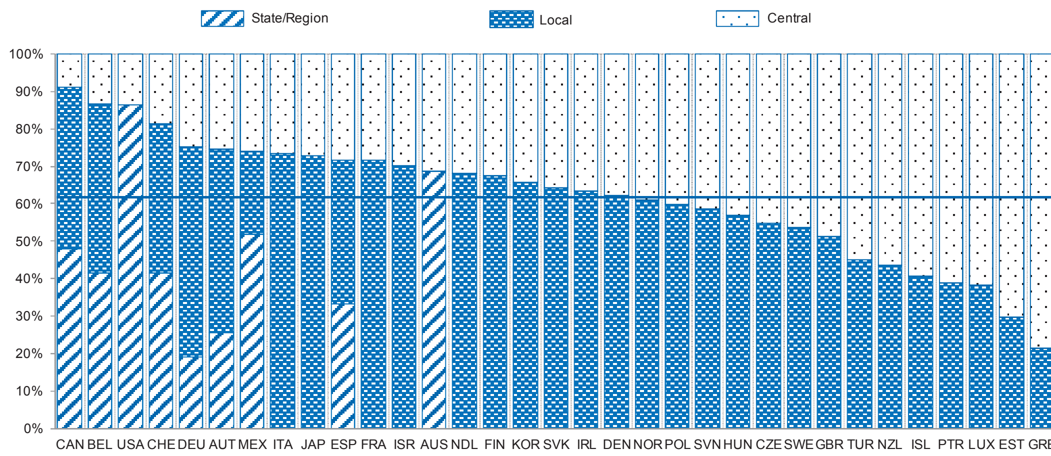
As for spending decentralisation, the share of sub-central governments in public investment has remained quite stable since 2000 on average, with some countries increasing it while others decreased it (Figure 3.2b). In particular, some historically very centralised countries such as Hungary, the Slovak Republic and Slovenia saw important increases in the share of sub-central government in public investment (it went from 12% to almost 65% in the Slovak Republic for example). Some of the large decreases may be linked to the financial crisis (Iceland, Ireland, Poland, Portugal). The initial weight of sub-central governments in public investment does not explain the direction of the change.

Box 3.2. Methodology and definitions: participation of sub-central governments in public investment

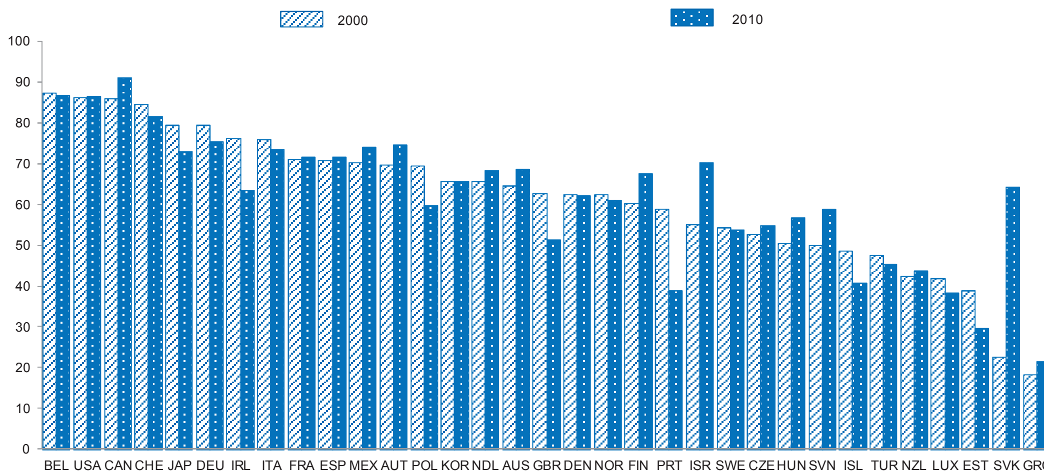
The variable used to measure public investment is the gross fixed capital formation. Capital transfers were not taken into account.

Figure 3.2. **Participation of each level of government in gross fixed capital formation spending (2010)**

a) In % of total gross fixed capital formation



b) 2000-2010 variation (in percent points of total gross fixed capital formation)



Notes: Data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and the United States correspond to 2009 instead of 2010. Data for Australia correspond to 2008 instead of 2010. Data for Poland and the United Kingdom correspond to 2001 instead of 2000. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts.

Sub-central governments have spending responsibilities in crucial areas

Education and social protection are the sectors that draw the most on sub-central government resources (Figures 3.3a and 3.3b and Box 3.3). In all OECD member countries, sub-central governments participate in education expenditure (even if it represents only a small share of their expenditure, as in the case of local governments in Greece and Spain), and in some countries, education represents more than 30% of sub-central governments' expenditure (Belgium/state, Canada local, Estonia, Iceland, Israel, the Slovak Republic, Slovenia, the United Kingdom and the United States/state). Social protection represents on average 16% of sub-central governments' expenditure. This function includes sickness and disability, old age, family and children, unemployment, social housing, social exclusion and social protection that is not otherwise classified. Health expenditures present a more varied picture, as in some countries they are decentralised, while in others they are a central government responsibility. In countries where they are decentralised, they represent a large share of sub-central government spending (more than 38% in Spain's regions, more than 45% in Italy, more than 20% in Austria/state, Canada/state, Denmark, Finland, Sweden and the United States) (Figures 3.3a and 3.3b). Economic affairs are also an important sub-central government responsibility, and represent on average 14% of state/region and of municipal expenditure. Economic affairs include mostly expenditure on regional development, such as general economic, commercial and labour affairs, agriculture, forestry and fishing, mining, manufacturing and construction, transport, communication, R&D, etc.

In most OECD member countries, education, health and social protection taken together represent more than 50% of sub-central government expenditures (Figures 3.3a and 3.3b). These are highly uncompressible expenditure, and in some cases, such as social protection, they can be pro-cyclical (because unemployment and social protection rise in bad economic times, as they did during and after the recent global financial crisis). Sub-central governments must therefore seek efficiency gains, to provide a similar level of public services at a lower cost. But achieving such gains in efficiency takes time, and often requires structural reforms, which are not easy to implement (see, Chapter 2 and Charbit and Vammalle, 2010).

Box 3.3. **Methodology and definitions: functional distribution of government spending**

Spending responsibilities (Figures 3.3 to 3.6b) were determined using the functional distribution of government spending, called Classification of the Functions of Government (COFOG). The COFOG classifies government expenditure data from the *System of National Accounts* by the purpose for which the funds are used. A first-level COFOG splits data into ten "functional" groups or sub-sectors of expenditure: general public services (which include R&D, public debt transactions and general-purpose transfers between levels of government); defence; public order and safety; economic affairs; environmental protection; housing and community amenities; health; recreation, culture and religion; education and social protection (OECD, 2011a).

When looking at specific expenditure by function (COFOG), some countries do not provide sufficient data for consolidation (Canada, France, Germany and Poland). In these cases, the share of spending of each level of government has been calculated dividing by the non-consolidated sum of central, state/region and local spending.

Figure 3.3. **Functional distribution of sub-central government spending (2009)**

Notes: Data for 2010 was available for only a few countries, so 2009 was chosen as a common reference. Data for Canada is for 2006 and New Zealand for 2005. Data is not consolidated for four countries (Canada, France, Germany and Poland). The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and *OECD Decentralisation Database*.

The weight of sub-central governments in education, health and social protection varies across countries

The previous section showed that education, health and social protection are the three largest drivers of sub-central governments' expenditure. But this does not necessarily imply that sub-central governments are the most important players in these policy fields. The data show a varied picture: in the case of education, it is one of the main sub-central government expenditures, and in most countries, sub-central

governments are an important player in the provision of this public good (Figure 3.4a). On average, sub-central governments represent almost 60% of education spending in OECD member countries, with the great majority of countries registering between 30% and 80%. For historical and constitutional reasons, in Belgium, education is entirely decentralised, mainly to the regional layer of government (the communities, which represent Belgium's different cultural and linguistic groups). At the other end of the spectrum, in Greece and New Zealand, education is entirely centralised.

As for health care, the picture is similar to that described in the previous section: in some countries, sub-central governments represent a high share of health spending (above 90% in countries such as Denmark,[3] Italy, Spain, Sweden or Switzerland), while in others, it is zero or close to zero (Figure 3.4b). Countries with three layers of government tend to have more decentralised health spending (except for Belgium and Germany). Centralisation of health spending reflects historical centralisation of the country (France, Greece, United Kingdom), or is characteristic of small countries (Iceland, Ireland, Israel, Luxembourg, New Zealand, Slovak Republic). Recently, several OECD member countries have been questioning the decentralisation of health care and are engaging in re-centralisation processes. Norway, for example, recentralised its health system in 2002, while Italy decentralised its system in 2000 (Mosca, 2006).

Finally, if social protection is sometimes an important expenditure for sub-central governments (Austria/state, Belgium/state, Canada/state, Denmark, Finland, Germany/state, and Sweden), sub-central governments only represent on average 16% of total spending on social protection (Figure 3.4c). In only three countries do sub-central governments represent more than one-third of the spending (Canada, Denmark[4] and Korea), but sub-central governments are present in this function in all countries, with most countries registering between 5% and 25%.

Figure 3.4. **Participation of each level of government in spending**

a) Education (2009)

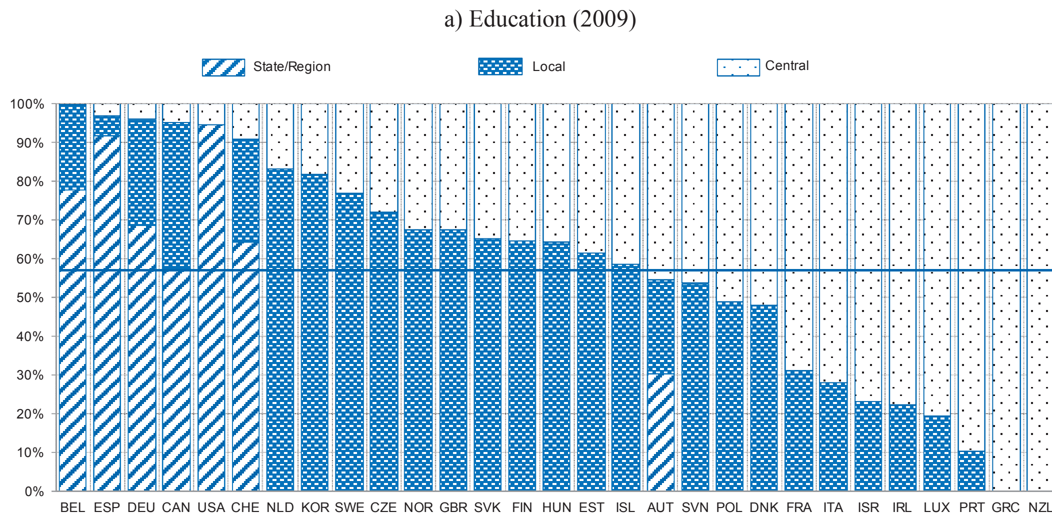
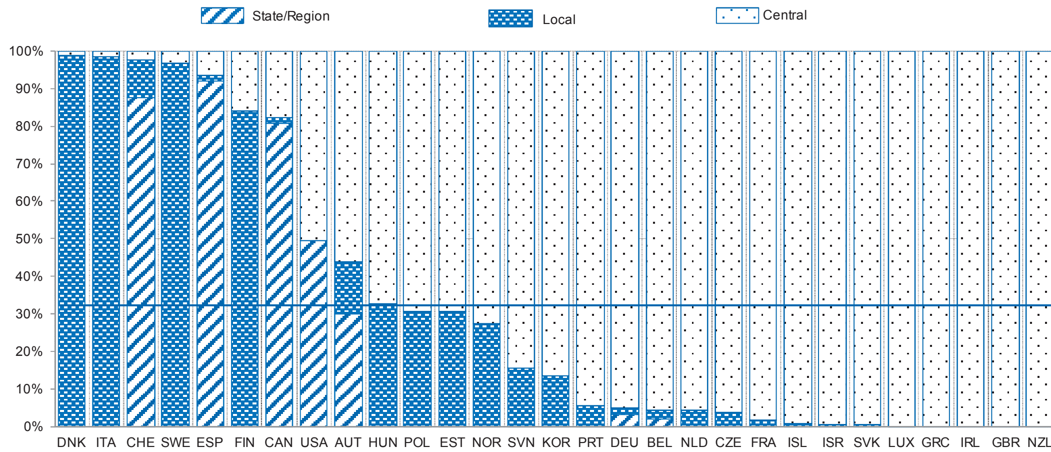
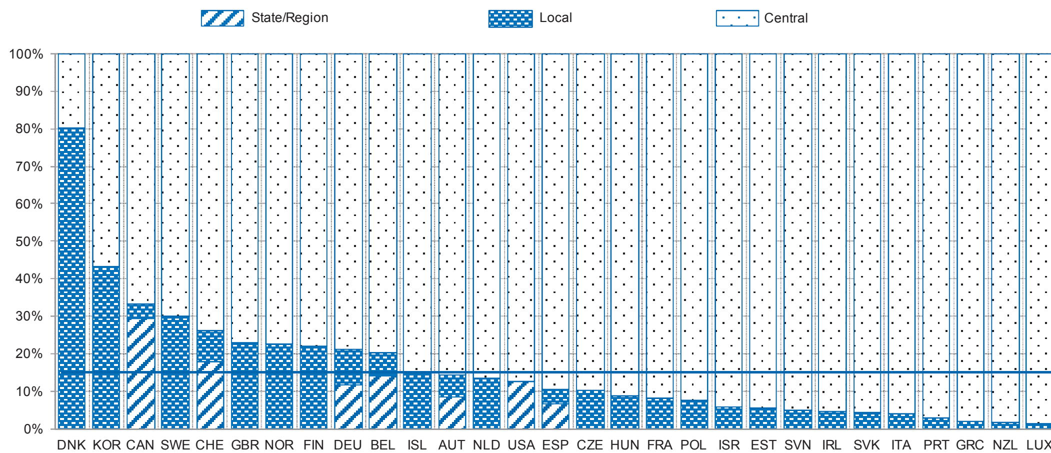


Figure 3.4. **Participation of each level of government in spending** *(cont'd)*

b) Health (2009)



c) Social protection (2009)



Notes: Data for 2010 was available for only a few countries, so 2009 was chosen as a common reference. Data for Canada is for 2006 and New Zealand for 2005. Data is not consolidated for four countries (Canada, France, Germany and Poland). The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and *OECD Fiscal Decentralisation database*.

Housing, environmental protection and recreation are typical sub-central government responsibilities

Environmental protection and housing seem to be the most typical sub-central functions, with sub-central governments accounting for more than 70% of spending in each (Figures 3.5a and 3.5b). In all but two OECD member countries (Estonia and Finland), sub-central governments represent more than 70% of environmental protection spending, and in all but four countries (Denmark, France, Israel and New Zealand), they represent more than half of housing and community amenities spending. Sub-central

governments are responsible for more than 90% of environment protection spending in three countries (Belgium, Spain and Switzerland), and for housing and community amenities in eight countries. Sub-central governments are also a key player in recreation, culture and religion, as they represent more than 60% of public spending in this area.[5]

Figure 3.5. **Participation of each level of government in spending**

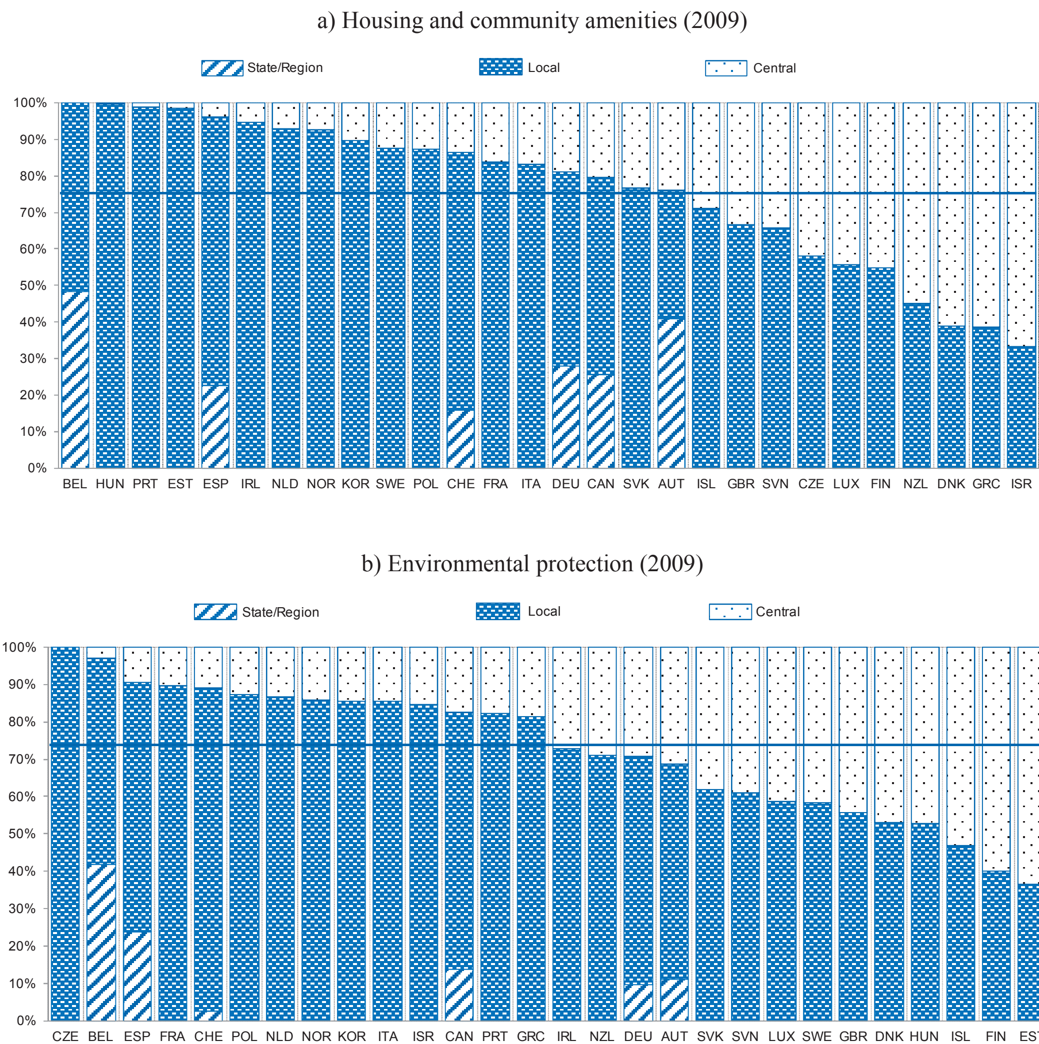
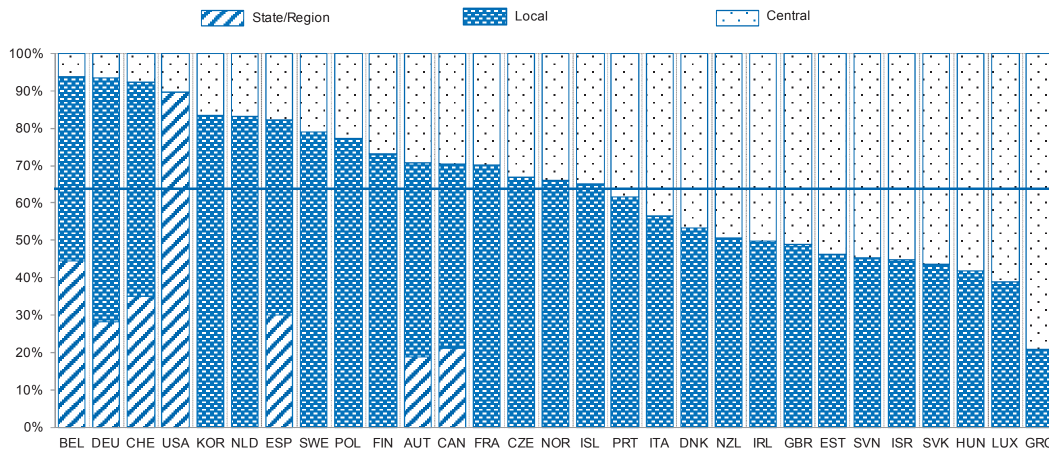


Figure 3.5. **Participation of each level of government in spending** *(cont'd)*

c) Recreation, culture and religion (2009)



Notes: Data for 2010 was available for only a few countries, so 2009 was chosen as a common reference. Data for Canada is for 2006 and New Zealand for 2005. Data is not consolidated for four countries (Canada, France, Germany and Poland). The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and *OECD Fiscal Decentralisation database.*

