FISCAL RELATIONS ACROSS GOVERNMENTAL LEVELS
EXPERIENCE IN OECD COUNTRIES

By Isabelle Joumard
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FISCAL RELATIONS ACROSS GOVERNMENTAL LEVELS  
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Isabelle Joumard

Introduction

1. OECD economies face the common challenge of raising efficiency in the public sector. In this regard, well-functioning fiscal relations between central and sub-central governments are important. In principle, decentralisation can make governments more accountable, allowing a better matching of resources to preferences. It may also introduce competition across jurisdictions and thus raise public sector efficiency. Political factors also often militate for decentralisation since, by bringing government closer to the people, it can strengthen the local democratic process.

2. Despite its apparent advantages, devolution has not proceeded evenly over the past two decades and the current state of central-local relations among OECD countries remains very heterogeneous. This may be because decentralisation can entail efficiency losses and/or make it difficult to implement redistributive policies. The weight given to nationwide policy objectives, including distributional ones, may differ across countries. A forward-looking perspective is also required, in particular since the fiscal consequences of population ageing may have different impacts across government levels, while increasing trade and financial integration as well as people mobility may change the balance between positive and adverse effects of fiscal decentralisation.

3. In Japan, the salient features of fiscal relations across levels of government are:

   • A very high share of local governments in general government spending (40 per cent in 2001). Using this indicator, Japan stood fourth among OECD countries (after Denmark, Canada, and Sweden) and before several federal countries (including Austria, Belgium, Germany and the United States). The fragmentation in the provision of publicly-funded services has, however, made it difficult to exploit scale economies, with many municipalities being considered to be too small to be efficient.

   • Local government share in general government revenue is much lower (at 26 per cent in 2001), restraining subnational government ability to respond to local citizens’ preferences, and thus minimising local government accountability. Although de jure local governments have some powers to set local tax rates, de facto most of them have applied the standard tax rates embedded in the national law. Some features of the grant system and access conditions to the bond market have been considered as factors limiting the effective autonomy of local governments in setting local tax rates.

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1. I am indebted to Per Mathis Kongsrud for letting me use part of the work we previously carried out in tandem. I also thank Jørgen Elmeskov, Michael Feiner, Hideyuki Ibaragi and Jørgen Lotz for their valuable comments. The information presented in this paper partly draws on OECD’s recent work on public spending and tax systems which have been reviewed in in-depth chapters in OECD Economic Surveys for more than half of the OECD countries. The opinions expressed in this paper, however, remain my own.
The fiscal gap (i.e. the gap between local government spending responsibilities and revenue-raising powers) is high by international standards. Intergovernmental grants play an extensive role in closing this gap. They have contributed to secure equity in access to public services throughout the country and have been used to promote specific spending areas by local governments – in particular infrastructure. Some doubts have, however, been raised about the impact of these grants on subnational government efficiency and fiscal sustainability.

Local government debt has edged up over the past decade to reach about one-third of GDP in the early 2000s.

Some of these features are shared by several OECD countries and this paper addresses the issues, and strategies to cope with them, which have arisen there and could be relevant in the Japanese context.

Outline and summary of the paper

The first section describes recent trends in decentralisation. On the basis of public finance data, devolution has not proceeded evenly in the OECD area over the past two decades. The subnational government share of public spending has increased in a majority of countries. However, central governments have increasingly countered this tendency by imposing norms and minimum quality standards on the public goods provided locally. And, on the revenue side, the subnational government share in general government revenues (excluding grants) has failed to keep pace with developments on the spending side and even declined in several OECD countries.

The second section examines spending assignment across levels of government and the practical issues which have emerged when public goods are provided locally. The main question is how can subnational government tailor the supply of public goods to local preferences while ensuring efficient provision and the fulfilment of distributional objectives? The paper recognises that allocative and cost efficiency gains may be difficult to attain in a decentralised setting, for two main reasons. First, economies of scale may prevail in supplying some goods and services currently under the responsibility of subnational governments in a number of countries (e.g. in hospital care and tertiary education). Second, public goods and services provided locally may have spillover effects on other jurisdictions (e.g. education, labour market programmes and infrastructure development may affect other jurisdictions and, more generally, the growth potential of the country). Failure to account for spillover effects may result in sub-optimal public good provision. A similar risk emerges when spending and financing responsibilities overlap -- as is often the case in health care, labour market and social assistance programmes -- so that a given level of government may try to minimise its costs at the expense of another. To counter these incentive problems and exploit scale economies, central governments have sometimes encouraged subnational governments to merge (often against fierce political resistance), but optimal boundaries may vary significantly between services. The alternatives to exploit scale economies are joint provision of public services or co-operation approaches, the latter displaying attractive features which merit greater consideration in several countries.

The third section looks at how financing schemes for subnational governments should be designed in order to allow them to respond to local preferences without creating efficiency concerns and compromising distributional objectives nationwide. Designing funding principles for subnational government raises difficult issues and trade-offs. It is often argued that revenue-raising powers should match spending responsibilities, so as to allow subnational governments to tailor the supply of public goods to local citizens’ preferences and their willingness to pay, and hence to be held accountable. However, there are few taxing powers which can be transferred to subnational governments without

4. Some of these features are shared by several OECD countries and this paper addresses the issues, and strategies to cope with them, which have arisen there and could be relevant in the Japanese context.
raising efficiency and/or distributional concerns. Intergovernmental grants have also a role to play, though their design is of paramount importance to avoid conflict between various objectives, namely efficiency, fiscal discipline and equity. Earmarked grants have been used extensively to minimise the risk of sub-optimal spending in domains characterised by significant spillover effects or to secure minimum standards for specific services. However, co-financing rates above levels which effectively account for spillover effects have often resulted in excessive spending, accompanied by poor cost effectiveness. Given these problems, there has been a move towards general purpose (block) grants, which often entail some elements of redistribution across jurisdictions. Fiscal equalisation schemes can promote economic efficiency by avoiding that regional disparities become self-perpetuating and by creating the ground for a fair and effective fiscal competition. However, they may also impede changes in cost differentials and hinder regional adjustment by creating “poverty traps”.

8. The fourth section evaluates the arrangements required to achieve consistency between subnational government fiscal strategies and overall macroeconomic policy objectives. Countries have relied on a wide array of strategies. In some countries where subnational governments do have some fiscal autonomy, fiscal rules (e.g. a balanced budget requirement) have been imposed. In others, mainly federal countries, fiscal co-ordination has been reinforced through co-operative arrangements. Taking another approach, some countries have relied on market mechanisms to secure fiscal discipline. Despite these efforts, some problems have emerged. Subnational governments have experienced fiscal slippages in a number of countries and/or have implemented a pro-cyclical fiscal policy. These problems may indicate a need for revisiting and strengthening the fiscal framework. In several countries, improving the availability, consistency and timeliness of subnational government public finance data is a prerequisite.