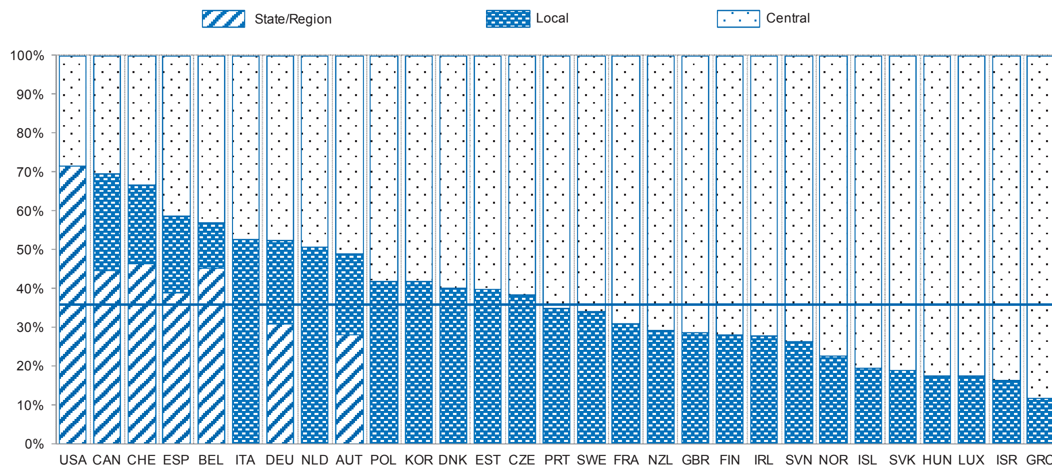
In some countries sub-central governments play an important role in economic affairs and public order and safety

Sub-central governments represent on average 38% of spending on economic affairs. In some countries (chiefly those with three layers of government), they account for more than 50% (Figure 3.6a). Economic affairs includes most expenditure on regional development (commercial and labour affairs, agriculture, transport, R&D, etc.). Combined with the weight of sub-central governments in public investment, this shows the importance of sub-central governments in regional development policies.[6]

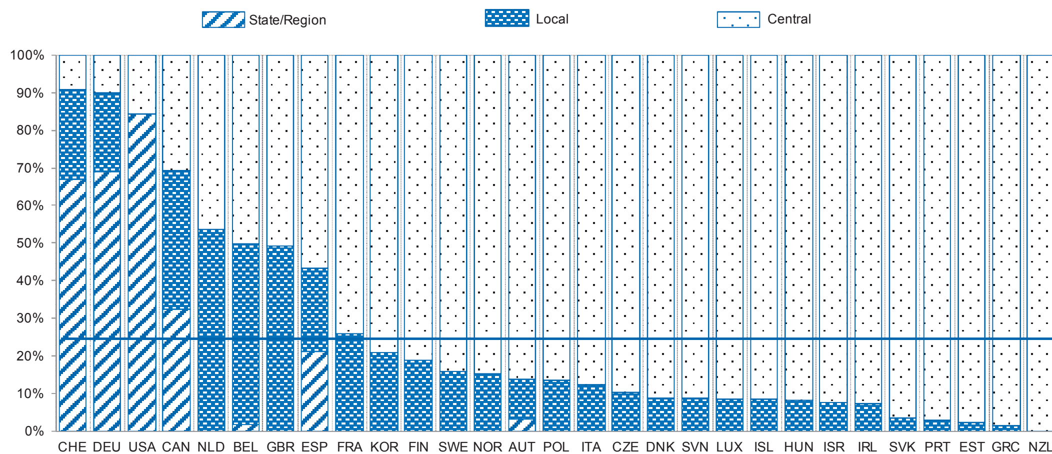
Public order and safety is mainly a central government responsibility: sub-central government participation is only 25% on average (Figure 3.6b). Except for a few federal countries where sub-central government participation is above 70% (Canada, Germany, Switzerland and the United States), in most OECD member countries, this share is below 20%. In countries with three layers of government, municipalities tend to represent a larger share of public order and safety spending than state/region governments.

Figure 3.6. **Participation of each level of government in spending**

a) Economic affairs (2009)



b) Public order and safety (2009)



Notes: Data for 2010 was available for only a few countries, so 2009 was chosen as a common reference. Data for Canada is for 2006 and New Zealand for 2005. Data is not consolidated for four countries (Canada, France, Germany and Poland). The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and *OECD Fiscal Decentralisation database*.

Sub-central government own revenues: taxes and user fees

Sub-central governments have three main sources of funds: own taxes, intergovernmental transfers from other levels of government and user fees (other sources of revenues, such as property revenues and non-intergovernmental transfers, usually make up for a low fraction of their revenues). Each of these types of revenue has different implications for the ability of sub-central governments to adapt to a tight fiscal context

and take the necessary actions for budget consolidation. It is therefore important to know the exact composition of sub-central government revenues.

The mainstream view is that sub-central government spending should essentially be covered by own tax revenues. Own taxes improve resource allocation and management efficiency, as citizens might be expected to put more pressure on sub-central governments to be more efficient and more responsive to their tastes and preferences when they are paying for the goods and services provided. For considerations of efficiency, the last dollar of spending should be financed by own tax, so that citizens only demand an extra service if they value it at more than the cost of providing it. Own taxes are also considered to promote democratic accountability, since the citizens who benefit from public services decide on taxation levels and pay the bill. Finally, a high reliance on own-resource revenues provides sub-central governments with incentives for growth-oriented economic and fiscal policies, since they may fully enjoy their financial benefits. The reality and variety of sub-central government revenue mixes, however, is far from these normative considerations.

For most OECD member countries, taxes represent an important share of sub-central government revenues. But what is the actual discretion of sub-central governments over this source of revenue? What rights do sub-central governments have to introduce or abolish a new tax, to set tax rates, to define the tax base or to grant tax allowances or relief to individuals and firms? In a number of countries, taxes are not assigned to a specific government level, but are shared between the central government and sub-central governments. Such tax-sharing agreements deny any single sub-central government control of tax rates and bases, but collectively, sub-central governments may negotiate the sharing formula with the central government.

The level of tax autonomy of sub-central governments is all the more important in turbulent economic times, as it determines the room for manoeuvre that sub-central governments have to reduce their deficits by increasing their tax pressure. A heavy reliance on taxes can prove pro-cyclical in sub-central government revenues, but may give sub-central governments more leeway to increase their revenues (even if increasing taxes is politically costly). Countries where autonomous taxes represent a small share of sub-central government revenues have almost no possibility of increasing their revenues without central government action, and will therefore be forced to rely more on expenditure cuts to balance their budgets. But wider tax autonomy may also lead to tax competition, which can lead to a race to the bottom.

This section outlines the reliance of sub-central governments on each revenue source in OECD member countries.

Sub-central governments represent a significant share of general government revenues

On average, sub-central governments account for about 20% of total public revenue in OECD member countries, which represents about 9% of GDP (Figures 3.7a and 3.7b and Box 3.4). These averages mask wide disparities: in some countries, sub-central governments receive more than 40% of public revenues (Canada, Switzerland and the United States), or around 20% of GDP (Canada and Sweden) while in others, sub-central government revenues represent less than 10% of total public revenues (Greece, Ireland, Israel, Luxembourg, Mexico, Turkey and United Kingdom). In general terms, countries with three levels of government (i.e. federal or quasi-federal) tend to have larger revenue

decentralisation than unitary countries. Mexico is the most evident exception, because in spite of being federal, sub-central governments only represent about 9% of total government revenue (less than 1% of GDP).

In most OECD member countries, the share of sub-central governments in public revenues increased between 2000 and 2010 (Figure 3.7c). In some cases, this is the result of a long-term process of decentralisation reforms (Belgium, the Slovak Republic and Spain). In other countries on the contrary, the share of sub-central governments in public revenues has decreased (Denmark, Hungary, Poland, Turkey).

Box 3.4. Methodology and definitions: total consolidated sub-central government revenues

Using sub-central *National Accounts* data requires consolidating the data across levels of government. If no corrections are made, the sum of central (including social security), state/region and local revenue is usually larger than general government revenue, as it double-counts intergovernmental transfers. To resolve this issue, the *OECD Fiscal Decentralisation database* consolidated the data, defining consolidated revenue of each level of government as total revenue minus the intergovernmental transfer revenue of that government level.

Consolidated total general government revenue has been calculated combining global total revenue at the general government level, plus the total intergovernmental property income. Indeed, the latter represents payments by one level of government for a service provided by another level of government, and thus avoids consolidation of property income at the general government level.

Figure 3.7. **Total consolidated sub-central government revenues (2010)**

a) In % of total government revenue

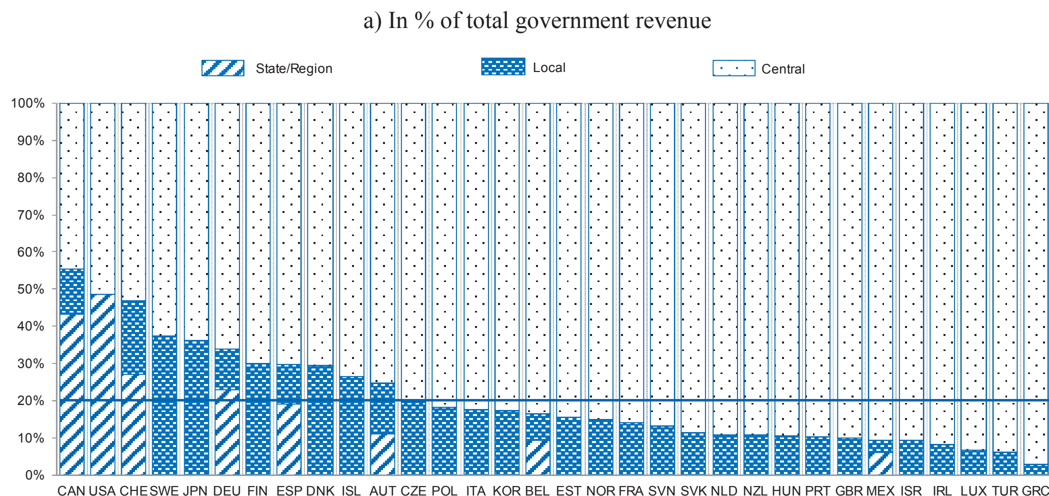
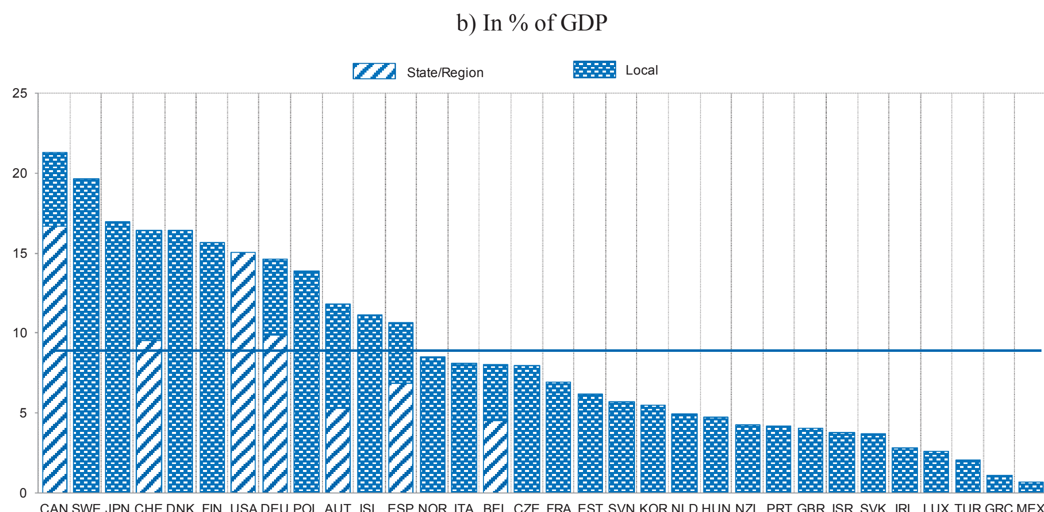
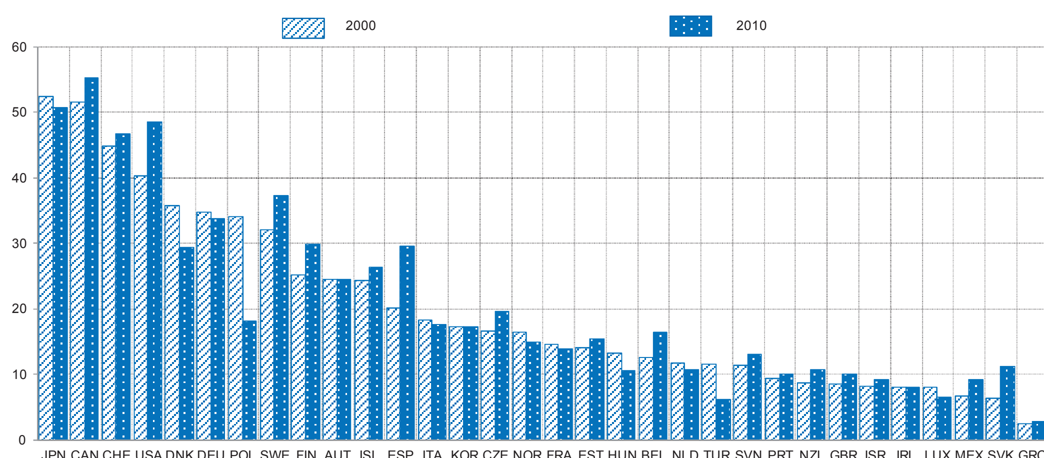


Figure 3.7. **Total consolidated sub-central government revenues (2010)** *(cont'd)*

b) In % of GDP



c) 2000-2010 variation (in percent points of total government revenues)



Notes: Data for Japan and Turkey are not consolidated. Data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. Data for Mexico are for 2003, Poland for 2005 and Turkey for 2006 instead of 2000. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

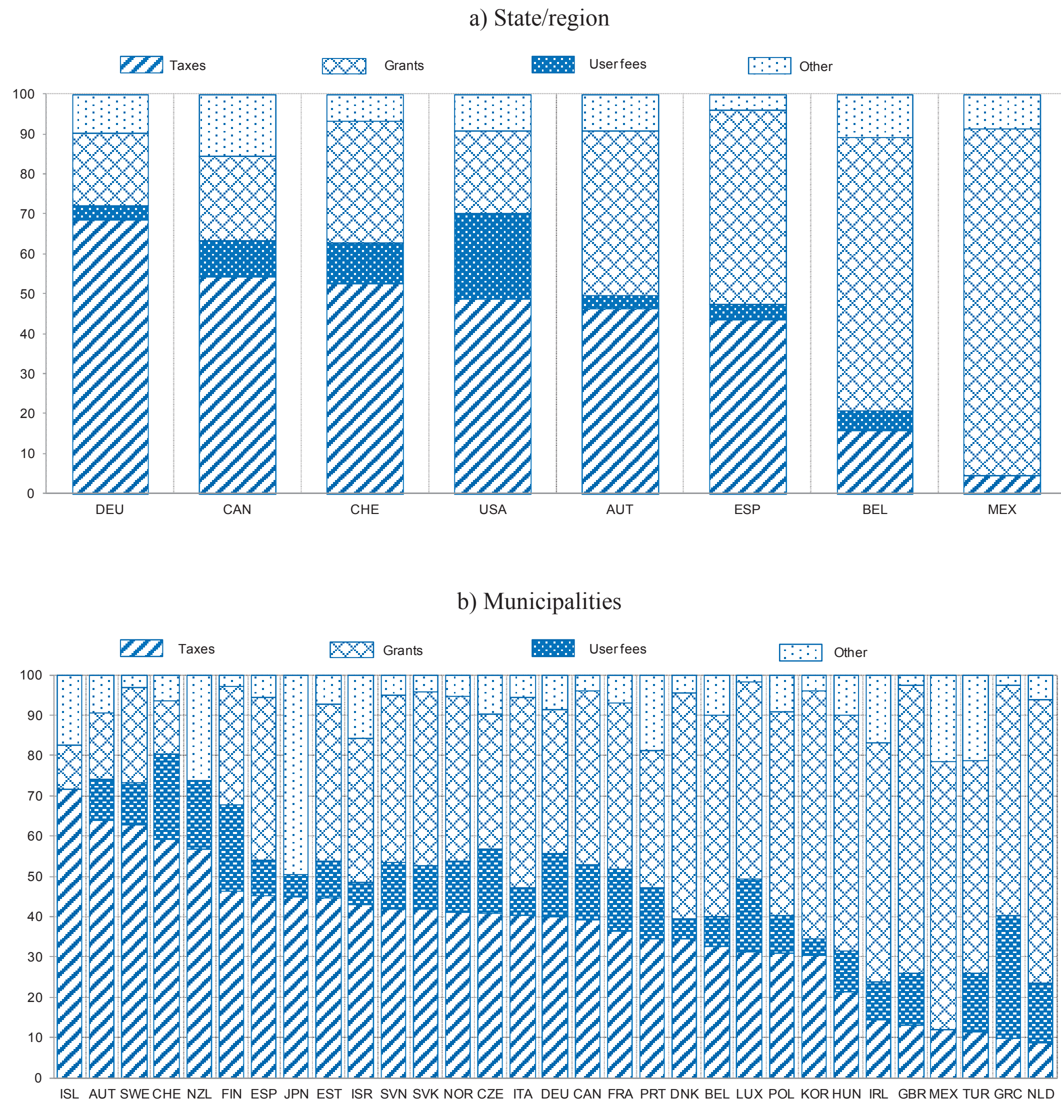
Source: OECD National Accounts and *OECD Fiscal Decentralisation database*.

Taxes and grants are the main sub-central government revenues

Taxes and grants are sub-central governments' main sources of revenues, representing on average about 80% of sub-central government revenues, while user fees and other revenues (property incomes and non-governmental transfers) only represent around 10% each (Figures 3.8a and 3.8b). Federal and quasi-federal countries tend to rely more on own taxes than unitary countries, especially at the state/regional level: own taxes represent about 42% of sub-central government revenues for states/regions, and only

about 37% for municipalities. Mexico and Belgium are exceptions, with taxes at less than 5% in Mexico and less than 16% in Belgium, at the state/regional level. Some unitary countries also rely heavily on own taxes for sub-central governments, such as Austria, Iceland and Sweden, where they represent above 60% of sub-central government revenues.[7]

Figure 3.8. **Sub-central government revenue composition (2010)**



Notes: Data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts.

The share of sub-central governments in national tax systems tends to be higher in federal countries

On average, own taxes represent less than 40% of sub-central government revenue in OECD member countries, but in all but seven countries, they are above 30% (Figure 3.9a). In general terms, federal countries tend to allocate a slightly higher share of own tax to their sub-central governments than unitary countries: own taxes represent on average 42% for states/regions in federal countries, while they only represent on average 37% for municipalities. These averages hide wide variations, with own tax revenues representing more than 70% of sub-central governments' revenues in Germany or Iceland, and less than 10% in Greece, Mexico/state and the Netherlands.

There is also a large country variation when considering sub-central government tax revenues as a share of GDP or total general government revenue (Figures 3.9b and 3.9c). Countries with three levels of government usually present a higher level of sub-central government tax revenues, surpassed only by some northern European countries (Denmark, Finland, Iceland and Sweden) and with the exception of Mexico. The weight of own taxes in northern European countries is more moderate as a share of total general government tax revenue than as a share of GDP.

Figure 3.9. **Sub-central government tax revenues**

a) In % of total revenues for each level of government (2010)

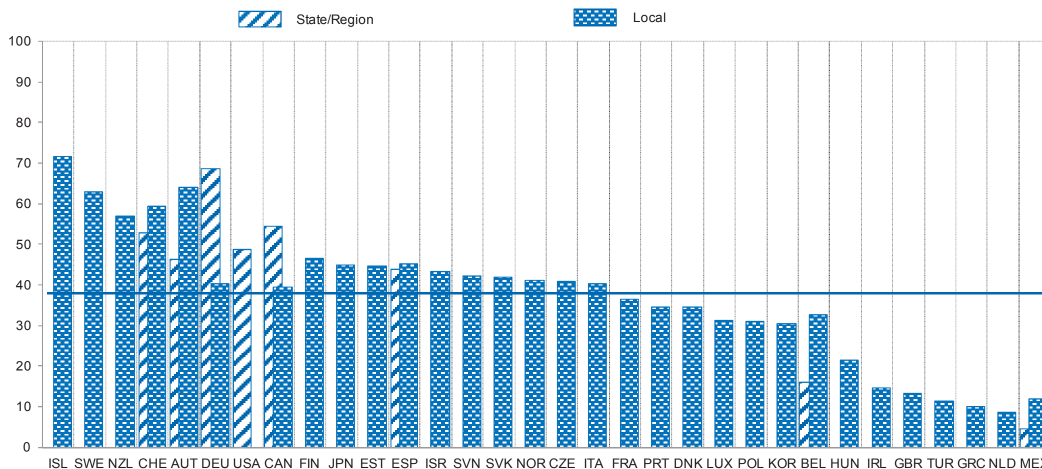
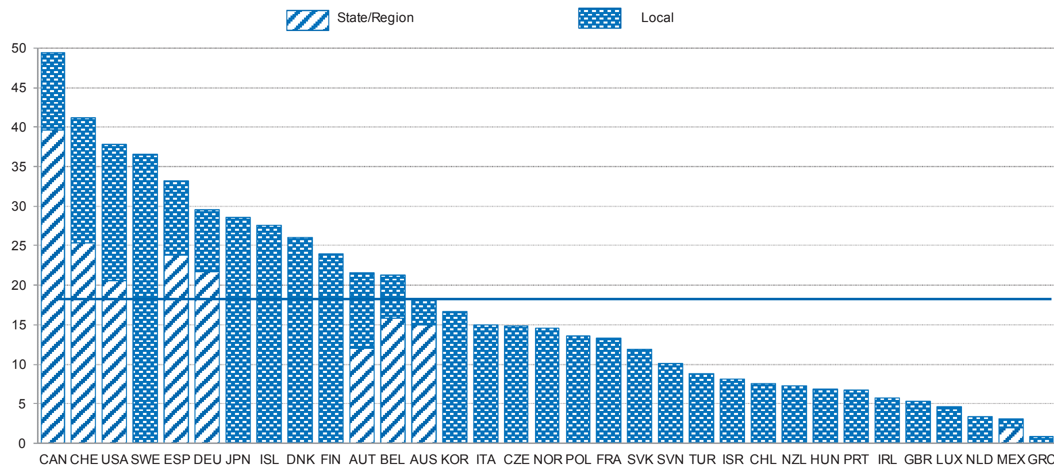
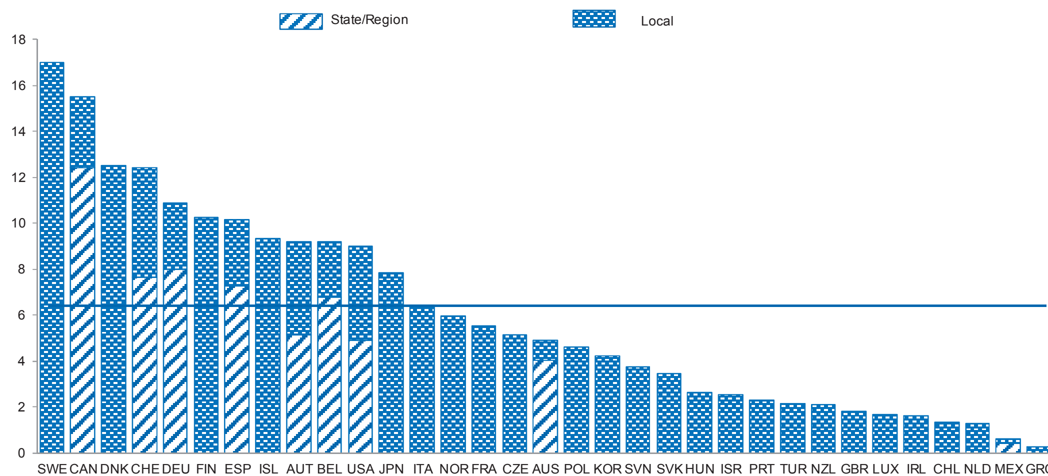


Figure 3.9. **Sub-central government tax revenues** *(cont'd)*

b) In % of general government tax revenue (2009)



c) In % of GDP (2009)



Notes: For Figure 3.9a, data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. For Figures 3.9b and 3.9c, data for Australia, Greece, Mexico, Poland and Portugal correspond to 2008 Instead of 2009. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts and OECD Revenue Statistics.

The autonomy of sub-central governments to set their tax rates and bases varies greatly across countries

When considering only the taxes over which sub-central governments have some degree of autonomy, the picture of the relative importance of sub-central governments is very different from when the total amount of sub-central government taxes is considered (Box 3.5). The percentage of taxes over which sub-central governments have the

authority to set the rate and/or the base represents less than 30% of sub-central government total revenues, while total taxes represented almost 40% (Figures 3.10a and 3.10b). In Germany, for example, own taxes represent about 70% of states' revenues, but autonomous taxes represent less than 2%. On average, the share of autonomous taxes in sub-central government tax revenues is close to 70%. But again, this masks wide variations: in nine countries it is above 99%, while in two countries, it is zero (Ireland and Turkey).[8]

Box 3.5. Methodology and definitions: SCG tax autonomy

The OECD Network on Fiscal Relations across Levels of Government has developed a set of institutional indicators to estimate tax autonomy. These taxing power indicators measure the degree of own-taxing power of sub-central governments by capturing the degree to which sub-central governments can set their own tax rates and bases. The framework consists of five main categories of autonomy, ranked in decreasing order from highest to lowest taxing power (Blöchliger and King, 2006). This classification is carried out through a questionnaire sent to the countries. As the tax systems are only infrequently subject to revision, the information does not need to be updated every year. The latest available information dates from 2005 and will be updated in 2011 (results will be available in 2012).

Figure 3.10. **Sub-central government autonomous tax revenues (2005)**

a) In % of sub-central government total revenue

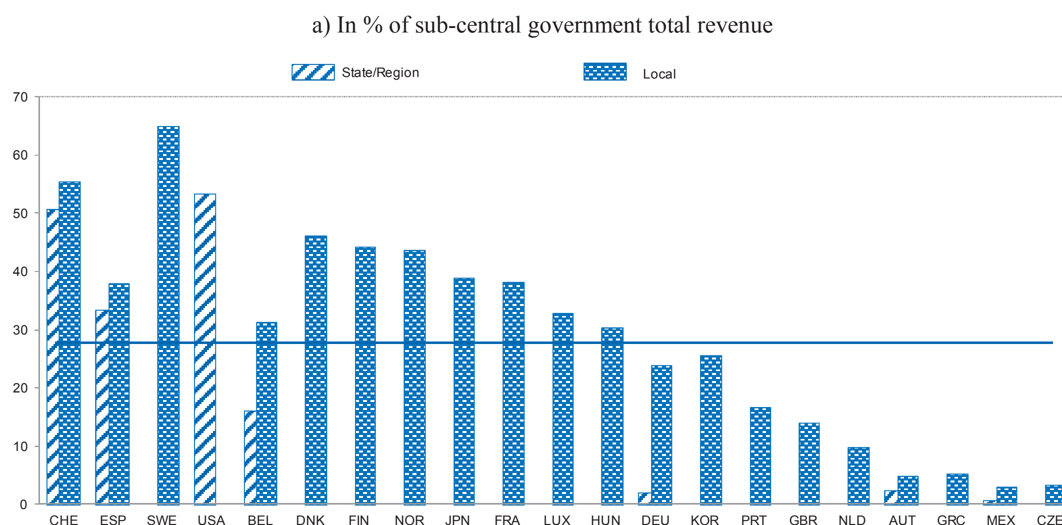
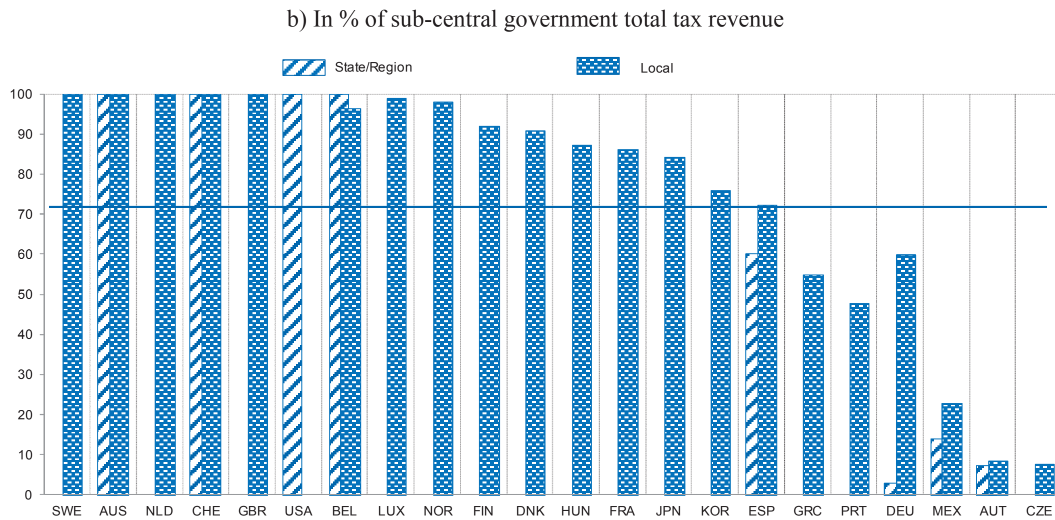


Figure 3.10. **Sub-central government autonomous tax revenues (2005)** *(cont'd)*

b) In % of sub-central government total tax revenue



Source: OECD Fiscal Decentralisation database.

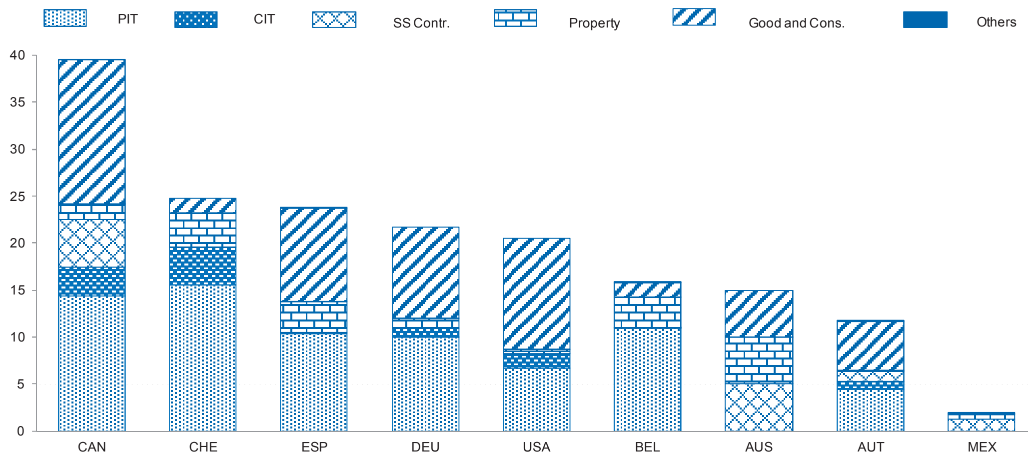
The actual composition of sub-central government tax revenues does not always correspond to the theoretical optimal composition

It is generally agreed that sub-central governments should rely on taxes levied on assets that are: *i)* relatively immobile (such as property) in order to avoid tax-induced migrations of factors of production; and *ii)* relatively stable, to avoid large sub-central government budget fluctuations and pro-cyclical effects. Central governments are therefore usually assigned the taxes levied on the most mobile factors, taxes with the higher income elasticity, and taxes levied on tax bases that are distributed unevenly across the country (Ter-Minassian, 1997). According to these criteria, CIT should be assigned to central government, while taxes on individuals and households (such as personal income taxes or property taxes) are more suited for sub-central governments, as these are seen as less mobile than businesses. Taxes on natural resources and on foreign trade are usually assigned to central governments, as well as multi-stage sales taxes (such as VAT), because issues of co-ordination between regions would make their management very difficult for sub-central governments, and can lead to damaging "tax wars" of the kind seen in Brazil, in an attempt to attract private investment (OECD, 2011d).

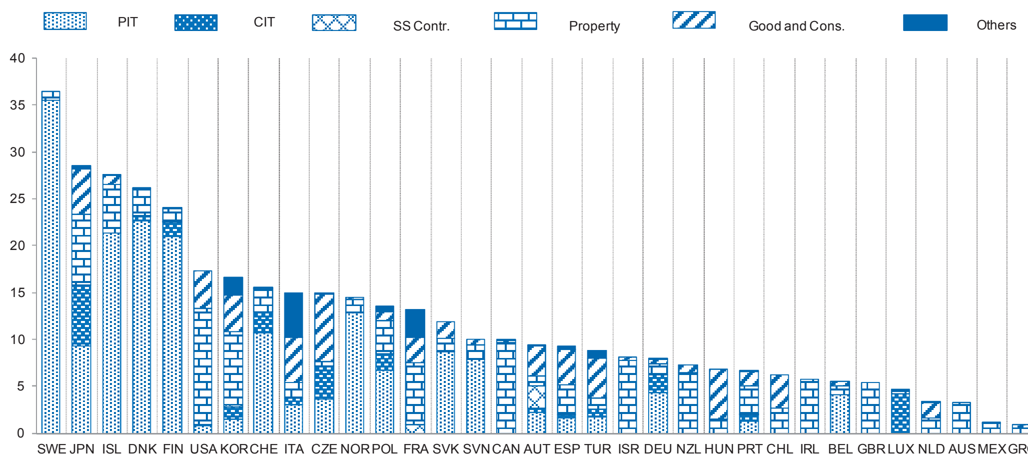
The composition of sub-central government tax revenue for states (when applicable) and municipalities shows a difference between the second level of government tax revenue composition (state/region) and third level (municipalities). For example, a decentralised personal income tax (PIT) is present in virtually all the states/regions, and often represents an important share of tax revenues (Figures 3.11a and 3.11b). As for municipalities, it is only present in about half the cases, but it often represents large shares when it exists. Taxes for goods and services follow the same pattern. Property taxes are the only taxes that are present in all sub-central government levels, but from a quantitative point of view, they do not provide the largest resources to sub-central governments (with some exceptions, in the case of municipalities in Australia, Canada, Ireland, Israel, the United Kingdom and the United States, where they represent the main tax income). Corporate income tax (CIT), social security contributions and payroll taxes (classified as SS Contr.) play a marginal role in tax decentralisation, except in the case of Luxembourg, whose municipalities rely mainly on CIT. This was also the case in France

before 2009, where the *taxe professionnelle* (CIT) was one of the main revenue sources for the *départements*. But this tax was eliminated and replaced by intergovernmental transfers, as part of the stimulus measures implemented by the central government to support businesses (Blöchliger et. al, 2010).[9]

Figure 3.11. **Composition of sub-central government tax revenue in % of total general government tax revenue (2009)**



b) Municipalities



Notes: Data for Australia, Greece, Mexico, Poland and Portugal correspond to 2008. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD Revenue Statistics.

There is no unique pattern of the participation of sub-central governments by type of taxes

Property taxation is considered the most appropriate tax for sub-central governments, and is by far the most decentralised kind of tax. In many countries, this tax is almost completely decentralised, as in the case of Australia, Canada, Germany, Mexico,

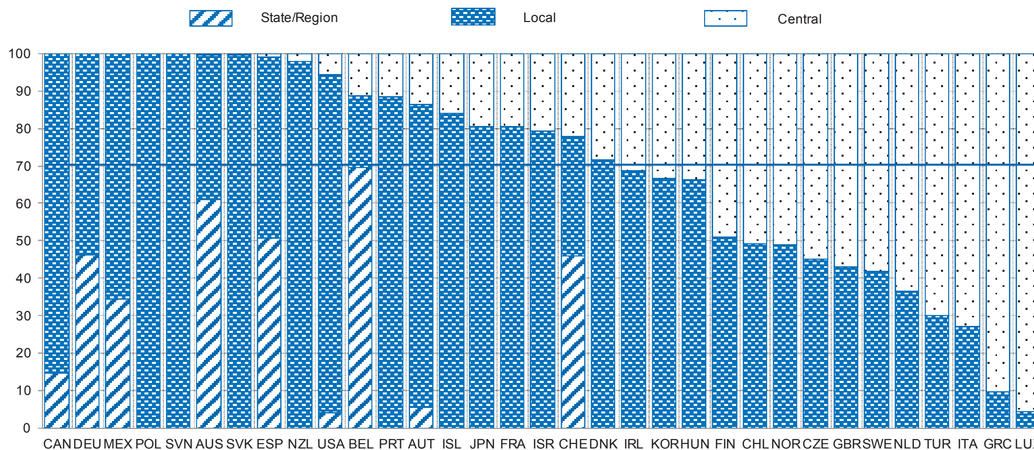
New Zealand, Poland, the Slovak Republic, Slovenia, Spain and the United States (Figure 3.12). All countries have decentralised property taxes to some extent, and only a few countries have decentralised it in less than half of its yields (only Greece and Luxembourg allocate less than 10% of its yields to sub-central governments). Regarding the allocation of the tax between state and municipal levels, a greater decentralisation towards the municipal level can be observed, with a bigger property tax share, despite the lower amount of tax revenues they represent. Belgium seems to be the only clear exception, with most of its property tax allocated to regions.

In theory, the second-best tax to decentralise is personal income tax (PIT), but in practice, the picture is quite varied (Figure 3.13). In about one-third of the countries, more than 50% of PIT revenues are assigned to sub-central government, while at the other end of the spectrum, in about one-third of countries, PIT is entirely centralised. In countries with two sub-central levels of government, decentralisation of PIT is always higher toward state/region than toward municipalities.

On average, the tax on goods and consumption is centralised, with only about 14% on average assigned to sub-central governments (Figure 3.14). Only three countries present rates of decentralisation of goods and consumption taxes higher than 50% of the total revenues (Canada, Spain and the United States). Decentralisation of the tax on goods and consumption is higher for states in three-tiered governments than for municipalities.

Finally, and in line with the theory, the corporate income tax (CIT) is the least decentralised tax: in more than half the countries, it is totally centralised, and only two countries (Germany and Switzerland) have decentralised CIT by more than 50% (Figure 3.15). Apart from Germany, decentralisation towards state/regions is higher than towards municipalities.

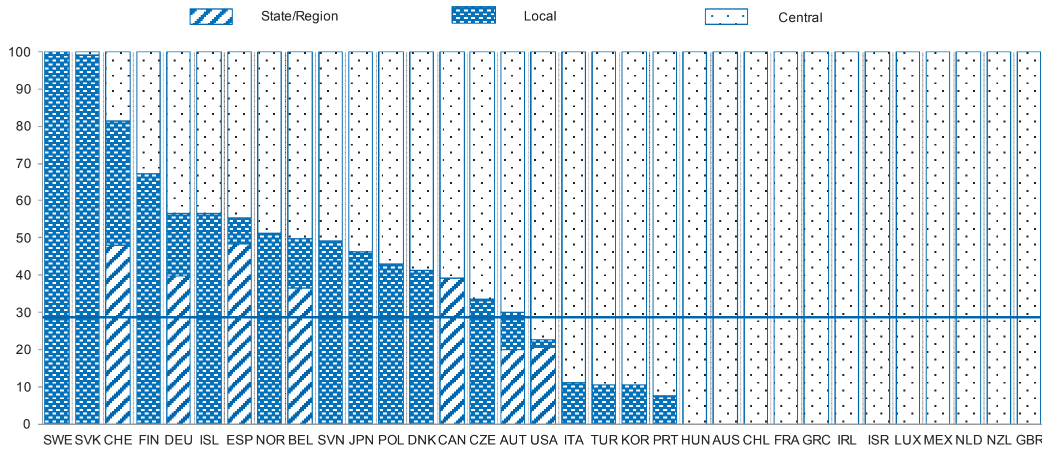
Figure 3.12. **Share of sub-central governments in total property tax revenue (2009)**



Notes: Data for Australia, Greece, Mexico, Poland and Portugal correspond to 2008. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD Revenue Statistics.

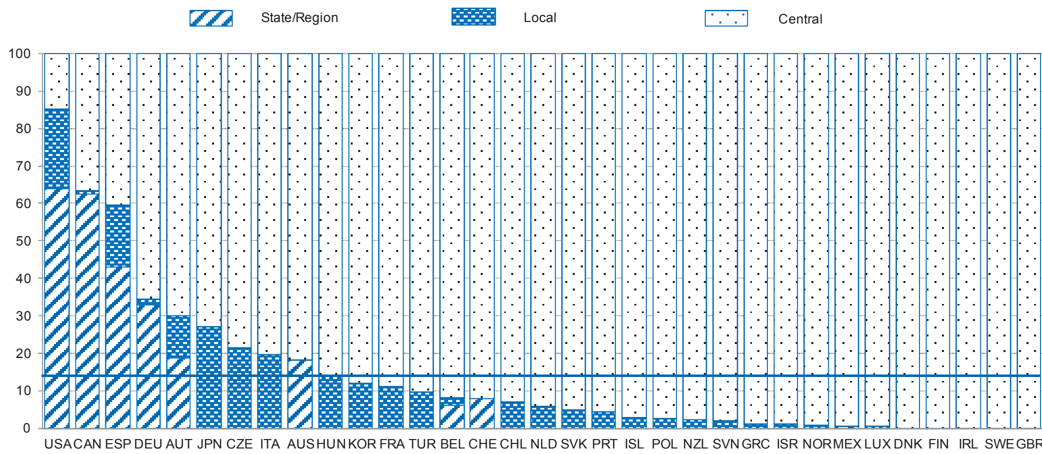
Figure 3.13. **Share of sub-central governments in total personal income tax revenue (2009)**



Notes: Data for Australia, Greece, Mexico, Poland and Portugal correspond to 2008. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

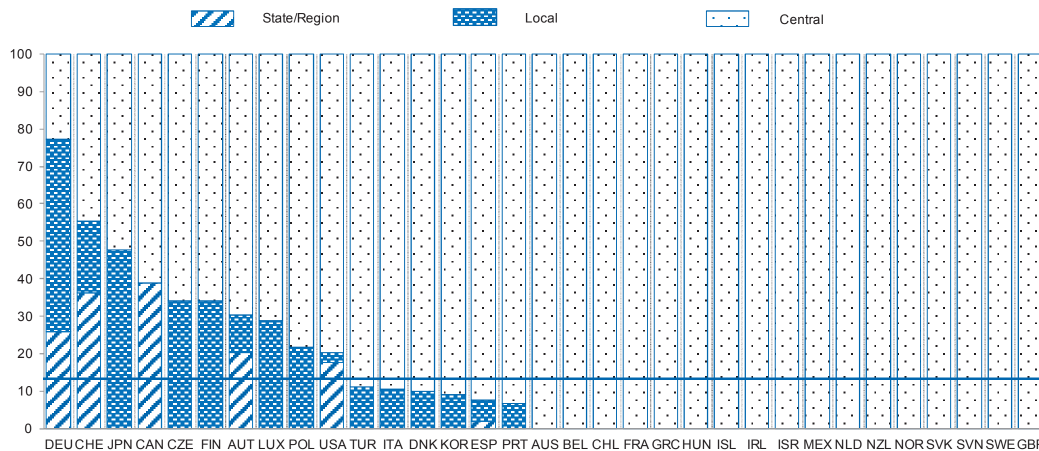
Source: OECD Revenue Statistics.