Forces shaping fiscal relations across government levels and recent trends

Extent of decentralisation

9. For a number of reasons, assessing the degree of fiscal decentralisation and drawing cross-country comparisons are difficult. Fiscal autonomy has several dimensions – in particular, the authority to decide on the level and composition of spending, revenues and borrowing – which often interact and which are not always easy to rank. Furthermore, relevant data which can be used for international comparisons are seldom available. Against this background, looking at indicators derived largely from national accounts data (Table 1) suggests that:

- As measured by the share of subnational governments in general government spending and revenue, the degree of decentralisation varies significantly across OECD countries.

- The institutional structure of a country -- whether or not it is recognised as a federal country -- does not directly correspond with the spending and revenue share of subnational governments. Subnational governments in some unitary countries are allocated a larger share of public spending than in those identified as federal countries. Public finance indicators for instance suggest that Denmark and Sweden — recognised as unitary countries -- are more “decentralised” than Germany, Mexico and the United States.

- In all countries, subnational government spending shares widely exceed their revenue share, pointing to the wide use of intergovernmental transfer schemes.
## Table 1. Indicators of fiscal decentralisation

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<tr>
<th>Subnational government spending and employment</th>
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<td>20.1</td>
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1. Excluding the transfers paid to other levels of government. National Accounts data.
2. Excluding transfers received from other levels of government and including tax sharing arrangements. National Accounts data.
4. Or earliest year available: 1986 for Ireland; 1987 for the Netherlands and the United Kingdom; 1990 for Canada, Japan, Luxembourg and Norway; 1991 for Germany; 1993 for Sweden; 1995 for Austria, Belgium, Denmark, Finland, Greece, Portugal and Spain.
7. Or latest year available: 1998 for Greece and Italy; 1999 for France, 2000 for Austria, Germany, the Netherlands, Poland and Turkey.
8. Or latest year available: 2000 for Austria, Germany, the Netherlands, Poland and Turkey.
9. Or latest year available: 2001 for Austria, Germany, the Netherlands, Poland and Turkey.
10. Public sector employment data are registered in full time equivalent.
11. Data based on SNA68 methodology.
12. The share in general government revenues is expressed in per cent of mainland government revenues.

Information derived from public finance data would, taken at face value, lead to a significant overstatement of the degree of fiscal autonomy of subnational governments in many countries. On the spending side, such data do not give an accurate picture of where responsibilities lie. The effective power of subnational governments to manage the programmes under their responsibility is often quite limited, with the central government increasingly engaged in setting standards and/or micromanaging subnational government implementation of various sectoral policies (Austria, Denmark, Germany and Norway). The education sector provides an illustration. Subnational governments are responsible for providing non-tertiary education in an increasing number of countries. However, in many cases the central government sets the curriculum, trains teachers and/or sets wages (Italy, Mexico and Norway). Standards in health care provision are also frequent in many countries. The way intergovernmental grants are specified can further influence subnational government spending behaviour. Earmarked grants in particular are often designed to influence subnational government decisions and promote government spending in specific areas. Unfortunately, internationally consistent information on both the total amount of intergovernmental grants, and the breakdown between block grants and earmarked grants, is lacking.
11. Indicators of revenue share allocated to lower levels of government do not provide accurate information on their effective revenue-raising powers. Limits on subnational government discretion to determine tax rates and tax bases significantly reduce local fiscal autonomy. Few synthetic indicators exist on subnational government effective autonomy to set tax bases and rates. Information based on an OECD survey for 1995, however, revealed that such taxing powers are rather restricted in several countries -- including Austria, Germany, Mexico and Norway (Table 2). Furthermore, in some countries, subnational governments have some de jure autonomy to set the tax bases or rates but rarely use it (including Finland, Japan, Korea, Norway and Spain). The benefits from an active use of local taxing powers may be reduced by discretionary elements in the grant system (Norway) and its redistributive nature (Austria and Germany, where the local business tax proceeds are partly shared across jurisdictions). National regulations applying to the scope and level of user charges (e.g. in the education sector) further restrict subnational government revenue-raising powers.

Table 2. Subnational government taxing powers in selected OECD countries

<table>
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<tr>
<th>Subnational government taxes relative to:</th>
<th>Discretion to set taxes</th>
<th>Summary indicator of taxing powers</th>
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<td>GDP</td>
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1. The countries are ranked in descending order according to the value of the summary indicator of taxing powers.
2. The figures show the percentage of their total taxes for which subnational governments hold full discretion over the tax rate, the tax base, or both the tax rate and the tax base. A value of 100 designates full discretion.
3. The summary indicator is the product of the ratio of subnational government taxes to GDP and the degree of discretion to set taxes. Thus, it measures subnational government taxes with full discretion as a percentage of GDP.

2. Information on the degree of subnational taxing power for 19 OECD countries in 1995 was published in OECD (1999). Fiscal discretion is considered as greatest if subnational governments are free to determine both the taxable base and the rates of a particular tax, without any limits on revenues, base or rate enforced by the central government. Since 1995 however, subnational government discretion has changed significantly in a number of countries. In particular, Spanish and Belgian regions have been granted more discretion in setting tax rates and rebates, in particular on the personal income tax base, while Mexican States are, since 2002, allowed to levy a retail sales tax and to add a surcharge on the individual income tax under specific regimes. Similar data have been produced for Estonia, Latvia and Lithuania for 1997 and 1999 (OECD, 2002a).
Recent trends

12. Subject to the above caveats, two contrasting trends emerge from aggregate public finance indicators.

- On the spending side, the subnational government share has increased in a majority of countries, but by no means all, over the past 15 years (Figure 1). The rising share partly reflects new responsibilities assigned to them (health care and/or non-university education in Italy, Mexico and Spain; active labour market policies in Canada in 1996; primary education in Hungary; and the management of some welfare programmes in Korea).³

- The subnational government share in general government revenues (both total revenues and tax revenues) has not increased commensurately, thus resulting in a larger “fiscal gap” (defined as the difference between subnational government spending responsibilities and their revenue-raising powers). In a number of countries, subnational governments have been granted increased autonomy to set tax bases or rates (such as regional governments in Belgium, Mexico and Spain). However, in other instances, effective taxing powers have been restricted, in particular at the local level (France and Germany).⁴

³ The decline in local government share in Japan over the 1990s cannot be attributed to a shift in responsibility from local government to the central tier. In fact, local government spending as a share of GDP increased slightly but this was accompanied by a substantial increase in social security spending as a share of GDP.