Figure 3.14. **Share of sub-central governments in total goods and consumption tax revenue (2009)**



Source: OECD Revenue Statistics.

Figure 3.15. **Share of sub-central governments in total corporate income tax revenue (2009)**



Source: OECD Revenue Statistics.

User fees represent a modest share of revenues in most sub-central governments

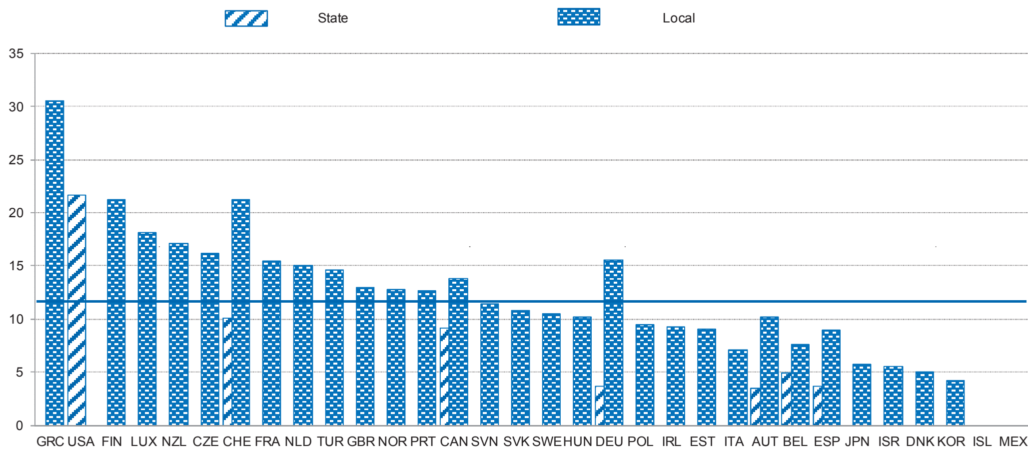
Today, in most OECD member countries, user fees are not a major source of financing for sub-central governments, despite the fact that they run many public services that could be subject to user fees (Box 3.6). Indeed, on average, user fees represent only 11% of sub-central government revenues, which is just above 1% of GDP (Figures 3.16a and 3.16b). In some countries, such as Finland, Greece and the United States, user fees are more developed, and represent more than 20% of sub-central government revenues. In other countries, such as Iceland and Mexico, they are zero or close to zero.[10]

Box 3.6. **Methodology and definitions: user fees**

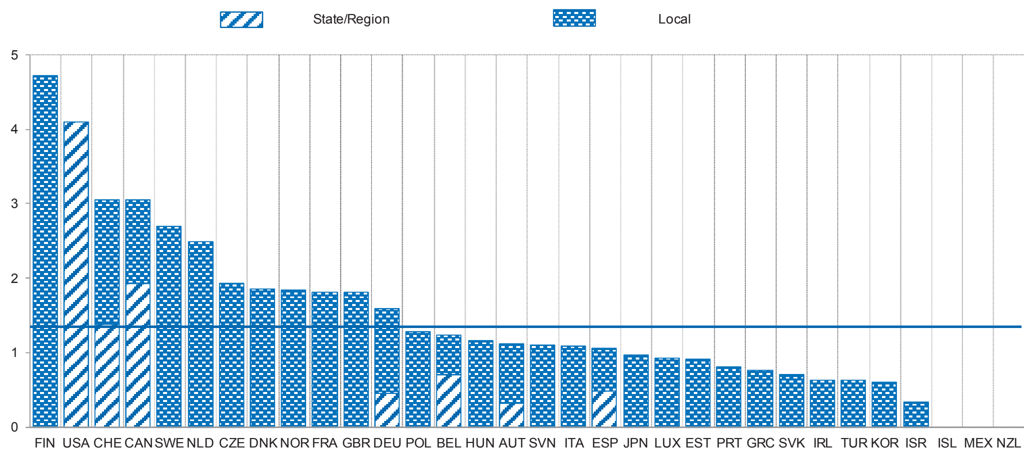
It is not easy to identify what should be considered user fees, but comparing the concepts set out in the IMF *Government Finance Statistical Manual* and the *National Accounts* data, it is possible to identify user fees as the sum of two items from the *National Accounts*: "Market output and output for own final use" and "Payments for non-market output".

Figure 3.16. **Sub-central government user fees (2010)**

a) In % of total sub-central government revenues



b) In % of GDP



Notes: Data for Japan, Korea, Mexico, New Zealand, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. Mexico (2003), Poland (2005) and Turkey (2006) data instead of 2000 data. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD Fiscal Decentralisation database.

Grants in sub-central government revenues

Intergovernmental grants have different origins. Together with taxes, intergovernmental grants are one of the sources of sub-central government revenues. In some countries, grants represent the main source of revenue, as in Belgium (states/regions), Denmark, Greece, Hungary, Ireland, Korea, Mexico, the Netherlands, Poland (municipalities), Turkey and the United Kingdom (Figure 3.8). A high reliance on intergovernmental grants may leave sub-central governments in a fragile position, as higher levels of government may cut grants to lower levels of government in an effort to

balance their own budgets. This is the case for example in the United States, where the states, which must present balanced budgets, cut transfers to local governments, thus exporting the problem to the next level of government (see Chapter 1). In Italy, reducing dependence on such transfers has been one of the drivers of the support from regions and municipalities for the recent (still ongoing) fiscal federalism reform.

Intergovernmental grants serve different purposes (Oates, 1990; and Bergvall et al., 2006):

- **Financing sub-central services and investments**: in most countries, spending by sub-central governments is larger than their own revenues. Grants are therefore used to fill the gap between sub-central governments' own revenues and their spending responsibilities.
- **Equalisation**: while taxes are preferable to grants in terms of efficiency and accountability, a high reliance on own tax revenues for sub-central governments might raise equity concerns. Indeed, tax-raising capacity is usually unevenly distributed across sub-central governments, which can lead to different levels of public service delivery across regions or to different levels of tax burdens on citizens. Equity concerns may then arise, and the central governments might prefer that sub-central governments provide the same basic bundle of services with roughly the same tax burden. Intergovernmental "equalisation" grants are then used to redistribute wealth from richer to poorer regions.
- **Correcting externalities (subsidisation)**: grants can also be used to correct potential fiscal externalities or "spillovers". Such externalities arise when the fiscal policy of one sub-central government affects outcomes in other sub-central governments. Grants (mainly matching grants) are then used to change the price of providing public goods, in order to internalise the externality.

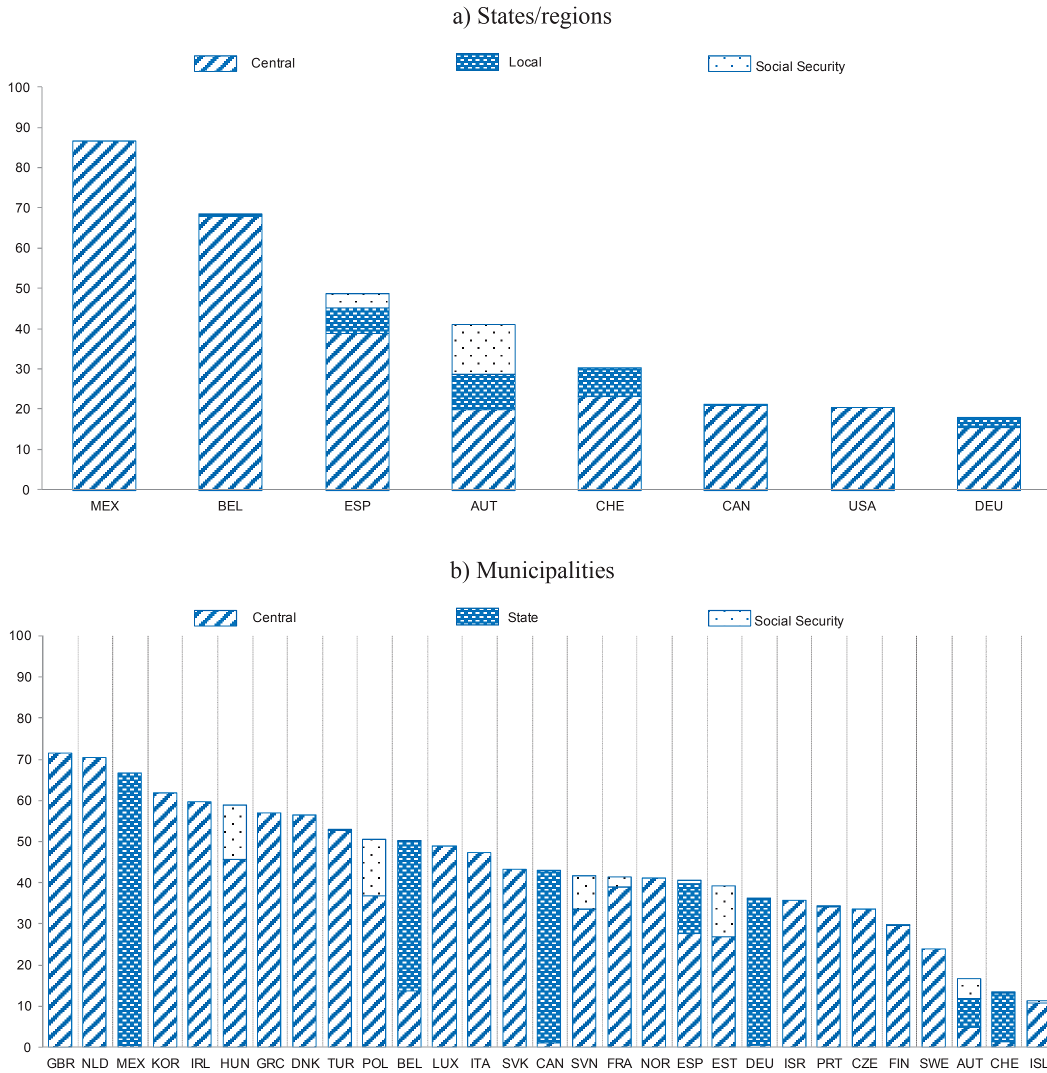
The following section describes the composition of intergovernmental grants in OECD member countries, by the level of government of origin and by the characteristics of the grants.

Intergovernmental grants come from different levels of government

Classifying grants by the level of administration of origin, some surprises arise: at state/region level, the predominant origin of grants is the central administration, but in some countries, like Spain, Austria and Switzerland, an important share of transfers comes from local administrations (mainly due to the contributions of local administrations to the equalisation system) (Figures 3.17a and 3.17b). In the case of Austria, a significant share of the transfers comes from social security.

At the municipal level, the predominant origin of grants is the level of administration just above: central level when there is no state/region, and state/region when it exists. But there are exceptions: in Spain, for example, most of the grants received by local governments come directly from the central government, and this share is quite large in Austria and Belgium too. In some European countries, social security is also a significant source of transfers for local governments, for example in Austria, Estonia, Hungary, Poland and Slovenia.

Figure 3.17. **Composition of sub-central government grants as a share of total transfer revenues, according to the origin of the grant (2010)**



Notes: Data for Korea, Mexico, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

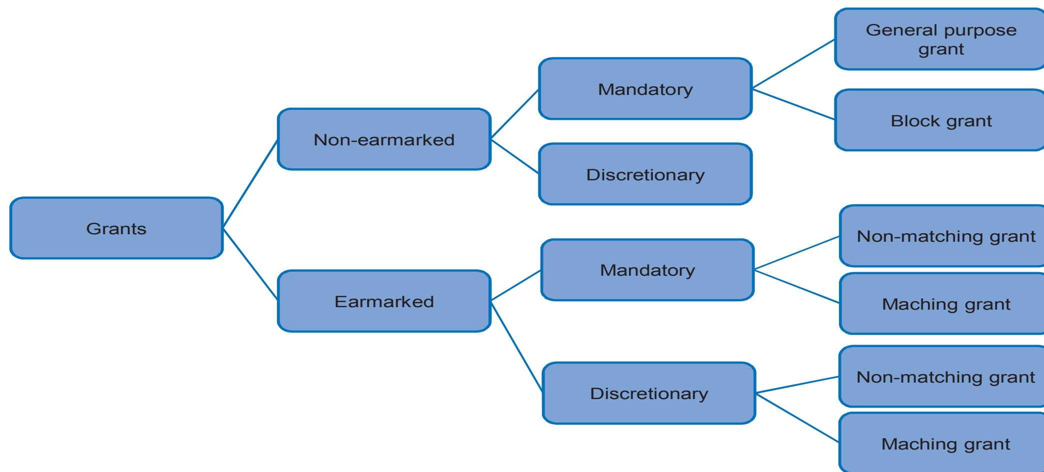
Source: OECD National Accounts.

There are different types of grants which serve different purposes

Grants can be divided into many different categories, each type of grant serving different purposes and having different advantages and drawbacks. The main distinction in the assessment of sub-central fiscal autonomy is the division between earmarked and non-earmarked grants (Figure 3.18). The two categories can be further subdivided into mandatory and discretionary grants, which has different implications for sub-central governments in terms of predictability of revenues. Earmarked grants may be further

subdivided into matching and non-matching grants, according to whether or not the transfer is linked to sub-central governments' own expenditure. This distinction has important consequences on sub-central governments' incentives to spend. Non-earmarked grants consist of block grants and general purpose grants. General purpose grants offer more freedom of use, but as both forms are unconditional, the distinction often collapses (Bergvall et al., 2006).

Figure 3.18. **OECD typology of grants**



Source: Bergvall D., C. Charbit, D.-J. Kraan and O. Merk (2006), "Intergovernmental Transfers and Decentralised Public Spending", *OECD Journal on Budgeting*, 5(4), OECD Publishing, Paris.

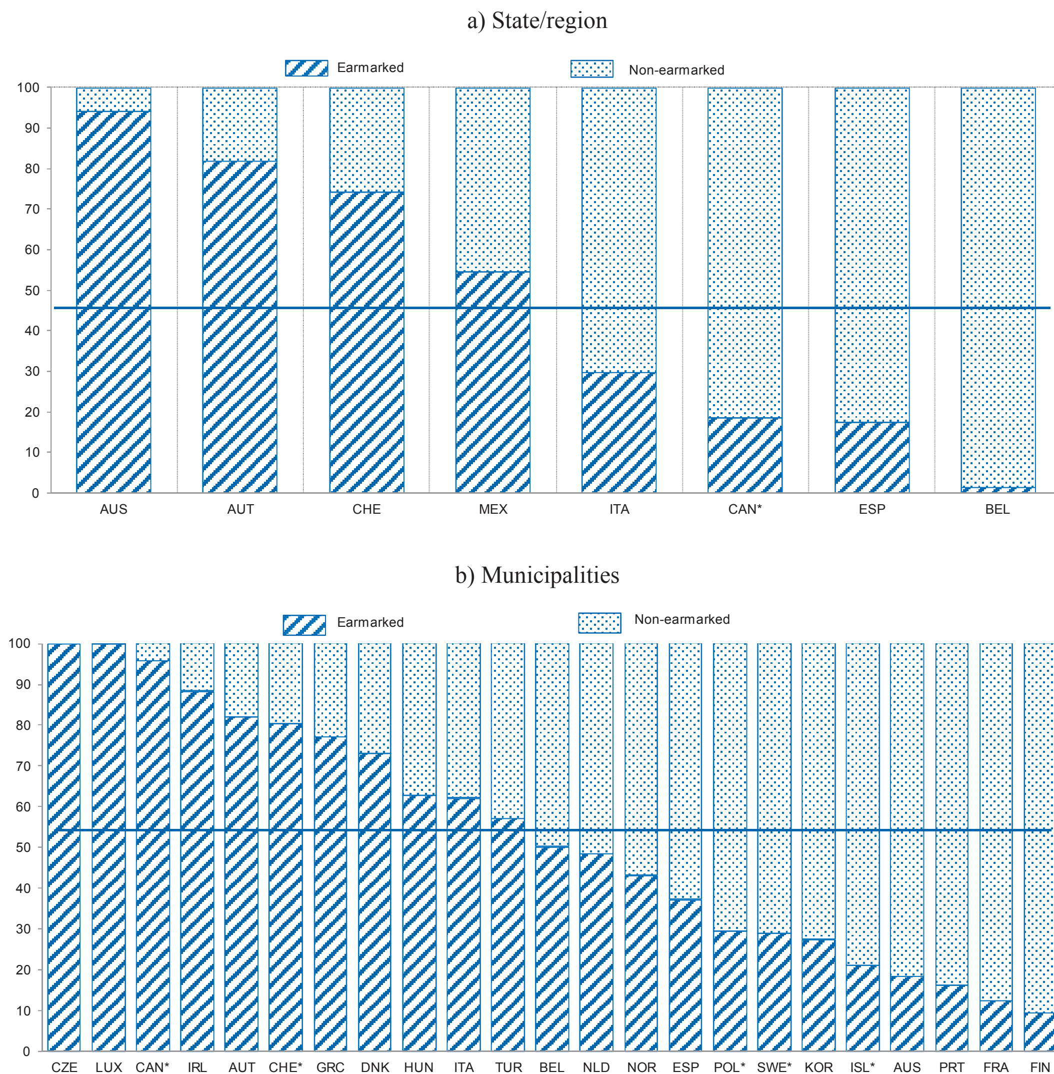
Earmarked vs. *non-earmarked grants*

Earmarked *vs*. non earmarked grants is perhaps the most important distinction associated with intergovernmental grants (Bergval et al., 2006). An earmarked grant is a grant that is given on condition that it be used only for a specific purpose, as defined by the government that issues the grant. It therefore restricts the spending autonomy of the receiving government. Non-earmarked grants can be spent as if they were the sub-central government's own tax revenues.

From a theoretical perspective, non-earmarked grants are considered a more effective tool for financing sub-central governments, especially for purposes of equalisation (Blöchliger et al., 2007 and Blöchliger and Charbit, 2008). However, there are specific cases where earmarked grants might be an appropriate policy instrument. These include addressing risk-sharing concerns (for example supporting innovation), supporting experimentation in public service delivery, and co-funding projects (see Chapter 2 and Blöchliger and Vammalle, 2010). In addition, temporarily using earmarked grants can help build capacity at the sub-central government level during decentralisation, as new tasks are assigned to sub-central governments, or can finance recovery after crises or natural disasters. The recent global financial and economic crisis has resulted in a surge in the use of discretionary earmarked grants in national stimulus packages, as they have proven to be a flexible and rapid instrument for addressing exceptional situations that require timely, geographically targeted responses (Blöchliger et al., 2010; and OECD, 2011b).

Earmarking is quite extensive in OECD member countries, representing more than half of intergovernmental transfers in a majority of OECD member countries, especially at municipal level. At the state/regional level, earmarking represents less than 50% of grants, and less than 20% in Canada, Spain and Belgium (in Belgium, earmarking is even less than 1%). At local level, earmarking represents on average 54% of grants. Australia, Finland, France, Iceland, Korea, Portugal, Poland, Spain and Sweden also allow their municipalities considerable leeway to spend transfers freely. In Belgium and Canada, the high share of non-earmarked grants at state/regional level is contrasted with a much higher portion of earmarked grants at municipal level (96% of total transfers in Canada and 50% in Belgium).

Figure 3.19. **Earmarked *vs.* non-earmarked grants as a share of total sub-central government total transfer revenues (2006)**



Source: OECD Fiscal Decentralisation database.

Mandatory vs. *discretionary grants*

Both earmarked and non-earmarked grants can be either mandatory or discretionary (Figure 3.18). Mandatory grants (entitlements) are legal, rules-based obligations for the government that issues the grant. This requires that both the size of the grant and the conditions under which it is given be laid down in a statute or executive decree, and that these conditions be both necessary and sufficient. Typically, sub-central governments can also appeal to a court or administrative judicial authority in order to obtain the grant. Most grants that are given to sub-central governments on a regular basis are mandatory. On the other hand, the size of discretionary grants, and the conditions under which they are handed out, are not determined by rules but decided on an *ad hoc*, discretionary basis.

Discretionary grants are often temporary in nature and include, for example, grants for specific infrastructure projects or emergency aid to a disaster area. Discretionary grants have been widely used by central governments in stimulus packages to support sub-central governments during the crisis (Blöchliger et al., 2011; and OECD, 2011b). While mandatory grants may put pressure on higher levels of government that grant the transfers, they offer relative revenue security to the sub-central governments receiving the grants (these may be more or less pro-cyclical depending on the formula, but they are at least predictable). On the other hand, discretionary grants give more flexibility to the upper levels of government to reduce intergovernmental transfers in case of financial difficulties, thus generating more uncertainty over sub-central governments' resources.