⁴ In France, the local business tax and one property tax (Taxe d’habitation) -- which accounted for the bulk of the municipalities’ tax revenues and over which they have had significant effective taxing powers -- are gradually phased out and replaced by central government grants. In Germany, the abolition of the business turnover tax in the late 1990s reduced municipalities’ effective taxing powers.
13. The increasing fiscal gap seemingly conflicts with the traditional view that the benefits from fiscal decentralisation arise when the costs of providing local public goods are borne locally (Box 1), at least at the margin. However, it may reflect an unavoidable tension between proliferating local spending demands and a scarcity of tax instruments with the correct characteristics for being levied locally. This tension has been reinforced by several forces, which are likely to continue to shape fiscal relations across government levels. One of these is that subnational governments may sometimes be more eager to take over new spending responsibility than taxing powers, as they would have to bear the political cost of raising taxes.

Box 1. Arguments in favour of local provision and financing

Several arguments in favour of fiscal devolution have been developed in the literature, supporting the idea that the provision of public goods and its financing should be assigned to the lowest level of government with the capacity to achieve objectives. These arguments include:

Response to local preferences. The traditional theory of fiscal federalism contends that the central government should have the basic responsibility for macroeconomic stabilisation functions, national public goods (such as defence) and income redistribution in the form of assistance to the poor (Oates, 1972). However, a “one-size-fits-all” approach may not deliver a basket of public goods that is optimal for all citizens. By being closer to local citizens, subnational governments are, in principle, better placed to respond to their preferences in term of local public goods, to assess willingness to pay and to target services at the right people. Hence, “Pareto efficiency” could be raised -- i.e. resources can be saved without making anyone worse off -- through fiscal decentralisation. Keeping incentives right does not necessarily entail an exact match between spending and revenue-raising powers at each level of government. Central government grants can play a role in subnational government finances without jeopardising incentives. One important condition, however, is that grants do not
accommodate extra spending decided upon by subnational government, leaving the cost of a marginal change in local spending to be borne locally.

*Increased government accountability* may enhance the efficiency gain. Since local officials can be easily identified by voters and taxpayers, they are expected to be more accountable, especially if the costs of providing public services are borne locally. Being closer to residents may, however, trigger decisions that favour particular individuals or groups, while the public interest sometimes takes a back seat (Tanzi, 1995). Where there is inadequate capacity for the population of some jurisdictions to hold their governments accountable through internal checks and balances, this could spill over into corrupt practices, though evidence of a link between the degree of decentralisation and the level of corruption amongst public officials remains mixed.

**Introducing competition across jurisdictions.** Diversity in fiscal packages offered by subnational jurisdictions -- in terms of quantity and quality of public goods and the associated tax burden -- may introduce some competition across jurisdictions, and thus incentives for governments to raise public sector efficiency. Competition between jurisdictions relies on the assumption of mobile citizens ("citizens vote with their feet"). In practice, several factors limit the mobility of citizens, in particular in European countries, especially taxes on property transactions and other rigidities in the housing sector. Moreover, tax competition in areas where the tax base is mobile may be seen as weakening tax capacity. The introduction of competitive pressures across subnational jurisdictions has thus increasingly come to be seen as dependent on informational channels. Some countries (including Scandinavian) have developed high-quality information to enable citizens to benchmark the performance of their administration against others and to allow local governments to identify best practices.1

**Supply-side efficiency.** Decentralisation may allow for experimentation in the management of public responsibilities (Oates, 1999). In some decentralised countries, subnational governments have taken the lead in designing innovative measures to increase public spending effectiveness. In Spain for instance, some regional pilot programmes focusing on containing pharmaceutical costs and reducing public hospitals’ waiting lists have shown promising results (OECD, 2000a). In Switzerland, new public management principles have been introduced by some cantons and communes and later replicated at the Confederation level. In many countries however, an information-sharing forum is lacking, reducing the benefits of these experimentation gains.

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1. Norway and Sweden have developed a comprehensive dataset, available on Internet, providing indicators on the coverage and costs of public services for each municipality.

**Forces shaping fiscal relations across government levels**

14. The forces underlying the above trends are both economic and political and derive from domestic and international sources. At a macroeconomic level, they include the efforts to involve local authorities in the drive for fiscal consolidation and to distribute the burden of population ageing, which will result in higher national and subnational government spending without adding to the resource base. The process of globalisation has also had an impact, increased international co-operation having a counterpart in a decentralising tendency emanating from a heightened cultural awareness at local and regional levels. Indeed, the political dimension inherent in the decentralisation process is as important as economic factors to an understanding of developments in central/sub-central relationships.

**Globalisation has had a centralising effect...**

15. Increasing trade and financial integration has made for increased centralisation, particularly on the revenue side. Competitiveness concerns associated with cascading turnover and retail sales taxes have reinforced the attractiveness of value added tax systems. Several countries (including Australia, China and Switzerland) have recently moved away from turnover and/or retail sales taxes – some of them formerly under the responsibility of subnational governments – towards value added tax systems managed by the central government. Furthermore, enhanced international co-operation in tax policy has been seen as an option to counteract the erosion of internationally mobile tax bases, in particular corporate and financial income. Some of the recent international agreements can be seen as
impinging on the tax autonomy of subnational governments. As an illustration, the EU Code of conduct for business taxation identified 66 harmful tax measures, some of them being implemented by subnational governments.\(^5\)

... but regional disparities remain marked...

16. The reduction of trade barriers, by increasing opportunities to exploit scale economies and potential agglomeration benefits, may have heightened regional income disparities, creating tensions in fiscal equalisation schemes.\(^6\) As an illustration, recent evidence suggests that the convergence in per capita income among countries in the EU has not been paralleled by a convergence across regions. Indeed, variations in inter-regional per capita income have increased, for example in Italy, West Germany and France (Decressin, 2002). Within regions, also, urban and intermediate areas are likely to benefit most from increased trade openness since they offer various key resources (including proximity to markets, quality and availability of labour and efficient transport and network systems). Regions with a low population density, a lack of critical mass and geographical isolation may benefit least.\(^7\) Dealing with increased regional income disparities may, in turn, call for a greater central government role, since it is typically involved in redistribution.

... with greater local and civic awareness...

17. Against a background where wider international considerations and bodies are increasingly shaping local economic conditions, the awareness of regional, local and civic identities has tended to grow, providing a momentum towards decentralisation in a number of countries. Empowering subnational governments with more responsibilities, by bringing government closer to the people, is seen as strengthening the local democratic process following a period when civic involvement in decision-making tended to be weak or even declining. Elected subnational authorities have been established recently in several countries. In Italy, the Parliament voted for the direct election of mayors and presidents of provinces in 1993. In Korea, subnational government representatives are no longer nominated by the central government since 1995, but are elected locally. In Ireland, two regional assemblies were created in 1999 and in the United Kingdom, a new Parliament and elected assembly, respectively, were established in Scotland and Wales.

...and rising benefits of a decentralised setting when economies mature

18. The potential benefits of, and issues related to, fiscal federalism may increase as economies develop. Several factors are at play. First, income growth may spur the demand for a more diversified basket of public goods or, put differently, the “one-size-fits-all” approach may increasingly fail to deliver a basket of public goods that is optimal for all citizens. Second, the rise in human capital (in particular higher educational attainment) has raised the ability of local citizens and their

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5. Among the 66 harmful tax measures (which unfairly encourage businesses to locate in one EU country at the expense of another) identified by the EU Code of Conduct groups were: the Aland Islands Captive Insurance regime in Finland, the Basque country and Navarra co-ordination centres in Spain and the Santa Maria (Azores) Free Zones in Portugal.

6. Such a process of agglomeration and regional specialisation has been discussed by Krugman (1993) and Krugman and Venables (1993). New growth theories argue that positive externalities at the local level generate increasing returns on investment, such that capital and other production factors are likely to flow to the most advanced regions, leaving poorer regions further behind.

7. A discussion on the likely uneven regional distribution of the benefits of trade liberalisation (WTO accession) for China is provided in OECD (2002b) and for Brazil by Haddad et al. (2002).
representatives to efficiently manage local affairs and participate in the nation’s decision process. Third, the spread of new information and communication technologies, together with more efficient transport modes, may increase the mobility of citizens across jurisdictions. Increased mobility of people may reinforce competitive pressures on subnational government to deliver good public services at low cost. It also reinforces spillover-related issues and the need for co-ordination mechanisms to mitigate their potential adverse effects (e.g. how to share the cost of transportation infrastructure between city centres and residential suburb areas? How to account for students residing in one jurisdiction but attending schools or universities in another?).

Fiscal consolidation has brought the need for co-ordination…

19. This momentum towards decentralisation has coincided with a period when the limits on available fiscal resources have become increasingly constraining. Fiscal consolidation efforts have significantly influenced fiscal relations across government levels, as governments have sought to apportion the pain of retrenchment. While changes in fiscal balances since the early 1990s indicate that central governments have contributed most to fiscal consolidation (Figure 2), cuts have often been effected by devolving spending responsibilities to lower levels of government without providing commensurate financial resources. Central government grants to subnational governments have also sometimes been reduced. In the United States for instance, through much of the 1990s, Congress kept a tight rein on grants to the states, while state income tax revenues increased rapidly. In Canada, the large cuts in federal expenditures included substantial ones in federal transfers to the provinces.

![Figure 2. Central government contribution to fiscal consolidation efforts](chart)

1. Financial balances used to measure fiscal consolidation efforts are not cyclically-adjusted since no such data exist for central government.

Source: OECD Economic Outlook, No. 73, June 2003.

20. Fiscal consolidation efforts have also made it necessary to reinforce co-ordination across government levels, especially in euro zone countries, where the compliance with the Stability and Growth Pact (SGP) rules is assessed by reference to general government performance. The central government is held responsible for non-compliance, both in terms of financial sanctions and credibility loss. But to address potential free-rider problems, fiscal co-ordination across government layers has

8. The fall in nominal and real interest rates during the 1990s also benefited most central governments through reduced debt-related interest payments since, in many countries, the central government holds the larger share of public sector debt.
recently been strengthened in many EU countries, some introducing an internal SGP (including Austria, Germany, Italy, Portugal and Spain), sometimes with sanctions in case of non-compliance.

... while ageing populations also have consequences for central-local relations

21. Population ageing is also exerting strong upward pressures on public spending, with differential effects on government tiers, reflecting spending responsibilities. Accommodating these pressures will require changes in the distribution of revenue-raising responsibilities and/or in the volume and design of intergovernmental transfers. In some countries, strong demand and/or cost pressures in the health and elderly care sectors have driven up the subnational government spending share. In Canada, population ageing is projected to result in a slightly faster increase in spending by the provinces and territories over the period 2001-2020 than for the federal government, largely reflecting their responsibility for financing health care services (Table 3). In Finland too, ageing population is likely to cause major pressures on local government expenditure. These pressures will not burden regions equally, and already large discrepancies in dependency ratio across regions are expected to grow (Finnish Prime Minister’s Office, 2003). By contrast, in countries such as Australia and Switzerland, upward pressures will largely be felt by the central government since it finances a large part of social insurance and assistance schemes.

Table 3. The consequences of demographic changes on fiscal outcomes in Canada

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9. Estimations of the fiscal consequences of ageing for the period 2000-2050, with a breakdown for old-age pensions, early retirement programmes, health care and long-term care, and child/family benefits and education, can be found in OECD (2001a).

10. Assuming constant coverage and quality of elderly care services in Norway, municipality employment in these services is projected to rise by 4 per cent over the 1998-2030 period (Joumard and Suiker, 2002a).

11. In 2000, the dependency ratio – defined as the ratio of those under 20 and over 60 years old to those aged 20-59 – varied significantly across Finnish regions, from 0.66 to 0.95. In 30 years, as a result of immigration and other demographic factors, it is expected to range between 0.95 and 1.70. Large discrepancies in dependency ratio also exist in Japan. There, 18 per cent of the population is now 65 or older but this share reaches 40 per cent in some municipalities (Council of Local Authorities for International Relations, 2002).
Issues determining the allocation of spending responsibilities

22. This section presents the main issues that have arisen in allocating spending responsibilities to subnational government levels and the expedients which have been adopted to deal with them. The economic issues raised are common to federal and non-federal states. They may also apply to the allocation or the use of authority within the EU area, although fiscal relations differ considerably from those within both federations and unitary countries (Box 2).

Box 2. Fiscal relations within the European Union

Fiscal relations between national authorities and community institutions within the European Union differ considerably from those between levels of government in mature federations or in decentralised unitary countries.

• Under the subsidiarity principle, powers or tasks rest with the sub-units unless a central unit is more effective in achieving certain specified goals. In the EU case, the principle results in EU member countries having retained most of their fiscal powers. The European Community does not provide core public services, such as defence, and has no specific revenue-raising powers. Spending on agriculture (appropriations for commitments) accounted for 44 per cent of the EU general budget for 2000.