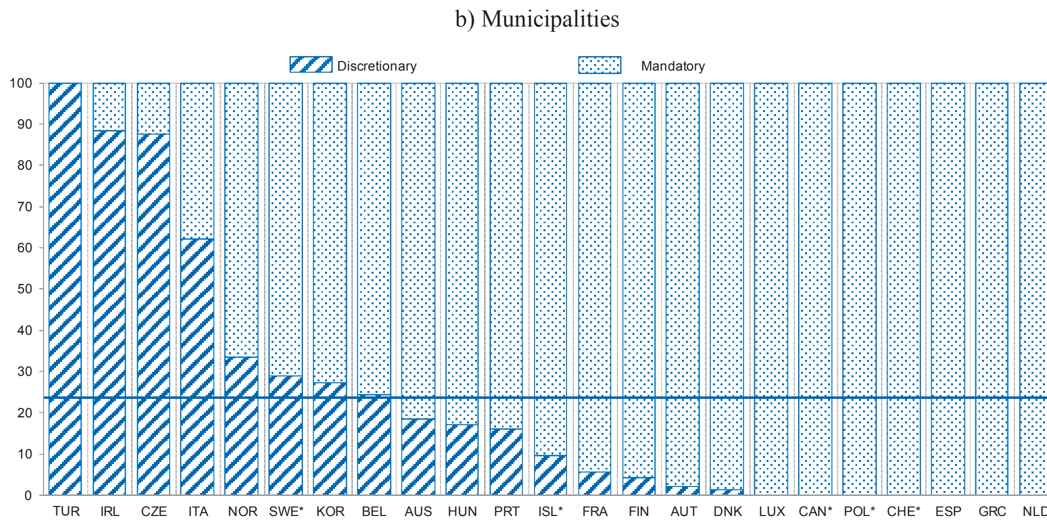
According to 2006 data, most transfers to sub-central governments are mandatory (they represent on average 85% for states/regions and 78% for municipalities) but some important exceptions emerge (Figures 3.20a and 3.20b). At state/regional level, Australia was the main exception, recalculating transfers every year. But after a major intergovernmental grants reform in 2008, its situation today is very different (updated information will be provided by the OECD Network on Fiscal Relations across Levels of Government in 2012). At the local level, the Czech Republic, Ireland, Italy and Turkey also present a high level of transfer allocated on a discretionary basis.

Figure 3.20. **Mandatory *vs.* discretionary grants as a share of sub-central government total transfer revenues (2006)**

a) States/regions

Figure 3.20. **Mandatory *vs.* discretionary grants as a share of sub-central government total transfer revenues (2006)** *(cont'd)*

b) Municipalities



Source: OECD National Accounts.

Matching vs. *non-matching grants*

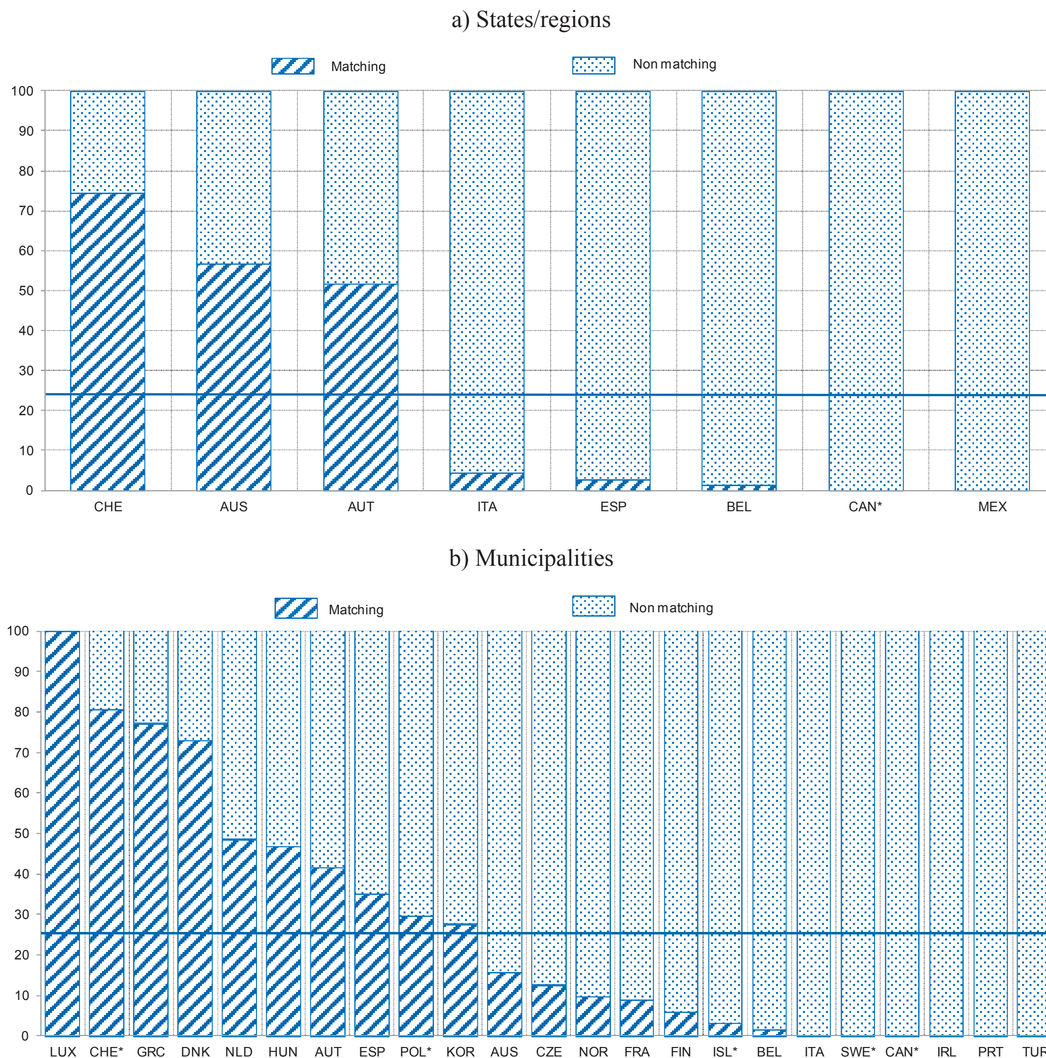
Earmarked mandatory grants can be either matching or non-matching (Figure 3.18). There are two types of matching grants: in some cases, a higher level of government (central government or supra-national) may provide a grant to finance a sub-central project, on the condition that the sub-central government bears part of the cost of the project. This is a way of screening investment projects, as the willingness of sub-central governments to pay for them is considered as a sign of their relevance and of the commitment of sub-central governments to implementing them. This type of matching grant is used for example by the European Union to finance investment projects in the context of the Cohesion Policy. Another common type of matching grant has the opposite mechanism: sub-central governments commit to an expenditure, and this spending must be matched with central government funds. In this case, matching grants complement sub-central contributions and are used as a means of sharing fiscal risks between governments. These matching grants may put pressure on central government spending, as the decision to spend is taken by the sub-central governments. They may also create incentives for overspending, as sub-central governments enjoy the full benefit of the services financed, while bearing only part of the costs. Finally, they may reduce the incentive to seek efficiency gains at sub-central level, especially when they are dependent on actual spending and not on standard costs for services for which the grants are earmarked.

All mandatory earmarked grants that are not allocated as a complement to sub-central contributions are non-matching. The decisive question in determining whether a grant is matching or non-matching is whether a decrease in sub-central spending would automatically lead to a decrease in the grant.

OECD member countries display contradictory approaches to matching grants: in about one-third of the countries, they represent close to or above 50% of total transfer revenues (states/regions in Australia, Austria and Switzerland; municipalities in

Denmark, Greece, Hungary, Luxembourg, the Netherlands and Switzerland), while in other countries, they are extremely rare or not used at all (states/regions in Belgium, Canada, Mexico and Spain, and municipalities in Belgium, Canada, Ireland, Italy, Portugal, Sweden and Turkey) (Figures 3.21a and 3.21b).

Figure 3.21. **Matching *vs.* non-matching grants as a share of sub-central government total transfer revenues (2006)**



Source: OECD Fiscal Decentralisation database.

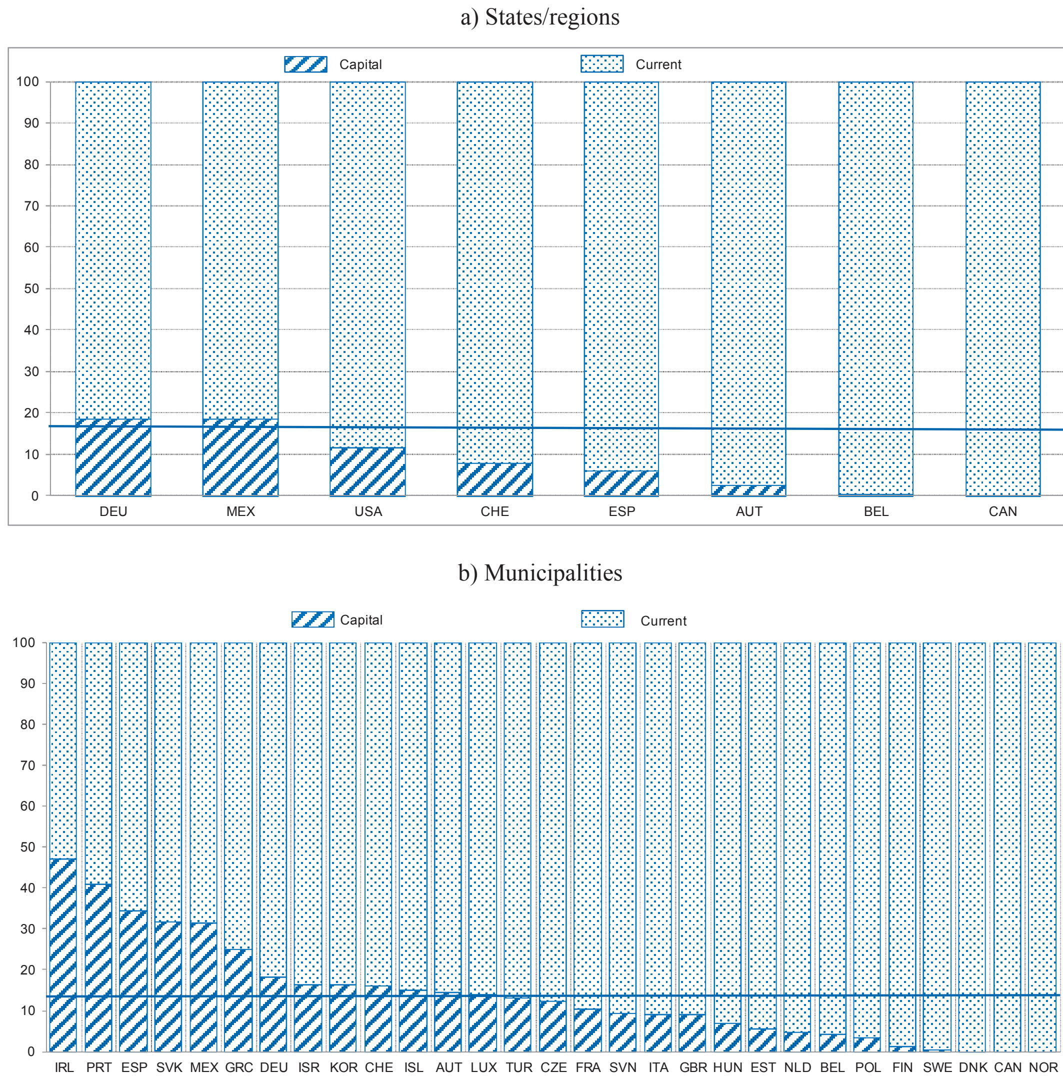
Current vs. *capital grants*

In addition to the classification described above, grants can also be divided into grants for financing capital expenditure, as opposed to grants that can be spent on any type of expenditure. On average, capital expenditure grants tend to be scarcer, as the definition of current grants is much wider and includes all grants that are not specifically required to be spent on capital expenditure.

Capital grants are more used in municipalities than in states/regions: they represent on average 8% for states/regions and 15% for municipalities. Besides, the share of capital grants is higher in EU countries than in non-EU countries (except for Mexico, most of the countries with an above-average share of capital grants belong to the EU: Germany, Greece, Ireland, Portugal, the Slovak Republic and Spain) (Figures 3.22a and 3.22b).

Figure 3.22. **Current *vs.* capital grants as a share of sub-central government total transfer revenues (2010)**

a) States/regions



Notes: Data for Korea, Mexico, Poland, Switzerland, Turkey and United States correspond to 2009 instead of 2010. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts.

Sub-central government debt

The ability of sub-central governments to issue debt, and the conditions under which this is possible are intrinsically related to the institutional and constitutional framework of the country. In some countries, sub-central governments are simply not allowed to borrow. In most countries, they can do so, but must follow a number of specific fiscal rules which were designed to avoid undermining national macroeconomic stability, as sub-central governments do not always take into account the effect of their fiscal decisions on the rest of the country, and may have incentives to over issue debt (in particular when a central government bailout is expected).

To avoid cutting public investment or increasing tax levels during the crisis, some countries have relaxed fiscal rules for sub-central governments to allow them to run higher deficits, thus leading to increase sub-central debt levels. Besides, as sub-central governments revenues have fallen, they face greater difficulties in servicing their debts. This lead to worries about the sustainability of sub-central governments' debts in several OECD member countries.

This section describes the composition of public debt by level of government, and the evolution of the weight of debt in sub-central government revenues since 2000.

Some OECD member countries have rising doubts about the sustainability of their sub-central government debts

The weight of sub-central governments in total government debt varies greatly across countries, ranging from as low as 1% in Greece, to more than 50% in Canada. On average, sub-central governments account for 15.7% of public debt (Figure 3.23 and Box 3.7). For states with three tiers of government, states/regions tend to represent a higher share of public debt than municipalities (19.5% on average).

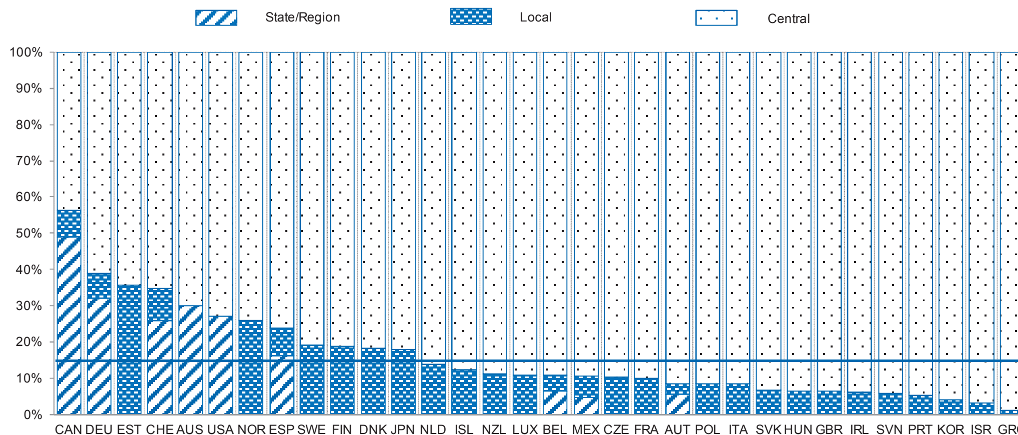
An interesting indicator for assessing the sustainability of sub-central government debt is the ratio of debt to revenues (Figures 3.24a and 3.24b). This gives the number of years of revenues that would be necessary to pay back the debt. On average, state/region debt represents about one year revenues, while it only represents little more than half a year for municipalities. With the sustained growth during most of the 2000s, the ratio of debt to sub-central government revenues had decreased in a number of countries between 2000 and 2007 (Czech Republic, France, Iceland, Netherlands, Slovak Republic, Switzerland, United Kingdom). Since the beginning of the crisis, this ratio tends to increase in most OECD member countries, and is expected to continue doing so in the coming years. In Iceland for example, sub-central government debt to revenues has increased by 41% from 2007 to 2010. In Italy, this increase was 20% from 2007 to 2009.

Box 3.7. Methodology and definitions: sub-central government debt

Debt corresponds to total liabilities of each level of government, not consolidated, as they are defined in SNA excluding insurance technical reserves. Therefore, debt definition in this paper includes: currency and deposits, securities other than shares, loans, shares and other equity and other accounts, payable. This is a broader criterion than the Maastricht criteria, which do not consider trade credits and advances, as well as shares, it does not include financial derivatives (securities) either. Moreover, Maastricht definition only takes into account loans outstanding at the end of the year.

Data are presented non-consolidated, in general, as in many cases, an important part of sub-central government debt is in the hands of higher levels of government, and would therefore disappear after consolidation.

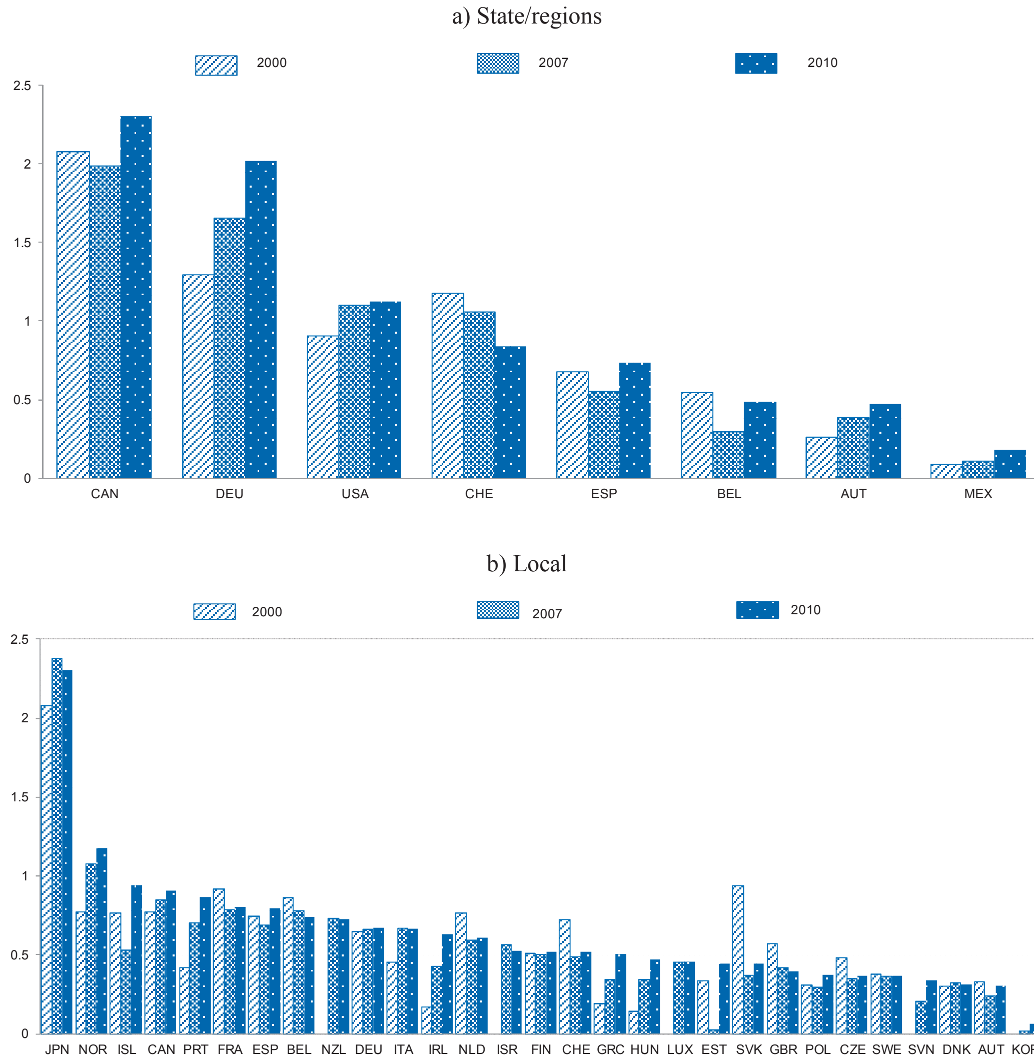
Figure 3.23. **Composition of public debt by level of government (2010)**



Notes: Data for Australia, Israel and New Zealand are consolidated. Data for Australia, Austria, Czech Republic, Estonia, France, Germany, Ireland, Israel, Italy, Japan, Luxembourg, Mexico, Netherlands, Poland, Slovak Republic, Spain and the United States correspond to 2009 instead of 2010. For Switzerland data correspond to 2008 and for New Zealand to 2007. The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Source: OECD National Accounts.

Figure 3.24. **Evolution of sub-central government debt as a share of sub-central government revenues (2000-2010)**



Notes: Data for Australia, Israel and New Zealand are consolidated. Data for Australia, Austria, Czech Republic, Estonia, France, Germany, Ireland, Israel, Italy, Japan, Luxembourg, Mexico, Netherlands, Poland, Slovak Republic, Spain and the United States correspond to 2009 instead of 2010. For Switzerland data correspond to 2008 and for New Zealand to 2007.

Source: OECD National Accounts.