• The European Union’s own budget is too small (less than 1.3 per cent of EU-wide GNP in 2000) to allow the pursuit of union-wide macroeconomic stabilisation objectives or to address country-specific shocks. It is mainly made up of a fixed share of VAT revenues collected by EU member countries and a contribution proportional to each member country’s GNP. The estimated revenue for a financial year must be equal to the appropriations for payments of that year: no borrowing is allowed to cover a budget deficit. The bail-out of a member country is explicitly forbidden in the Maastricht Treaty.

There are, nevertheless, similarities between fiscal relation issues arising at the EU level and within an individual country, particularly with respect to enforcement of budget discipline, the co-ordination of tax practices and the regional distribution of funds:

• The introduction of the single currency by 12 EU countries has reinforced the need to co-ordinate fiscal policies within the euro area, as fiscal profligacy in some countries could lead to a risk premium for the area as a whole. The Stability and Growth Pact, which embodies fiscal rules agreed by EU countries is supported by multilateral surveillance and peer pressures.

• On the revenue side, creating the appropriate conditions for the free movement of people, goods, services and capital, has entailed some co-ordination of national tax practices across EU countries. In particular, the sixth VAT directive has brought the harmonisation of the VAT bases across EU countries, a key condition to reduce administrative and compliance costs for companies engaged in intra-EU trade. In addition, securing fair competitive conditions has underpinned several initiatives by the European Commission, including the EU Code of Conduct on business taxation, the arrangements on the taxation of e-commerce transactions, the proposed directive on the taxation of pensions and the proposed directive on the taxation of cross-border savings of individuals.

• Inter-regional redistribution schemes are also in place at the EU level, with EU Cohesion and Structural Funds aimed at promoting the growth potential of lagging countries and regions. Structural and cohesion funds amounted to about one-third of the EU general budget for 2000. Per capita GDP differences at the European national level are much higher than among the US states and Canadian provinces (Hoeller et al. 1996) and will widen further after the accession of new Eastern European countries.

23. The fiscal federalism literature contends that the provision of local public goods at sub-central level can promote allocative efficiency and democratic choice. However, the key conditions for this to hold are not always fulfilled in practice, in particular:

• There is often potential for scale economies in providing public services. In such cases, local provision will fail to be cost efficient.
• In many cases, the quality and quantity of public goods provided locally have effects on economic performance in other jurisdictions ("spillover effects"). If it fails to account properly for these effects, local provision will be sub-optimal.

• Spending assignment across levels of government sometimes lacks clarity or overlaps. This weakens accountability, and thus incentives to best respond to citizens’ needs, and may also result in an inappropriate provision of public services.

24. Responsibility for providing redistributive public goods and services and assistance to the poor often lies at subnational government levels, whereas it is typically seen as a central government task in the fiscal federalism literature. Health care, social assistance and education account for the bulk of subnational government spending in many countries (Table 4), often with significant discretionary powers to set social assistance benefit levels and/or to assess the eligibility for some social benefits (Denmark, the Netherlands, Norway, Spain, Sweden, Switzerland and the United States).
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1. Economic services in the case of Austria, Belgium, Denmark, France, Japan, Luxembourg, Spain and Sweden.
2. Provincial and local governments.
Local provision may fail to exploit economies of scale

25. The smallness of local jurisdictions often implies that they are below the critical size for cost-efficient provision of public goods. Empirical works often lead to the conclusion that most jurisdictions are too small, thus entailing extra costs for the public purse. In Japan for instance, the size needed for obtaining the lowest unit costs of public services has been estimated to be a population of 120,000 in the early 1990s, with about 80 per cent of municipalities being under-populated in this regard (Hayashi, 2002). The “economically optimal size” likely varies significantly across countries, along with differences in spending assignment as well as some socioeconomic and topographic factors. As an illustration, the Danish Ministry of Interior has estimated the “economically optimal size” for a municipality (providing childcare, primary schools, elderly care and administrative functions) to be around 20,000 to 30,000 inhabitants.¹²

26. Few studies provide direct estimates of the economies of scale by economic activities. Partial evidence suggests however that they are prevalent, in particular in the health care sector. Many countries are indeed rationalising their supply of hospital care services. Small hospitals or clinics are being closed down or transformed to deliver services of a more specialised nature, thereby contributing to economies of scale and scope, with the aim of improving health care quality (Canada: British Columbia, Finland, France and Italy). For public procurement, country surveys also reveal that subnational governments rarely tend to rely on competitive tendering, as information and transaction costs act as a serious barrier for the smallest jurisdictions (e.g. in Denmark, Norway but also in Switzerland where regulatory fragmentation further raises inter-jurisdiction transaction costs).¹³ In addition, small jurisdictions may not be able to carry out the professional administration of complex tasks such as assessing eligibility for early retirement pension (Denmark), providing active labour market programmes (Switzerland and Denmark), developing appropriate benchmarking between the quality and costs of services by different providers (Hungary) or monitoring the implementation of regulations in the construction sector (Turkey).

... and to internalise territorial spillovers

27. The absence of a close match between local benefits and costs may result in a sub-optimal provision of public services and goods. This issue can often arise in the case of public services and infrastructure provided by cities which benefit suburban residents who use inner centre services and transport facilities. There are only a few papers trying to quantify these effects. However, Haughwout (1998) found that city-centre infrastructure raises housing prices in the suburbs while Solé Ollé and Viladecans Marsal (2002) estimated that increases in operating spending and in the capital stock in the central areas of Spanish cities have had positive effects on long-run output growth in the suburbs.

28. Other territorial spillover issues may arise when education and training programmes are managed at a subnational level. If they are too targeted on local needs, they may not respond adequately to countrywide needs and thus hinder the mobility of employees. In Canada for instance, the federal government has recently handed over much responsibility for training workers to the provinces. According to some observers, however, this move has made it more difficult to develop and implement efficient and

¹² If all municipalities were of an optimal size, the potential permanent efficiency gains have been estimated at around 1¾ per cent of total local government outlays (about 0.5 per cent of GDP) in Denmark.

¹³ In some cases subnational government have not actively sought to rely more on competitive tendering and to encourage the performance of the bidding system because one of their objectives is to support local companies (Japan and Switzerland). This may, however, hinder cost efficiency.
effective pan-Canadian sectoral policies (Di Giacomo, 2003).\textsuperscript{14} In Switzerland, primary and secondary education programmes are set under the responsibility of the cantons. The close proximity of managers to the communities which they serve facilitates feedback and adaptation of the system to users' preferences. Care should, however, be taken that the absence of a nationwide school curriculum does not reduce the geographical mobility of the parents once they have made a choice of the school for their children, thus hampering labour market flexibility.\textsuperscript{15}

\textbf{The risk of under-provision of welfare benefits and redistributive services}

29. Devolving welfare state programmes to subnational governments may bring some benefits but also entails some risks. Local provision allows for experimentation and innovation which generate valuable information and has the potential to promote progress in public policy nationwide (Oates, 1999). Local provision also allows for tailoring welfare programmes to local conditions. In particular, the optimal mix of assistance across cash, childcare, training, housing and transportation to facilitate work might be very different across urban and rural areas. Assigning responsibility to finance these programmes to the subnational authority can, however, destabilise local finances, especially when the poor are concentrated in city centres and/or rural areas -- an issue in Switzerland and the United States.

30. A risk of under-provision of public services may emerge when jurisdictions providing better quality services attract residents from others. The perceived threat of welfare-induced migration may trigger a strategic game, whereby subnational governments set welfare benefits and the quality of social services too low from the society’s point of view. Welfare-induced migration in the United States, where the states deliver core social welfare programmes, is a case in point. Though evidence on welfare-induced migration remains mixed, the empirical findings suggest that states do act as if welfare migration was common.\textsuperscript{16} They may either set benefits at a low level, so as to avoid becoming a “welfare magnet” or institute “two-tier” schemes with less generous benefits to migrants from other states. The relatively low mobility of people in European countries reduces the need for such devices. However, reluctance by municipalities to welcome new elderly residents has been reported in Finland (Hemmings et al., 2003).

31. The risk of under-provision could also materialise even in the absence of (a threat of) migration flows, when eligibility for local public services is not conditional on residence, while the costs are born by individual subnational governments. In Brazil, for instance, municipalities are responsible for providing, and financing, most health care services for any citizen, whether or not he/she resides in the municipality. This is an inducement to reduce their services and push people to rely on other municipalities’ services (Afonso et al., 2003).\textsuperscript{17}

\textsuperscript{14} The reduced opportunity for stakeholder involvement in the setting of labour market policy – since stakeholder groups wanting to change public policy have to deal not with one government but with several while they may have limited resources – has also been identified as a potential drawback.

\textsuperscript{15} In Japan, the recent Special Zones initiative also allows some differentiation in the management of schools and curricula. Several municipalities have announced their wish to launch schools that prioritise teaching English. Regulations governing curricula, textbooks and teacher recruitment will be eased to effect more flexible and diverse educational programmes. Differences across jurisdictions are, however, expected to remain limited and not hamper geographical mobility of people.

\textsuperscript{16} For a survey on these issues, see Brueckner (1998).

\textsuperscript{17} The authors report that “It is said as a joke – but it is not too far from reality – that Osasco, a municipality in the metropolitan area of Sao Paulo, solved all its health problems by buying ambulances that remove its sick residents to hospitals in the City of Sao Paulo.”
Inefficiencies due to overlapping responsibilities across government levels

32. The lack of a clear division between the spending responsibilities of higher and lower-level spending authorities may result in too few services, or in an inefficient use of resources. Such issues have emerged in the health care sector where local governments are often responsible for primary health care, while a higher government tier is responsible for providing and financing hospital care. In Norway for instance, the central government is responsible for managing and financing the hospital care sector, while municipalities are responsible for primary care. Since municipalities do not pay the costs of hospital treatment received by their residents, they have an incentive to under-supply preventive and outpatient care. They may also postpone the reintegration of patients who are no longer in need of hospital-based care into the health care services they finance (Joumard and Suyker, 2002a). This creates a risk of an over-reliance on costly hospital resources while waiting lists to get hospital treatment remain long.

33. Duplication of tasks, or attempts to shift the financial burden to another government layer, are also frequent when labour market and social assistance programmes are under the responsibility of different levels of government. In Norway, some municipalities have complained about the strategic failure of the public employment service (PES) to reduce the number of unemployed. The concern is that, because the government-managed PES fails to take account of the cost of unemployment assistance paid for by municipalities, it tends to underestimate the benefits of investing in active labour market policies. This has led some of the Oslo districts to start their own “miniature employment offices”. In Germany up to 2003, municipalities were responsible for administering and financing social assistance, while unemployment assistance was managed by the Federal Labour Office and financed by the central government. The fact that means-tested benefits, based on different rules, are processed by two different layers of administration increases administrative costs.

34. Splitting budgetary costs for assistance programmes across government layers might also have a negative impact on job placement efforts by the labour office. Furthermore, each government level has an incentive to shift the financial burden for these programmes to the other layer. At the federal government level, lowering unemployment assistance benefits (as occurred in 1999) effectively shifts part of the costs to municipalities (Wurzel, 2003). Municipalities also have an incentive to induce unemployed social assistance recipients to participate in work provision schemes offered by the Federal Labour Office, which re-establishes eligibility for unemployment benefits. Similar issues have arisen in Canada and Finland.

Frequent approaches include amalgamations or a “two-speed” system, …

35. Merging subnational governments is one option to exploit scale economies and internalise spillovers. Amalgamations can also help to reduce the duplication of tasks, in particular administrative ones, and to balance intra-regional disparities in income levels with the needs of public services (in Austria, the sharing of responsibilities for social and unemployment assistance across government levels is broadly similar and raises the same issues.

18. In Canada, Gray (2003) reveals that there are some instances where provinces finance job-creation programmes that generate entitlement to the employment insurance. In Finland, municipalities are responsible for providing “bottom rung” social assistance for those who do not qualify or have used up their rights to the safety net provided by the Social Insurance Institution (KELA). Until recently, it was apparently not uncommon for municipalities to wait until the long-term unemployed are close to the end of their KELA benefits and then offer a job (partly subsidised by the central government) until they re-qualify for KELA benefits, thus avoiding payment of municipality social assistance (Hemmings et al., 2003). In the late 1990s, the required working period to qualify for unemployment insurance was raised, making it less attractive for the municipalities to offer subsidised jobs to the unemployed.
particular between city centres and suburban areas). Japan has experienced several waves of amalgamations over the past five decades, with the number of municipalities being cut by more than two-thirds since the early 1950s. In a number of other OECD countries, recent mergers have also led to fewer authorities of larger size (including Belgium, Canada, Iceland, Netherlands and Sweden). The upper government tier often contributes financially to improve the attractiveness of amalgamation (Finland, Japan, Norway, and some cantons in Switzerland), as it may benefit from lower costs at a local level through the grant system. But amalgamation often meets fierce political resistance. Measures taken in Japan to avoid putting incumbent members of the local assemblies in an unfavourable position are in this respect interesting (Mabuchi, 2001). Amalgamation is, however, not always a panacea since optimal boundaries may vary significantly between different public services (e.g. water management versus health care provision). This implies that the redefinition of borders will never lead to an “optimal area” division for service provision.