Notes

1. The case of Denmark is a bit misleading, as sub-central governments are responsible for public welfare, for which they act as mere agents of the central government, with no spending autonomy whatsoever. In other countries, this function is classified as social security. If such a correction was made for Denmark, spending by sub-central governments would be much closer to the OECD average.
2. *Idem.*
3. With the same caveat as mentioned previously, as sub-central governments act as mere agencies for the central government, as they manage funds that in other countries would be attributed to social security.
4. Same caveat.
5. For further reading, please see: OECD (2010a, 2010b, 2011d).
6. For further reading, please see: OECD (2009a, 2009b, 2011c, 2011d) and *OECD Territorial Reviews:* www.oecd.org/gov/regional.
7. For further reading, please see: Bergvall et al. (2006); Blöchliger and Petzold (2008); Blöchliger and Vammalle (2010) in Junghun Kim, Jorgen Lotz and Niels Jorgen Mau (eds.); and Charbit (2009).
8. For further reading, please see: Blöchliger and King (2006); Blöchliger and Petzold (2009); Blöchliger and Piñero Campos (2011).
9. For further reading, please see: Blöchliger et al. (2010); OECD (2010d); and OECD (2010c).
10. Further reading please see: Blöchliger (2008) and OECD (2010c).

Bibliography

Allain-Dupré, Dorothée (2011), "Multi-level Governance of Public Investment: Lessons from the Crisis", *OECD Regional Development Working Papers*, 2011/05, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5kg87n3bp6jb-en*.

Bach S., H. Blöchliger and D. Wallau (2008), "The Spending Power of Sub-central Governments: A Pilot Study", COM/CTPA/ECO/GOV/WP(2009)8, OECD, Paris.

Bergvall, D., C. Charbit, D.-J. Kraan and O. Merk (2006), "Intergovernmental Transfers and Decentralised Public Spending", *OECD Journal on Budgeting*, 5(4), OECD Publishing, Paris, *http://dx.doi.org/10.1787/budget-v5-art24-en*.

Blöchliger, H. (2008), "Market Mechanisms in Public Service Provision", OECD Economics Department Working Papers, No. 626, OECD Publishing, Paris, *http://dx.doi.org/10.1787/241001625762*.

Blöchliger H. and D. King (2006), "Fiscal Autonomy of Sub-central Governments", COM/CTPA/ECO/GOV/WP(2009)9, OECD, Paris.

Blöchliger H., O. Merk, C. Charbit and L. Mizell (2007), "Fiscal Equalisation in OECD Countries", COM/CTPA/ECO/GOV/WP(2007)4, OECD, Paris.

Bloechliger H. and C. Charbit (2008), "Fiscal Equalisation", *OECD Journal: Economic Studies,* Vol. 2008/1, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_studies-v2008-art8-en*.

Blöchliger H. and O. Petzold (2009a), "Taxes and Grants: On the Revenue Mix of Sub-central Governments", COM/CTPA/ECO/GOV/WP(2009)7, OECD, Paris.

Blöchliger H. and O. Petzold (2009b), "Finding the Dividing Line between Tax Sharing and Grants: A Statistical Investigation", COM/CTPA/ECO/GOV/WP(2009)10, OECD, Paris.

Blöchliger, H. and C. Vammalle (2010), "Grants Systems in OECD Countries: Trends and Some Policy Issues", in *General Grants versus Earmarked Grants, Theory and Practice: The Copenhagen Workshop 2009* (17-18 September), Junghun Kim, Jorgen Lotz and Niels Jorgen Mau (eds.), Korean Institute for Public Finance (KIPF) and Danish Ministry of the Interior and Health.

Blöchliger H., C. Charbit, J.-M. Piñero Campos and C. Vammalle (2010), "Sub-central Governments and the Economic Crisis: Impact and Policy Responses", *Economics Department Working Papers*, No. 752, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5kml6xq5bgwc-en*.

Blöchliger, H. and J.-M. Piñero Campos (2011), "Tax Competition between Sub-central Governments", *OECD Economics Department Working Papers*, No. 872 OECD Publishing, Paris, *http://dx.doi.org/10.1787/5kgb1mfm6jnw-en*.

Blöchliger, H. and C. Vammalle (2011), *Reforming Fiscal Federalism and Local Government: Beyond a Zero-Sum Game*, OECD Publishing, Paris.

Charbit C. (2009), "Explaining the Sub-national Tax-Grants Balance in OECD Countries", COM/CTPA/ECO/GOV/WP(2009)11, OECD, Paris.

Charbit C. and C. Vammalle (2010), "Modernising Government", in *Making Reform Happen: Lessons for the Future*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264086296-9-en*.

Mosca, I. (2006), "Is Decentralisation the Real Solution? A Three-Country Study", *Health Policy*, 77(2006): 113-120.

Musgrave, Richard A. (1959), *The Theory of Public Finance*, McGraw Hill, New York, NY.

Musgrave, Richard A. and Wallace E. Oates (1972), *Fiscal Federalism*, Harcourt Brace Jovanovich, New York, NY.

Oates, W.E. (1990), "Decentralisation of the Public Sector: An Overview", in R. Bennet (ed.), *Decentralisation, Local Governments, and Markets*, Oxford University Press, pp. 43-58.

OECD Territorial Reviews: *www.oecd.org/gov/regional.*

OECD (2009a), *How Regions Grow: Trends and Analysis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264039469-en*.

OECD (2009b), *Regions Matter: Economic Recovery, Innovation and Sustainable Growth*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264076525-en*.

OECD (2010a), *Cities and Climate Change*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264091375-en*.

OECD (2010b), *Cities and Green Growth*, OECD Publishing, Paris.

OECD (2010c), *Revenue Statistics 2010*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/rev_stats-2010-en-fr*.

OECD (2011a), *Government at a Glance 2011*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/gov_glance-2011-en*.

OECD (2011b), *Making the Most of Public Investment in a Tight Fiscal Environment. Multi-Level Governance Lessons from the Crisis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264114470-en*.

OECD (2011c), *Regional Outlook*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264120983-en*.

OECD (2011d), *Regions at a Glance*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/reg_glance-2011-en*.

OECD (forthcoming), *OECD Territorial Reviews: Brazil 2010*, OECD Publishing, Paris.

Ter-Minassian,Teresa and Jon Craig "Control of Subnational Government Borrowing", in *Fiscal Federalism in Theory and Practice*, edited by Teresa Ter Minassian, International Monetary Fund, Washington, D.C.

Chapter 4

Country notes

The present chapter presents a synthesis of fiscal federalism in eight OECD member countries (Finland, France, Italy, Korea, Portugal, Spain, Sweden, and the United Kingdom). In each country note, the first section describes the institutional framework (description of the different levels of government, responsibilities of sub-central governments), the second section provides the key figures in fiscal relations across levels of government, and the third section gives a synthesis of recent and current fiscal federalism reforms.

Finland

Institutional framework

Finland is a unitary state composed of regions (*maakunnan liitto*), provinces (*lääni*) and municipalities (*kunta*). In 1949 and 1977, several local government acts abolished distinctions between rural and urban areas, thus unifying the country. The deconcentrated state administration is divided into 6 administrative provinces, within which there are 90 state local districts.

The 1995 Local Government Act recognises diversity among sub-central governments (SCGs). It affords local authorities leeway and flexibility to organise their functions and administration. Mergers of small local authorities are encouraged.

Levels of government

19 regions (*maakunnan liitto*) and 1 autonomous province (Åland)	The Regional Council is a statutory joint local authority indirectly elected by the municipalities of the region and supported by its own administration. The autonomy of the Åland Islands is established by international treaties and confirmed in the Finnish Constitution (Paragraph 120). As an autonomous entity, the province of the Åland Islands has its own political and administrative bodies responsible for decision making. The Parliament of Åland (*lagtinget*) exercises legislative power within the framework permitted by its autonomous position. In all other instances, the laws enacted by Finland's Parliament apply. The Government of Åland (*landskapsregeringen*) is responsible for regional administration.
6 administrative provinces (*lääni*), within which there are 90 state local districts	Each administrative province is managed by a provincial governor.
326 municipalities (*kunta*)	The Municipal Council (*kunnanvaltuusto*) is composed of members elected every four years by proportional representation from party lists. The Executive Board (*kunnanhallitus*), composed of members appointed by the Municipal Council, is responsible for running the municipal administration and for its finances. The mayor is elected by the municipal council and heads the executive.

Sources: OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*; and European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

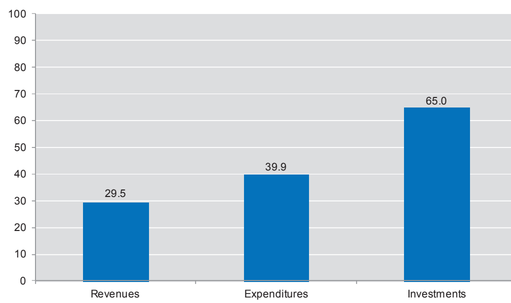
Responsibilities of sub-central governments (SNGs)

Regions	Municipalities
– Regional development; – Regional planning; – Preparation and execution of programmes co-financed by structural funds; – Co-operation among local governments.	– Health care; – Social welfare; – Education (preschool, primary school, secondary school, vocational training, adult education); – Culture, leisure, sport; – Land use planning and building control; – Environment (energy management and supply, water and sewage works, waste management, environmental protection, public transport and harbours); – Rescue services; – Economic development, promotion of business and employment.

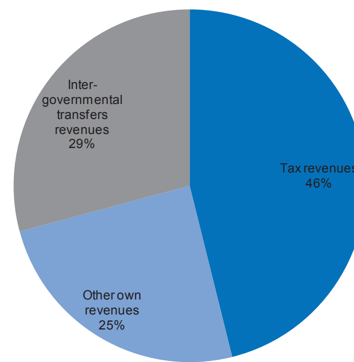
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in Finland

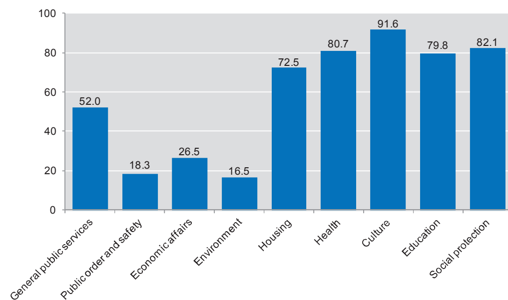
Participation of sub-central governments in total public revenues, expenditure and investments (2009)



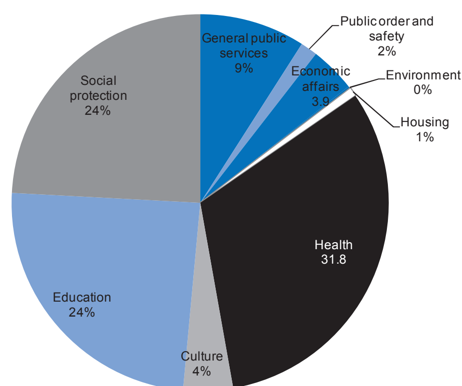
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms[1]

In 2007, Finland started implementing the Act on Restructuring Local Government and Services (also known by its acronym "PARAS reform"), which aims to create economies of scale by encouraging voluntary municipal mergers and municipal co-operation areas for the delivery of public services. Municipalities could choose between merging and joining larger co-operation areas, but financial incentives were used to encourage municipalities to merge. Municipal mergers were already on the agenda before this reform, and in 2002, a substantial number of merger subsidies were granted to municipalities wishing to merge. This led to a reduction of the number of municipalities, from 452 in 2001 to 432 in 2005. The PARAS reform further reduced the number of municipalities to 348 in 2009, and municipalities have until 2013 to benefit from financial incentives under the current framework.

In connection with these structural reforms, the Ministry of Finance defined a method to identify municipalities that risk falling into severe financial difficulties. The method is based on six economic criteria that aim to measure the fiscal position of Finnish municipalities. If the municipality's fiscal health falls consistently below the country average and below the limits specified by the central government for two consecutive years, a negotiating procedure is initiated between the municipality and the Ministry of Finance. The objective of the negotiation process is to implement economic rescue plans, which may include measures such as economic recovery plans to be followed in exchange for supplementary aid granted by the Ministry of Finance (Moisio et al., 2010).

France

Institutional framework

France is a unitary state composed of regions (*régions*), departments (*départements*) and municipalities (*municipalités*). Traditionally a highly centralised country, France began large-scale decentralisation in 1982 with major legislative changes in 1982-83. In 2003, decentralisation was reinforced. Sub-central governments in France have administrative autonomy, own responsibilities, executive powers and, since 2003, financial autonomy. Due to the large number of small municipalities, inter-municipal co-operation arrangements are common, covering a range of services such as water supply, household waste collection and sewage. Notwithstanding the considerable fiscal autonomy of sub-central governments, the state closely supervises and monitors sub-central governments' financial accounts through three institutions: the prefect (*préfet*), the regional chambers of accounts (*chambres régionales des comptes*, or CRC) and public accountants (*comptables publics*).

Levels of government

22 regions (*régions*), 4 overseas regions and 7 overseas regions with special status	The regions' deliberative body is the Regional Council, which is composed of councilors elected by direct universal suffrage for a six-year term. The president, who is also elected by the Regional Council for a six-year term, is the region's executive and the head of the regional administration. A deliberative board, the Permanent Committee, which is made up of the region's vice-presidents, assists the Regional Council in the execution of some of its responsibilities. The prefect of the region is responsible for the services devolved to the regions by the central government (CG). Other duties of the prefect include relaying to the region the government's policy on major projects, monitoring the legality of the region's actions and its respect of budgetary regulations and drawing up policies for the region's economic, social and territorial development.
96 departments (*départements*) and 4 overseas departments	The department's deliberative body is the General Council. This is composed of members elected by direct universal suffrage for a six-year term; 50% of the General Council is renewed every three years. The President of the Council, the department's executive authority, is elected by the General Council for three years and assisted by a permanent committee composed of vice-presidents. The prefect represents the central government in the department. He or she is in charge of maintaining public order and holds police powers. The prefect is also in charge of monitoring the legality of the actions of local authorities.
36 791 municipalities (*municipalités*)	The municipal council is composed of councilors elected by direct universal suffrage for a six-year term. The mayor, who is elected by the council, heads the deliberative assembly. The mayor and his/her deputies represent the municipality's executive. The mayor is in charge of the municipal administration.

Source: Direction Générale des Collectivités Locales (DGCL) (2011), *Les collectivités locales en chiffres 2011*, DGCL, Ministry of Interior, Paris, *www.dgcl.interieur.gouv.fr/sections/a_votre_service/statistiques/collectivites_locale.*

Responsibilities of sub-central governments

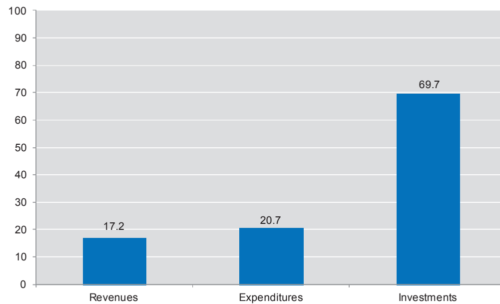
Regions, departments and municipalities have no legislative competences. Their main functions are exercised through the execution of their budget, over which they have authority within the rules set by national law.

Regions	Departments	Municipalities
– Education (creation, construction, maintenance and operation of high schools, or *lycées*; establishments for specialised education; vocational training and apprenticeships); – Planning (regional development and land use plan, state-regional planning contracts); – Transport (school transport, road transport, rail transport); – Economic development (economic aid, management of EU structural funds); – Environment (environmental protection, heritage and sites board, regional air quality plan, classification of regional nature reserves); – Cultural affairs (regional archives, regional museums, protection of historic heritage and listing of monuments and artistic heritage).	– Social welfare (aid for children, social aid for families, accommodation for the disabled and elderly, supervision of the constituency's social establishments); – Education (creation, construction, maintenance and operation of secondary schools; creation, construction, maintenance and operation of colleges); – Regional planning (rural equipment aid programme, associated state-region planning contracts); – Transport (school transport outside towns, passenger transport between towns); – Economic development (direct economic aid, indirect aid for businesses); – Town planning; – Environment (departmental waste disposal plan); – Culture (departmental archives, departmental museums, central lending library).	– Social welfare (day care centres, shelters for the homeless, municipal hygiene offices); – Education (creation, construction, maintenance and operation of preschool classes and primary schools); – Planning (regional planning – joint municipal boundary initiatives, town planning); – School transport (financing and organisation within municipal boundaries); – Economic development complementary to that of regions and departments; – Environment (drainage, distribution of drinking water, collection and processing of household waste); – Culture (art schools, municipal archives, municipal museums, music academies).

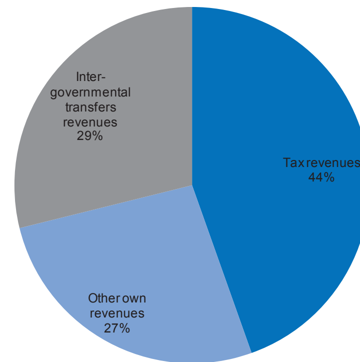
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government

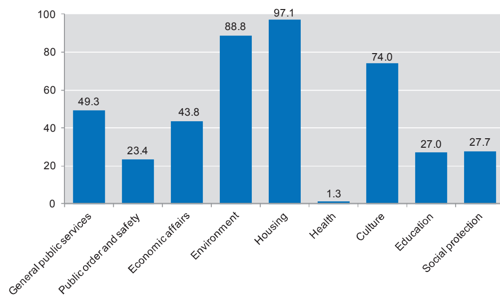
Participation of sub-central governments in total public revenues, expenditure and investments (2009)



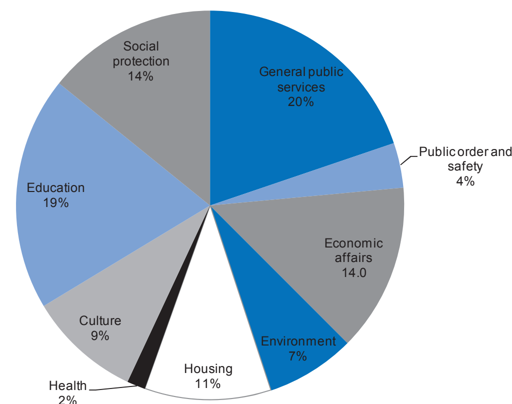
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms

In the early 1990s, certain French municipalities experienced severe financial distress. In the second half of the 1990s, the central government tightened the regulatory framework for sub-central government borrowing, introduced greater disclosure and transparency requirements and implemented an early warning system. Key elements of prudential rules regulating debt, liquidity and contingent liabilities include:

- New long-term borrowing of sub-central governments is available only to fund capital investments.
- Debt payments are compulsory expenditures and must be fully budgeted for.
- Annual debt service, including interest paid on guaranteed loans, must be less than 50% of operating revenue.
- No single borrower may benefit from a guarantee exceeding 5% of the sub-central government's operating revenue.[2]

In 2004, the Law on Local Liberties and Responsibilities led to an additional devolution of responsibilities from the central government to sub-central governments. This new distribution of powers has been in force since January 2005. Departments gained additional responsibilities in the social welfare area, while regions were granted new powers over health policy, transport, education and territorial development. Municipalities have not been significantly affected by this new step in the decentralisation process.

In 2009, the central government announced that it would abolish the business tax (*taxe professionelle*), one of the most important sources of tax revenue for sub-central governments. The tax was replaced by budgetary allocations and the transfer of other existing tax revenues (Fitch Ratings, 2009). This reform was implemented in 2010.

Italy

Institutional framework

Italy is a unitary parliamentary republic composed of regions (*regioni*), provinces (*provincie*), and municipalities (*comuni*). Under the Constitution of 1948, Italy was a unitary republic that recognised local autonomy. Four regions with special status were established in 1948 and a fifth in 1963. Ordinary status regions were not established until 1970. In 1997, two laws – the Bassanini laws – introduced several reforms that devolved responsibilities from the central government to sub-central governments. A constitutional revision enhanced the regional legislative powers in 2001. These measures introduced the principle of subsidiarity, whereby competences are exercised at the lowest level appropriate. They paved the way for a new federal institutional framework.

Levels of government

21 regions (*regioni*)	Each region has its own status. Two of the 21 regions have the status of autonomous provinces (Trento and Bolzano). The legislative body is the Regional Council (*consiglio regionale*). It is composed of 30 to 80 councillors; 80% are elected by direct universal suffrage, 20% are drawn from the president's list. The council elects the president from within its ranks. The executive body is the Executive Committee (*giunta*), composed of the president and the regional councillors. The councillors are designated by the council or the president and have a five-year mandate. The *giunta* must resign if it loses the confidence of the council. The Executive Committee has overall administrative competences; it can propose regional bills. It prepares and implements the regional budget, and implements the council's decisions. The president (*presidente*) is elected by direct universal suffrage for five years and designates and dismisses the members of the *giunta*. The president represents the region and directs the region's policies. The president enacts regional laws and regulations and assumes the administrative functions that the central government delegates to the regions.
110 provinces (*provincie*)	The province is an administrative division of intermediate level between municipalities and regions. The Provincial Council (*consiglio provinciale*) is elected by direct universal suffrage for five years. It decides on the province's broad policy lines and votes on the budget. The Executive Committee (*giunta provinciale*) is designated by the president of the province. Its members cannot be members of the council. The executive committee implements the council's decisions. The president (*presidente*), elected by direct universal suffrage for five years, designates the members of the executive committee.
8 100 municipalities (*comuni*)	Each municipality is attached to a province but has direct access to its region and to the central government. The Local Council (*consiglio comunale*) is elected for five years by direct universal suffrage. As the legislative and main decision-making body, the Local Council votes the budget. The executive body is the Executive Committee (*giunta communale*), which implements the decisions taken by the council. Its members are designated by the mayor, who delegates to it some of his or her competences. The mayor (*sindaco*) is elected for five years by direct universal suffrage and designates the deputies (*assessori*) who are the members of the executive committee. The mayor is the head of the local civil service.