36. Designing a “two-speed”, or asymmetric, assignment of spending responsibilities could be an option, by transferring spending responsibilities only to jurisdictions with a critical mass and/or sufficient human and technical knowledge. In practice, however, few countries have used such an asymmetric assignment (the exceptions including Brazil, Italy, Russia and Spain) and then mostly for political or geographical reasons.

… centralisation or norms imposed on subnational spending programmes

37. Strategies to internalise spillovers and exploit scale economies have also included the reassignment of spending responsibilities to an upper government tier. In Norway, responsibility for hospital care was transferred from the counties to the central government in 2002. In Switzerland, professional regional placement offices managed by the Swiss cantons substituted municipal labour offices (over 3 000 before 1995) with low professional abilities and a too local orientation of their training programmes. The German government and the opposition agreed in December 2003 to combine means-tested social and unemployment assistance into one benefit for the persons who are able to work. This new scheme should be managed by the Federal Labour Office – de facto removing municipalities’ responsibility for social assistance. This will allow strengthening coherence between social assistance benefits and job placement services, which will both be managed by the public employment service. In Ireland, local government environment responsibilities have largely been transferred to central government agencies and the management of sewage facilities will be transferred from town councils to county councils from 2004.

38. In many countries, although there has not been a formal transfer of responsibilities from subnational to central governments, the central government and/or Parliament has increasingly been engaged in setting standards on the coverage, quality and price of public services provided by lower levels of government. These standards and norms are particularly frequent in the health care and education sector, as well as in welfare programmes. They potentially address equity issues but rarely scale economies. In the education sector, rather detailed regulations on the curriculum are imposed by the central government in most decentralised systems (e.g. Denmark, Spain and Mexico). In Germany and Switzerland, where education is under the sole responsibility of subnational governments, most of them have gradually agreed some common rules. For social assistance programmes, where they have significant autonomy, the Swiss

20. According to the provision of the Local autonomy law, the number of the local assembly seats is set in accordance with its population. The number of seats after amalgamation would then be fewer than the sum of the seats of the local assemblies before amalgamation, thus giving incumbent members of the municipal assemblies a disincentive to amalgamation. Special provisions were introduced to allow the amalgamated municipality to organise its electoral districts in a manner that would not put the incumbent members in an unfavourable position.
... co-operation agreements across and between levels of government

39. Ad hoc co-operation agreements among levels of government have increasingly been used to achieve “optimal” functional areas specific to each public service. There are two broad approaches to such co-operation. The first relies on a purchaser/provider split. The supply of public services is concentrated in some jurisdictions, which receive some compensation from other jurisdictions benefiting from the services. This approach has been implemented in Switzerland, in particular for hospital care services and tertiary education through co-operation agreements between cantons (Joumard and Giorno, 2002). Similar horizontal arrangements, with compensation for the providers’ costs, are in place in Denmark and Sweden for hospital care where patients have a legal right to choose hospital treatment outside their county of residence. Such a co-operative approach based on a purchaser/provider split can also be extended between levels of governments when spending responsibilities overlap. As an example, the financial responsibility for long-term care in Sweden was shifted to the municipalities in 1992. Municipalities are now required to pay hospitals for care services for patients who are no longer in need of hospital-based treatment (Roseveare, 2002). Apart from allowing the exploitation of scale economies and the internalising of spillover effects, this approach has the advantage of introducing some competition between providers of public-funded services, whether public or private, inducing greater cost-efficiency.

40. The joint provision of public services through jurisdiction associations has been another form of co-operation. In some countries, such co-operation arrangements have been encouraged by the government. In Hungary for instance, the central government promotes joint service supply organisations created by municipalities through the Act on Municipal Associations and Inter-Municipal co-operation passed in 1997 (Cekota et al., 2002). Financial incentives amount to an additional 1 per cent top-up to central government grants. In many countries, this form of association has been used to provide public utilities -- e.g. waste water treatment, water provision, and energy distribution -- and for regional public transport systems. These associations can contract out by tendering the service or provide it themselves, generally through a jointly-owned public corporation. However, in some cases, the lack of division between purchasers and providers has hampered competition to develop and has made it difficult to improve cost-efficiency. As an example, Finnish municipalities acquire services from hospital districts (an association between several municipalities) that they are themselves responsible for running. Since hospital districts are also large local employers, municipalities may not be in a position to force cost-effectiveness (Hemmings et al., 2003). Transferring the responsibility for the provision of a service to an intergovernmental body may also lower democratic accountability, leaving citizens with little influence on local public services.

41. There are two main constraints for the co-operative arrangements to develop further. First, it requires appropriate and transparent cost accounting -- which in many cases is not available in the smallest jurisdictions – so as to set the financial compensation for the “buying” jurisdictions at a “fair” level. This has led the Swiss confederation to set up a model contract, containing minimal standards with respect to

21. Since 1981, inter-cantonal agreements have provided payments from cantons without a university in proportion to the number of students they send to other cantonal universities. The compensation varies across study fields to reflect tuition costs. The inter-cantonal agreements recognise that host cantons do benefit from having a university in their jurisdictions and thus set per capita compensation slightly below tuition costs.
cost transparency, rights and obligations of the partners, and overall democratic accountability (OECD, 2002c). Second, it may be difficult to apply to public services which are non-rival and non-excludable (e.g. roads) since free riding could not be discouraged.

**Funding principles to promote efficiency**

42. Funding principles play a key role in influencing subnational government spending behaviour. To be “optimal”, financing patterns should meet several, sometimes conflicting, objectives. On the one hand, matching spending responsibilities with revenue-raising powers is desirable because it would allow subnational government to exercise fiscal autonomy and improve their accountability. Also, subnational governments may be better placed to test local citizen willingness to pay. On the other hand, the need to smooth volatile local tax revenues, efficiency of tax collection, minimisation of compliance costs and equity concerns often argue in favour of some co-ordination/centralisation of taxing powers. In practice, subnational governments rely on very different mixes of resources -- grants, tax and non-tax revenues (Figure 3). This section discusses both the extent to which control over tax instruments can be decentralised and the issues that arise in designing intra-governmental transfer systems.