Sources: OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*; and European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Responsibilities of sub-central governments

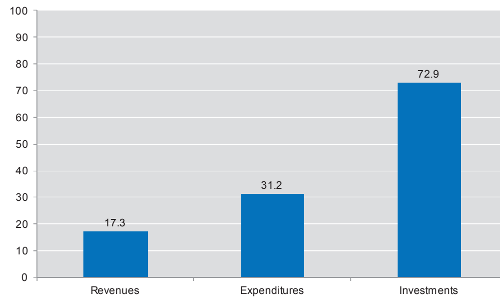
Regions have legislative and administrative competences, defined by the status they adopt. The constitutional court checks regional status and laws for conformity with the Constitution. Provinces and municipalities have only administrative competences, which are exercised on the basis of the relevant national and regional laws.

Regions	Departments	Municipalities
– Health and labour; – Social welfare (complementary social security); – Education (training and vocational education); – Planning (town planning, land development); – Public housing; – Economic development (foreign trade, research and development, production and delivery of energy, tourism, mining); – Culture; – Agriculture and forestry; – Transport (regional public transport, civil ports, local airports); – Regional electoral law; – Environment; – International relations with other regions and with the EU; – Implementation of EU regulations and policies.	– Planning (spatial planning, social and land-use planning); – Environment (environmental protection, nature reserves and parks, water, waste collection); – Police (civil protection); – Culture (protection of cultural heritage); – Transport (provincial highways and public transport); – Agriculture and fishing (inland waters, hunting and fishing); – Labour market; – Education (school education); – Data (compilation of public information); – Technical and administrative assistance for municipalities; – Economic development (local economic development, energy resources).	– Social welfare (personal social services and community assistance); – Education (school-related services, preschool child care, nursery schools); – Culture and recreation (museums, exhibition halls, cultural activities, theatre); – Planning (town planning, housing and land registry); – Transport (operation of local transport, upkeep of local roads); – Economic development (drafting of plans for trade; planning, programming and regulation of commercial activities; establishment and management of industrial and trade zones); – Environment (including waste management); – Police (local police).

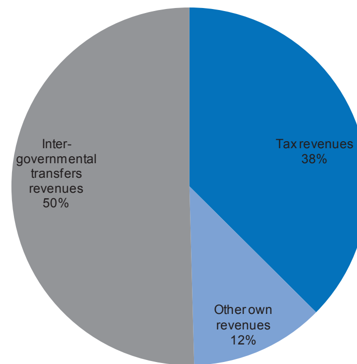
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in Italy

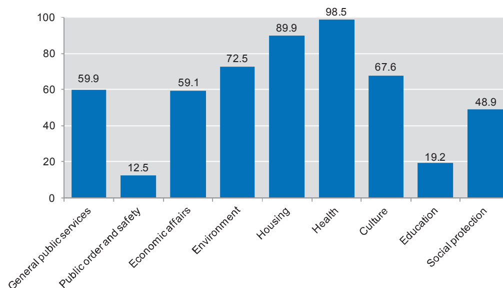
Participation of sub-central governments in total public revenues, expenditure, and investments (2009)



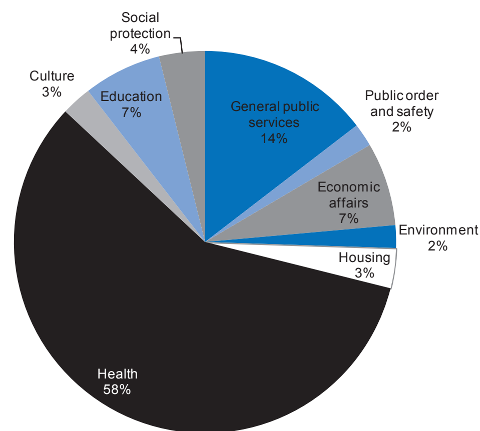
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms[3]

In 2009, the Italian Parliament passed a framework law that thoroughly reshaped fiscal relations between central, regional, provincial and municipal governments. The law, based on a constitutional amendment dating back to 2001, aims to increase both the efficiency and accountability of sub-central governments and to guarantee adequate levels of sub-central public services across the country. The reform consisted of the following elements:

- **Sub-central government spending responsibilities to be covered by own taxes.** The increase in taxing power will be fully offset by a reduction in intergovernmental grants. Only equalising grants and some special-purpose grants will remain.

- **Clarification of spending obligations.** Responsibilities for public services at the sub-central government level will be divided into compulsory services (health care, education, social protection and local transport) and all other public services. While the central government will define minimum standards for compulsory services, sub-central governments are free to define standards and spending levels for the other services. All services not explicitly allocated to the central government level will be the region's responsibility.
- **Equalisation of tax-raising capacity and standard cost,** distinguishing between compulsory services, for which equalisation will be full, based on standard costs and equalisation of tax-raising capacity, for which the equalisation rate would be less than 100%, leaving sub-central governments an incentive to develop their economic and fiscal base.
- **Harmonisation of accounting principles:** for regional and local governments, to make them truly comparable and to avoid "creative accounting".

Law 42 is a framework law that sets out the principles for reform but leaves their implementation to a set of legislative decrees. These decrees must also be passed by Parliament, and only five were in force as of mid-2011. Pending issues include the functioning of the equalisation scheme and the tax shares allocated to each government level. There is some uncertainty as to whether the reform will be fiscally neutral for the central government. In addition to adopting Law 42, the central government tightened fiscal rules in the Internal Stability Pact, to sanction sub-central governments that do not comply. To moderate the strictness of the rules, regions are given some flexibility in dividing up overall deficits and debt among their provinces and municipalities (Pola, 2010; and Fitch Ratings, 2010b).

Korea

Institutional framework

Korea is a unitary republican state with two levels of sub-central government.

The first level is composed of nine provinces (*do*), six metropolitan cities (*gwangyeoksi*) and one special city (*teukbyeolsi*), i.e. Seoul. The second level is mainly composed of counties (subdivisions of the provinces), cities (including counties with a population of 150 000 or above) and districts (subdivisions of the metropolitan cities). Counties outside urban conurbations are subdivided into either towns or townships.

According to Article 117 of the Constitution, local governments have to focus on "matters pertaining to the well-being of local residents, manage properties and may establish their own rules and regulations regarding local autonomy as delegated by national laws and decrees". This constitutional provision, however, remained largely unfulfilled until July 1995, when, for the first time in more than 30 years, the country elected governors and mayors for provincial and local governments. Until then, local governments were essentially local administrative districts of the central government, whose heads were appointed by the central government. Their capacity for autonomous decision making was virtually nonexistent.

Levels of government

1 special city (Seoul)	The Seoul Metropolitan Government is based on the office of the elected mayor. The mayor appoints three vice mayors to supervise the city administration, as well as several assistant mayors. The legislative branch consists of the 104-member Metropolitan Council, elected every four years.
9 provinces, 6 metropolitan cities, 75 cities, 86 counties, and 69 districts	There is a mixed electoral system for city, province, county and district council members. Some are elected by proportional representation as a single electoral constituency. Another contingent of local council members is elected in local constituencies. The executive of a local government is elected in the territory under jurisdiction of the relevant local government as a unit.

Source: OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*.

Responsibilities of sub-central governments

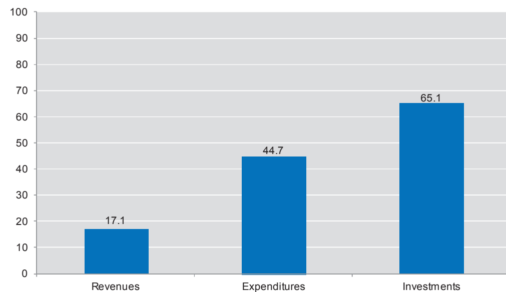
Provinces, metropolitan cities and special city	Counties, cities and districts
– Management of public properties and facilities;	– Management of public properties and facilities;
– Assessment and collection of local taxes and fees;	– Assessment and collection of local taxes and fees;
– Education;	– Education;
– Environment;	– Environment;
– Housing;	– Housing;

– Culture;	– Culture;
– Local audit.	– Local audit.

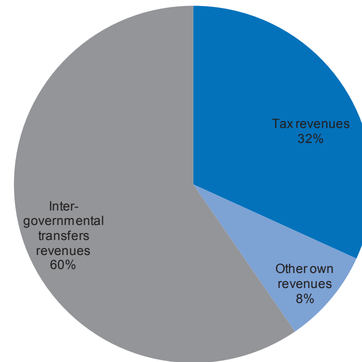
Source: United Cities and Local Governments (2007), *Country Profile: Republic of Korea*, Barcelona.

Fiscal relations across levels of government in Korea

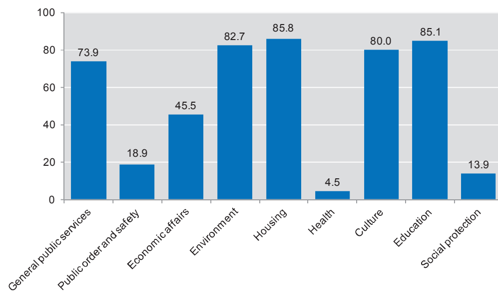
Participation of sub-central governments in total public revenues, expenditure and investments (2008)



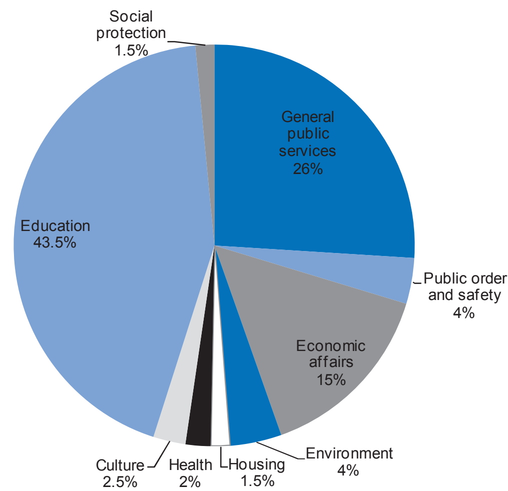
Sources of sub-central government revenues (2008)



Participation of sub-central governments in total public expenditure, by type of spending (2008)



Distribution of sub-central government expenditure (2008)



Source: *OECD National Accounts*.

Recent and current reforms

In 2005, a fiscal reform was enacted establishing the "Special Account for National Balanced Development" which transformed many specific-purpose grants into integrated national grants for regional development that were otherwise scattered throughout the central government's accounts. The Special Account for National Balanced Development was then reorganised and the Regional Development Special Account was established in 2009 to expand fiscal spending for local municipalities. Two hundred projects were

integrated into 24 comprehensive projects, and a block grant was adopted to give local municipalities the authority to autonomously design the projects (OECD, 2010).

In July 2008, 13 years after the 1995 reform, the government announced a mid-term plan to devolve considerable powers from deconcentrated central government special agencies to local governments, but the reaction to the crisis has shown that policy making and implementation is still extremely centralised in Korea (OECD, 2011).

Portugal

Institutional framework

Portugal is a unitary republican state composed of parishes and municipalities. Article 237 of the Portuguese Constitution indicates that the law regulates the responsibilities and organisation of local authorities and the responsibilities of their bodies in accordance with the principle of administrative decentralisation.

In addition to these two levels of sub-central government, there are two specific administrative levels: the district and the region.

The civil governor (*governador civil*), who heads the district, is nominated by the central government. The governor represents the government in the district. Though the Portuguese Constitution includes a regional level, proper regions have not been created yet, with the exception of the two autonomous regions: the islands of Açores and Madeira. These two regions have a legislative assembly elected by universal suffrage, a regional government headed by the region's president and a Minister of the Republic. The minister, who is the national government's representative in the region, has the right of veto over decrees of the assembly and appoints the president of the regional government.

Levels of government

4 259 parishes (*freguesias*)	The Parish Assembly (*assembleia de freguesia*) is the deliberative body of the parish. The assembly is composed of councillors elected for a four-year term by direct universal suffrage via a proportional representation system. The Executive Committee (*junta de freguesia*) is the executive body of the parish. Members are elected by and within the assembly. They are responsible for the preparation and implementation of decisions of the assembly. The president is the candidate heading the list with the most votes. S/he is elected for four years.
308 municipalities (*municípios*)	The Municipal Assembly (*assembleia municipal*) is composed of: *i)* members elected by direct universal suffrage for a four-year term; and *ii)* the municipal area parish presidents. The assembly, the deliberative body of the municipality, also monitors activities of the executive. The Executive Council (*câmara municipal*) is a collegial body composed of members elected by direct universal suffrage for four years. Members of the executive can intervene in the Municipal Assembly, where they also vote. This executive board has competences in the organisation and functioning of services. The mayor is the candidate heading the list with the most votes at the time of the assembly election. S/he is elected for four years.

Sources: OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255*-en; and European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

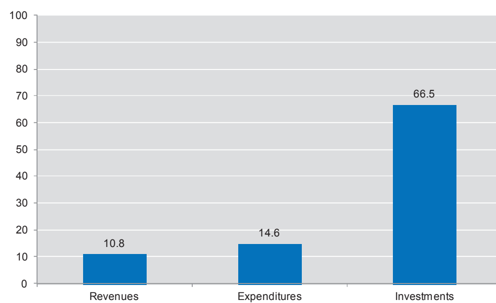
Responsibilities of sub-central governments

Parishes	Municipalities
The parishes have sole responsibility for:	– Health;
– Administration of parish property;	– Culture;
– Registration (electoral register);	– Education;
– Transport (upkeep of local highways).	– Local planning;
The parishes share responsibility with the municipalities for:	– Energy;
– Economic development;	– Local transport;
– Environmental protection;	– Powers shared with parishes.
– Public health;	
– Social welfare (protection of children and the elderly).	

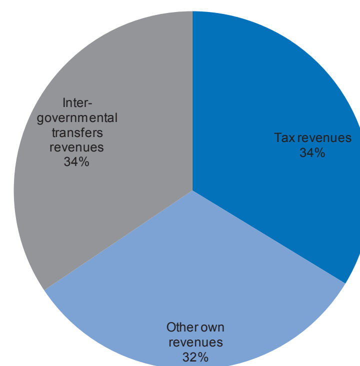
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in Portugal

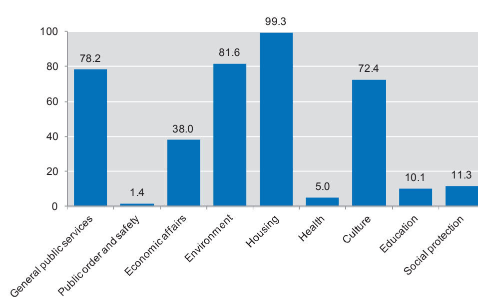
Participation of sub-central governments in total public revenues, expenditure and investments (2009)



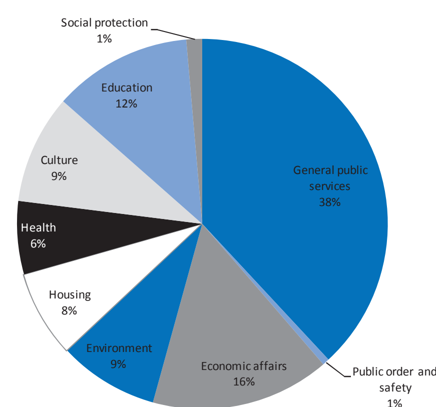
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms[4]

In January 2007, a new Local Finance Law came into force whose objective was to increase the equity and efficiency of sub-central public finances while being financially neutral for the central government. One of the main aims of this reform was to tighten budget constraints and to reduce the revenue dependence of municipalities on immoveable property. In particular, municipalities relied heavily on housing transaction fees as a source of revenue, which gave local governments an incentive to grant building licenses that led to urban sprawl. Another objective was to reduce corruption and other illegal practices at the local level. Finally, the reform aimed at increasing equity by correcting flaws in the previous 1998 Local Finance Law, which were seen as favouring small municipalities over larger ones.

The reform consisted of four elements: *i)* a reform of the revenue mix of municipalities, with an increased municipal share of personal income tax and more tax autonomy, and a reform of the general-purpose grant system; *ii)* new fiscal rules for sub-central governments; *iii)* a reform of the statutory reporting and auditing of accounts, which states that municipal accounts must be consolidated with those of their local public enterprises and submitted to external audit; and *iv)* two institutional reforms (harmonising the rules on fees and prices for local public services, and reforming the law governing municipal-owned companies in order to increase transparency and better regulate their activity).

The recent financial crisis has had a major impact both on the central government and on the sub-central governments. In May 2011, the “Memorandum of Understanding on Specific Economic Policy Conditionality” regarding Portugal was released by the European Central Bank/European Commission/International Monetary Fund (see European Commission, IMF and European Central Bank, 2011). One of the main proposals was to reduce transfers to local and regional governments by at least EUR 175 million in 2012 (i.e. 5% of current transfers) and by EUR 175 million in 2013 and limit the reduction of corporate income tax in autonomous regions to a maximum of 20% compared with the rates applicable in the mainland.

Spain

Institutional framework

Spain is a constitutional monarchy. After the transition to democracy and the adoption of the Constitution of 1978, all the regions in Spain assumed regional autonomy, creating a regionalised state, also known as the *Estado de las autonomías*. Regional and local autonomy is guaranteed by Article 2 and Article 137 of the Constitution.

Levels of government

17 autonomous communities (*comunidades autónomas*) and 2 autonomous cities	The autonomous community's assembly has various names (*Parlamento, Juntas, Cortes, Asamblea regional, Procuradores...*). The assembly is the deliberative body of the community. Its members are elected by direct universal suffrage for a four-year term and exercise devolved legislative power. The Regional Government Council (*Consejo de Gobierno*) is the executive body of the community. It is headed by the president, who appoints its members. It can also regulate and initiate legislation. The president is elected by the assembly. The president manages and co-ordinates the work of the council. S/he also represents the autonomous community to the central government. The two autonomous cities (Ceuta and Melilla) are special administrative units, halfway between a municipality and an autonomous community. Unlike the independent communities, they do not have their own legislative assembly.
50 provinces (*provincias*)	The Provincial Council (*Diputación Provincial*) is composed of members elected by indirect universal suffrage, by and from among the province municipal councillors (*concejales*), for a four-year term. The provincial councils elect the president. The provincial government is the Government Council (*Comisión de Gobierno*). This body is composed of the president and the deputies designated by her/him. The president is elected by the provincial council, holds executive power and heads the government and the administration. The president appoints the vice-presidents within the provincial council.
8 109 municipalities (*municipios*)	The deliberative assembly of the municipality is the Municipal Council (*Pleno*). It is composed of councillors (*concejales*) elected by universal suffrage for a four-year term. This assembly approves the budgets, urban planning, by-laws and municipal rules. The main executive body local is the Government Council (*Junta de gobierno local*). It is composed of elected municipal councillors appointed by the mayor. Their main duties are to assist the mayor but also include some executive functions. The mayor (*Alcalde*) is the head of the executive body. S/he is appointed by the councillors and is assisted by councillors. The mayor chairs the municipal council.

Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

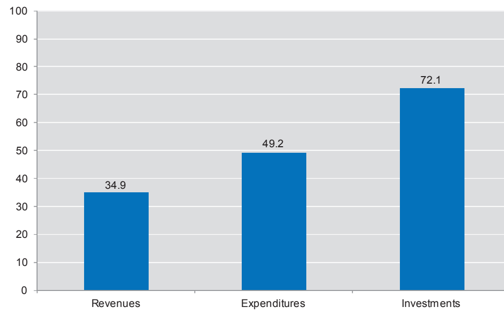
Responsibilities of sub-central governments

Autonomous communities have legislative and administrative competences over:	Provinces	Municipalities
– Urban and regional spatial planning; – Organisation of the institutions of autonomous government; – Economic development; – Transport (roads, waterways, local railways); – Agriculture, forestry and fisheries; – Culture (museums, libraries, monuments); – Social welfare and social services; – Environment; – Health; – Education.	– Co-ordination of municipal services; – Assistance and legal, economic, and technical co-operation with the local authorities; – Protection of supra-municipal services; – Development and administration of the specific interests of the province.	– Environment (household refuse, water supply, sewer system); – Health (public health standards, supervision of food and beverages); – Street lighting; – Transport (urban traffic control); – Public areas (cemeteries, street cleaning, paving).
	Provinces also provide public services that transcend municipal boundaries and offer technical, economic and legal aid, especially to smaller and poorer municipalities.	Municipalities with a population of more than 5 000 inhabitants have additional responsibility for: – Culture and recreation (public libraries); – Environment (green areas); – Local police.
		In addition, municipalities of over 20 000 inhabitants are responsible for: – Social welfare (personal social services); – Fire fighting and fire prevention; – Sports (facilities).
		In addition, municipalities of more than 50 000 inhabitants are responsible for: – Public transport; – Environmental protection.

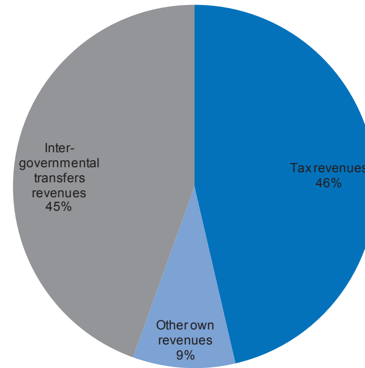
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in Spain

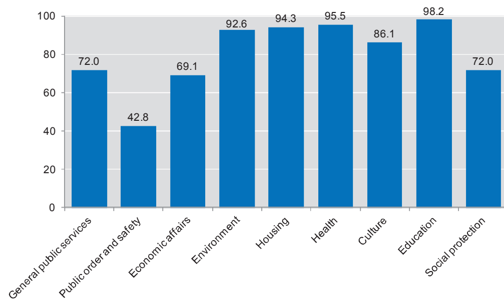
Participation of sub-central governments in total public revenues, expenditure and investment (2009)



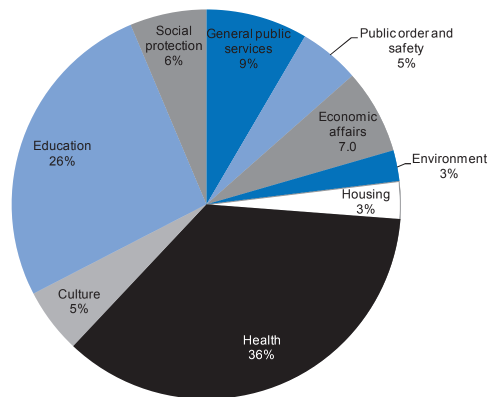
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure,by type of spending (2009)



Distribution of sub-central government expenditures (2009)



Source: *OECD National Accounts*.

Recent and current reforms[5]

After several years of intense negotiations between the autonomous communities and the central government through the Council of Fiscal and Financial Policy (CPFF), a new Financing Law for Autonomous Communities (LOFCA) was passed in December 2009 by the national Parliament and subsequently ratified by all of the autonomous communities. The main elements of the new law are the following:

1. The share of the autonomous communities in shared taxes was raised.
2. Several specific funds were created for different purposes (the Fund to Guarantee Public Services, the Global Sufficiency Fund and two convergence funds: the Competitiveness Fund and the Co-operation Fund).
3. The equalisation scheme was reformed. The previous system of total equalisation, based on a static assessment of relative needs, was changed to a system that only equalises partially, but is frequently adjusted.

4. The criteria for allocating funds to autonomous communities were changed, taking into account an “adjusted population” criterion, i.e. population weighted by age group, area of the autonomous community, dispersion of the population in the autonomous community, island status, etc. This fund is adjusted yearly, taking into account the evolution of these variables. Additionally, a second fund provides resources sufficient for the rest of the responsibilities devolved and guarantees that there are no net losers due to the reform.

Despite the creation of the Territorial Councils of Tax Co-ordination and Management, autonomous communities are still only marginally involved in tax collection. Further involvement might be achieved through bilateral agreements. As under the previous model, some of the main taxes (VAT and special taxes) are distributed among autonomous communities according to indexes calculated by the National Statistics Office (Fitch Ratings, 2010a).

Sweden

Institutional framework

Sweden is a constitutional monarchy and a decentralised unitary state composed of two levels of sub-central governments: counties and municipalities. Local self-government is embedded in the Constitution. In 1991, the New Local Government Act provided greater freedom for municipalities to organise. In 1997 and 2001, two laws provided for regionalisation.

The right of municipal and county councils to impose taxes is set out in the Constitution. While the central government establishes the framework for the competences and resources of localities, both counties and municipalities enjoy general authority for matters within their territory and benefit from the resources that these responsibilities entail.

Levels of government

18 counties (*landsting*) and 2 regions (Skåne and Västra Götaland)	The County/Regional Council (*landstingsfullmäktige*/*regionfullmäktige*) is elected by direct universal suffrage for a four-year term. This assembly takes decisions on matters of principle or major importance. It approves the budget and tax rate. The council can delegate important decision-making power to its executive committee and to other committees. The Executive Committee of the County/Regional Council (*landstingsstyrelsen*/*regionstyrelsen*) is composed of members elected by the County/Regional Council. It has executive and co-ordinating functions and monitors the activities of the other committees. It drafts the budget of the council. The Executive Committee prepares and implements decisions taken by the council and is presided over by the leader of the majority party. The specialised committees (*nämnd*) are composed of members elected by the County/Regional Council. The committees are responsible for preparing items for final decision by the council, and for the administration and implementation of decisions.
290 municipalities (*kommuner*)	The Municipal Council (*kommunfullmäktige*) is composed of members elected by direct universal suffrage for a four-year term. This assembly makes every important decision in the municipality, levies taxes and adopts the budget. The council can delegate important decision-making powers to its Executive Committee and to other committees. The Municipal Executive Committee (*kommunstyrelsen*) is composed of members elected by the Municipal Council. The committee prepares and implements decisions taken by the council. It has executive and co-ordinating functions and monitors the activities of the other committees. It drafts the budget of the municipality and is presided over by the leader of the majority party. The specialised committees (*nämnd*) are composed of members elected by the Municipal Council. The committees are responsible for preparing items for final decision by the council, and for the administration and implementation of decisions.

Sources: OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*; and European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

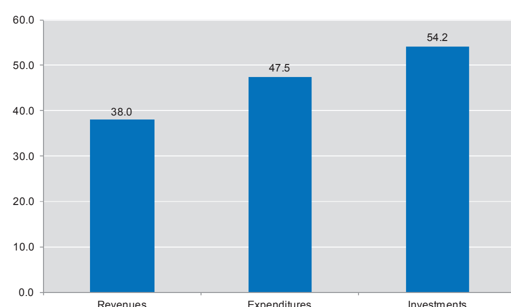
Responsibilities of sub-central governments

Regions	Municipalities
– Health (the counties are responsible for the national health care system); – Regional development strategy; – Transport (planning of regional public transport); – Regional economic support; – Culture.	– Culture and recreation; – Transport (local roads; public transport); – Public areas (public parks); – Economic development (energy supply); – Social welfare (care for the elderly and disabled, social services, schools, child care); – Local planning; – Housing; – Emergency and rescue services; – Health (environmental health); – Environment (waste management, water and sewage); – Police (public order and safety).

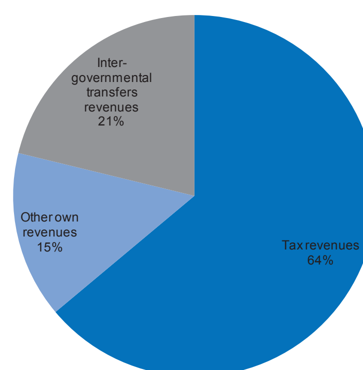
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in Sweden

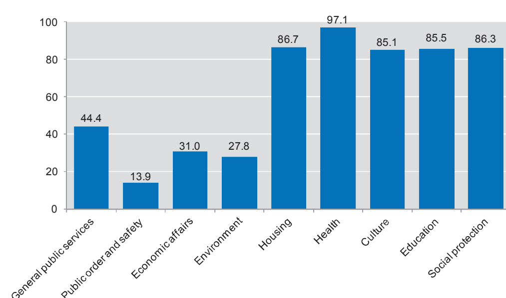
Participation of sub-central governments in total public revenues, expenditure and investments (2009)



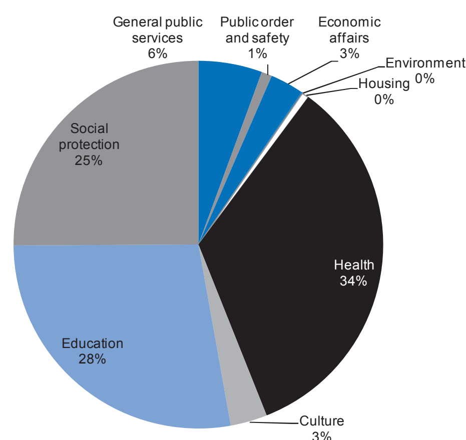
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms

In the past two decades, several reforms have affected the areas of municipal responsibilities. Some of these reforms consist of decentralisation measures; others are "re-centralisation" reforms.

In 1991, a first reform reorganised the Swedish school system. Until that year, the school system was heavily centralised. There were strict central government regulations and controls, centrally employed teachers and a system of intergovernmental grants that were earmarked for specific categories of school spending. Municipalities had little freedom to allocate expenditures on different items within the school system. The decentralisation reform started in 1991, with the main change being that municipalities could freely allocate their money across schools and items within schools.

In contrast, in 1998, a "race to the bottom" in the setting of welfare benefit levels between municipalities led the Swedish Government to centralise social welfare services by setting mandatory minimum allowance levels.

In 1992 and 2002, two reforms imposed a cap on user fees that the municipalities could set regarding care of the elderly and child care. Prior to these reforms, the fees varied considerably among municipalities. The new fee system specified an upper limit to enhance financial discipline in municipalities and achieve horizontal equity among families (Blom-Hansen, et al., 2010).

United Kingdom[6]

Institutional framework

The United Kingdom is a constitutional monarchy without a codified Constitution. It is a multi-national state consisting of England, Scotland, Wales and Northern Ireland. England is a unitary state, whereas Scotland, Wales and Northern Ireland are governed under a system of devolution that allows the central government to intervene in all areas and even abolish the devolved institutions. This is the consequence of the lack of a codified Constitution or a separate category of constitutional law. There are 34 shire counties in England, divided into districts. London is divided into 32 London boroughs and the City of London. Councils in shire counties may ask to be made unitary authorities, and several of these are under consideration. Local authorities in England can opt for one of the four following models of management: *i)* a mayor and cabinet; *ii)* a council leader and cabinet; *iii)* a mayor and council manager; *iv)* a traditional committee-based system.

Levels of government in the United Kingdom

3 Parliaments (in Scotland, Wales and Northern Ireland)	The Scottish Parliament is elected by a mixed proportional representation system. Seventy-three members are elected in constituencies by the "first past the post" system. A further 56 members are elected by proportional representation on closed party lists in 8 regional constituencies. The First Minister is elected by Parliament and heads the Scottish Government of ministers. All must be members of Parliament. The National Assembly for Wales is elected by a mixed proportional representation system. Forty members are elected in constituencies by the "first past the post" system. Twenty members are elected by proportional representation on closed party lists in regional constituencies. The First Minister is elected by the Assembly and heads the Welsh Assembly Government. The Northern Ireland Assembly is elected by proportional representation and includes all the main parties. It is headed by a First Minister and a Deputy First Minister drawn from the largest and second largest parties, respectively.
The Greater London Authority	The Greater London Authority is considered a regional authority. It has an assembly of 25 elected members elected by a mixed proportional representation system. Fourteen are elected in constituencies by first past the post, and 11 by proportional representation across the whole of London on party lists. The mayor of London is directly elected on the alternative vote system.
34 counties, 238 non-metropolitan district councils, 36 metropolitan district councils, 46 "unitaries"	All councils are elected in single-member districts by first-past-the-post. Councillors are elected for four years. In some councils, the whole council is renewed every four years.

Source: Council of European Municipalities and Regions (n.d.), "Local and Regional Structures in the United Kingdom", Council of European Municipalities and Regions, Paris and Brussels, *www.ccre.org/royaume-uni_en.htm*.

Responsibilities of sub-central governments

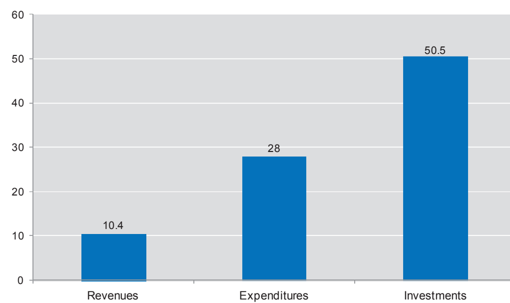
Counties	Districts
– Education (primary and secondary); – Transport (traffic, public transport, highways); – Social welfare (personal social services); – Environment; – Culture and recreation (libraries, museums, parks and recreation facilities); – Consumer protection; – Fire services and emergency planning; – Planning; – Police.	– Housing; – Environment (environmental health, measures to reduce pollution); – Housing and building regulations; – Local planning; – Culture and recreation (museums, parks and recreation facilities); – Electoral registration.

Note: Unitary authorities combine the competences of county and district councils.

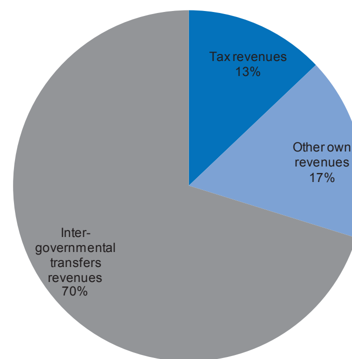
Source: European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fiscal relations across levels of government in the United Kingdom

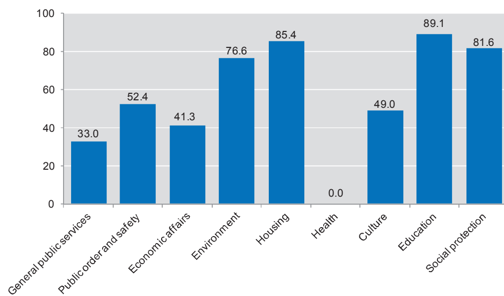
Participation of sub-central governments in total public revenues, expenditure and investments (2009)



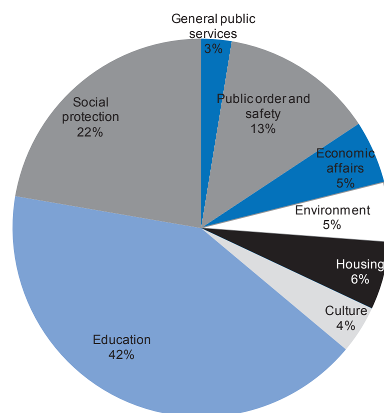
Sources of sub-central government revenues (2009)



Participation of sub-central governments in total public expenditure, by type of spending (2009)



Distribution of sub-central government expenditure (2009)



Source: *OECD National Accounts*.

Recent and current reforms

Several laws have modified the United Kingdom's system of government in recent years. The Scotland Act (1998) established the Scottish Parliament. The Government of Wales Act (1998) established the National Assembly for Wales. The Northern Ireland Act (1998) established the Northern Ireland Assembly. The Greater London Authority Act (1999) established the Greater London Authority and provided for the direct election of the mayor of London. Applying to England and Wales, the Local Government Act (2000) provided for a stronger executive authority and gave local authorities the power to promote well-being. The Governance of Wales Act (2006) extended the power of the National Assembly for Wales and gave it some legislative competences (see European University Institute, 2008).

In May 2010, the newly elected Conservative/Liberal Party government took a series of measures to control spending at the sub-central government level. These included a GBP 780 million (EUR 680 million) cut in the Department for Communities and Local Government, a GBP 1.2 billion (EUR 1.05 billion) reduction of local authority grants and the removal of a GBP 1.7 billion (EUR 1.5 billion) earmarked grant to local governments. The final plans set out in the 2010 Spending Review imply that departmental expenditure limits (DELs) – i.e. the annual limits for departmental programme expenditure – would, on average, be reduced from their 2010/11 level by 11.7% in real terms by 2014-15 (Institute for Fiscal Studies, 2011). Besides, the "local government" budget and the "communities" budget of the Department for Communities and Local Government (DCLG) are predicted to see substantial cuts, of 27.3% and 67.8%, respectively, by 2014/15 (Institute for Fiscal Studies, 2011).[7]

Notes

1. For more information on the recent reform in Finland, please refer to Annex 2.1A and to the country note in Blöchliger and Vammalle (2011).
2. Articles D. 1 511-32 through D. 1 511-34 of the *Code Général des Collectivités Territoriales*.
3. For more information on the recent reform in Italy, please refer to Annex 2.1A and to the country note in Blöchliger and Vammalle (2011).
4. For more information on the recent reform in Portugal, please refer to Annex 2.1A and to the country note in Blöchliger and Vammalle (2011).
5. For more information on the recent reform in Spain, please refer to Annex 2.1A and to the country note in Blöchliger and Vammalle (2011).
6. The Secretariat is thankful to Mr. Dudley Stephen Wyber (UK Permanent Delegation to the OECD) for commenting on this section.
7. The "Local Government" DEL includes the revenue support grant, national non-domestic rates (property taxes) and related grants to local authorities in England that support services that are typically the responsibility of other government departments. The "Communities" DEL includes the department's main programme expenditure and administration costs.

Bibliography

Blöchliger, H. and C. Vammalle (2011), *Reforming Fiscal Federalism and Local Government: Beyond a Zero-Sum Game*, OECD Publishing, Paris.

Blom-Hansen, J., L.-E. Borge and M. Dahlberg (2010), "Local Government in Denmark, Norway and Sweden", in Moisio, Antti (ed.), *Local Public Sector in Transition: A Nordic Perspective*, VATT Publications.

Council of European Municipalities and Regions (n.d.), "Local and Regional Structures in the United Kingdom", Council of European Municipalities and Regions, Paris and Brussels, *www.ccre.org/royaume-uni_en.htm.*

Direction Générale des Collectivités Locales (DGCL) (2011), *Les collectivités locales en chiffres 2011*, DGCL, Ministry of Interior, Paris, *www.dgcl.interieur.gouv.fr/sections/a_votre_service/statistiques/collectivites_locale*.

European Commission IMF and European Central Bank (2011), "Portugal: Memorandum of Understanding on Specific Economic Policy Conditionality", 3 May, *www.anmp.pt/anmp/doc/Dsg/2011/Memorando-FMI_BCE_CE1230044.pdf*

European University Institute (2008), *Study on the Division of Powers between the European Union, the Member States, and Regional and Local Authorities*, European University Institute, Florence.

Fitch Ratings (2009), "Business Tax Abolition: Potentially Adverse Impact on French LRGs", 7 May.

Fitch Ratings (2010a), "Spanish Autonomous Communities' New Funding System", 21 April.

Fitch Ratings (2010b), "2011 Outlook: Fiscal and Operational Challenges Remain for European Sub-nationals", 13 December.

Institute for Fiscal Studies (2011), *The IFS Green Budget*, The Institute for Fiscal Studies, London, February, *www.ifs.org.uk/budgets/gb2011/gb2011.pdf*.

Moisio, Antti, Heiki Loikkanen and Lasse Oulasvirta (2010), "Public Services at the Local Level – The Finnish Way", in Moisio, Antti (ed.), *Local Public Sector in Transition: A Nordic Perspective*, VATT Publications.

OECD (2010), *Regional Development Policies in OECD Countries*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264087255-en*.

OECD (2011), *Making the Most of Public Investment in a Tight Fiscal Context: Multi-Level Governance Lessons from the Crisis*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264114470-en*.

Pola, Giancarlo (2010), “Italy Out of the Crisis: More Centralised or Federated?”, *L’Europe en formation*, No. 358.

United Cities and Local Governments (2007), *Country Profile: Republic of Korea*, Barcelona.

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

KOREA INSTITUTE OF PUBLIC FINANCE (KIPF)

The Korea Institute of Public Finance (KIPF), a government research institution established in July 1992, specialises in high-quality policy-oriented research and analyses in all aspects of taxation and public finance. The institution provides policy recommendations to assist the government in formulating national tax, fiscal, and SOEs policies through systematic and scientific research.

Since its foundation, KIPF has played a significant role in the development of tax and budget policies and in the improvement of tax administration. Also, with the opening of the Research Center for State-Owned Entities in 2009, substantial changes and improvements have been made in the management policies of state-owned enterprises. The team of economic and public policy experts at KIPF strive to develop strategic insights to provide more innovative and effective tax, fiscal, and SOEs policies. KIPF publishes detailed research studies and analyses in various forms such as books, research papers, policy papers, and policy reference manuals.

OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(42 2011 24 1 P) ISBN 978-92-64-16689-9 – No. 59877 2012

OECD Fiscal Federalism Studies

Institutional and Financial Relations across Levels of Government

The OECD Fiscal Federalism Series presents policy analysis of, and statistics about, intergovernmental fiscal relations and state/regional and local public finance. It draws on the work of the OECD Network on Fiscal Relations across Government Levels and of other OECD bodies covering these areas.

Contents

Introduction

Part I. Managing institutional and financial relations across levels of government in times of economic and financial turmoil

Chapter 1. A sub-central government perspective on fiscal policy in a tight fiscal environment

Chapter 2. The political economy of fiscal decentralisation

Part II. Institutional and financial relations across levels of government: information on countries

Chapter 3. Financial resources, expenditures and debt of sub-central governments

Chapter 4. Country notes

Further reading

Reforming Fiscal Federalism and Local Governmet: Beyond the Zero-Sum Game (2012)

OECD Regional Outlook: Building Resilient Regions for Stronger Economies (2011)

Making the Most of Public Investment in a Tight Fiscal Environment: Multi-level Governance Lessons from the Crisis (2011)

OECD Regions at a Glance (2011)

Please cite this publication as:

OECD/KIPF (2012), *Institutional and Financial Relations across Levels of Government*, OECD Fiscal Federalism Studies, OECD Publishing.
http://dx.doi.org/10.1787/9789264167001-en

This work is published on the *OECD iLibrary,* which gathers all OECD books, periodicals and statistical databases. Visit ***www.oecd-ilibrary.org***, and do not hesitate to contact us for more information.

OECD*publishing*
www.oecd.org/publishing

ISBN 978-92-64-16689-9
42 2011 24 1 P

9 789264 166899