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22. These costs and risks associated with the devolution of revenue-raising powers to subnational governments has led Tanzi (1995) to raise the following question: “If decentralisation is defended because it improves the allocation of resources on the expenditure side, how much of this efficiency is lost when the financing of that expenditure is highly distorted?”
Figure 3. Composition of subnational government financial resources
As a percentage of total financial resources, 2000

<table>
<thead>
<tr>
<th>% of state government resources</th>
<th>% of local government resources</th>
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Federal countries

- Tax revenue
- Non-tax revenue
- Grants

Unitary countries

1. 1997 for France, Ireland, Luxembourg, Netherlands and Spain; 1998 for Iceland, Portugal and the United Kingdom; 1999 for Australia, Austria, Germany, Finland, Norway and Sweden; Fiscal year 1999 for Japan.
2. Non-tax revenues include: operating surpluses of public enterprises controlled by sub-national governments; property income; fee, sales and fines; contributions to government employee pension funds and capital revenues.

Assigning revenue-raising powers to subnational governments

43. There are few taxing powers which can be transferred to subordinate levels of government without raising efficiency and/or distributional concerns. The literature on fiscal federalism contends that subnational governments should minimise the use of mobile tax bases, redistributive taxes, unevenly distributed tax bases (e.g. on natural resources) and taxes subject to sharp cyclical fluctuations.\(^{23}\) It thus excludes corporate income taxes and redistributive personal income taxes. Consumption taxes could be candidates, but administrative considerations (compliance and collection costs) and the mobility of the base (cross-border shopping in boundary areas and inter-jurisdiction trade) reduce their attractiveness. Property taxes avoid some of these pitfalls, making them attractive for subnational government use, but raise equity issues and their yield is low. Revenues from property taxes amounted to less than 2 per cent of GDP in the OECD area in 2001 (2.8 per cent in Japan). For countries with significant devolution of expenditure powers, this is insufficient. Thus, subnational governments rely on other tax bases (Figure 4). Income taxes predominate in the Nordic countries, some Eastern European countries (Poland and Slovak Republic) and to a lesser extent in Japan, while consumption taxes play some role in many countries.

User fees and charges

44. User charging follows closely the benefit principle, whereby local households and businesses pay for what they get and get what they pay for. They may also act as price signals, reducing excess demand and encouraging customer-oriented management by subjecting public bodies to a market test. Information on subnational government revenues from user fees and charges is seldom available, let alone on which services they apply. For some countries however, piecemeal information reveals that user fees and charges account for a significant share of subnational government financial resources. They are frequent for waste collection and wastewater treatment, while a number of municipalities have introduced road toll systems.\(^{24}\)

\(^{23}\) On this issue, see McLure (2000) and Oates (1999).

\(^{24}\) According to information available in individual countries’ Economic surveys, in 2000 user fees and charges accounted for 26 per cent of Finnish municipalities’ financial resources; 14 per cent for Norwegian municipalities and counties; and 23 per cent for Danish local governments. Toll systems have been introduced in some countries (e.g. in some large city centres in Norway, the United Kingdom and the United States).
Figure 4. Composition of tax revenues of subnational governments as percentage of total tax revenue, 2001

Source: OECD Revenue Statistics, 1965-2002
45. Further reliance on user fees and charges by subnational governments, however, faces two main constraints. First, increasing subnational government reliance on user charges may raise equity concerns, especially when applied to core goods and services (namely education, health care and social assistance). Subnational governments are frequently bound by legal constraints in setting the level of charges. In most countries, they are not entitled to introduce tuition fees for public primary and secondary education, with frequent limitation on user fees for childcare and educational facilities (Denmark and Norway). Second, user charging is an attractive option only if the implementation costs (including administrative costs, but also in some cases, the investment necessary to “individualise” consumption) are lower than the expected efficiency gains. Implementation costs are likely to reflect scale economies and thus be high in the smallest jurisdictions. Waste collection provides an example of this trade-off between implementation costs and efficiency gains from user charging – subnational governments having adopted rather different approaches. In some countries, including Australia, Canada, Denmark, Sweden and the United States, certain municipalities have implemented weight- or volume-based charging for household waste, and there is some evidence that this has resulted in reduced waste generation. These charges, however, involve rather high implementation costs. In other countries, waste collection costs are reflected in a resident base tax (e.g. on a per household basis in Ireland) or incorporated into property taxes paid by residents (e.g. through a surcharge on the Taxe foncière in France). These formulae provide fewer incentives to reduce the generation of waste but are less costly to implement. Overall, there are serious limits to how much revenue can be generated from user fees at a subnational level.

Property taxes

46. Property taxes have key advantages as subnational taxes. Most notably, the tax base is highly immobile, there is no ambiguity about which authority is entitled to the tax on any given property, the tax is difficult to evade and efforts to improve local infrastructure are likely to be reflected in property values, thus increasing the tax yield for subnational governments. Property tax revenues are also relatively predictable. These advantages have been exploited in many countries. Property taxes account for all, or most, local government tax revenues in Australia, Canada, Mexico, Ireland, New Zealand, the United Kingdom, and to a lesser extent in France, Korea, the Netherlands and the United States. In Japan, property taxes amounted to about 30 per cent of local government revenues. Furthermore, contrasting with most other tax revenues allocated to them, subnational governments have significant autonomy in setting property tax rates, though less frequently in setting the base (OECD, 1999).

47. Recognising their merits, the OECD has recommended that subnational government reliance on property taxes be increased in a number of countries (Czech Republic, Finland, Greece, Japan, Mexico, Norway, Poland, and Portugal), e.g. by lowering the administrative barriers to their wider use, by giving subnational governments greater autonomy in setting property tax rates or by updating the land and housing register. Japan has moved in these directions recently. First, since 1998 local governments are no longer required to notify the central government before raising property tax rates above the standard rates. In addition, the valuation of land for tax purposes has been raised to better reflect market prices.


26. A serious constraint to a wider reliance on property taxes has been the difficulty in assessing land and housing value in some countries, as a land and housing register is lacking (Greece and Poland) or the cadaster is out of date (Austria, France, Mexico, Portugal and Spain). At stark, the assessment of property values in Japan is performed every 3 years in accordance with a uniform method undertaken by the central government.
48. Giving subnational governments discretionary powers with respect to general consumption taxes, either sales taxes or value added taxes, may entail high compliance and administrative costs to contain tax fraud and evasion and may create distortions in inter-jurisdiction trade. The United States is the only OECD country not to have a national value added tax (VAT). Instead, the sales tax accounts for a large share of subnational government revenues (about one third of state tax revenues in 2000). Each state and municipality has its own exemption rules and its own definition of products and services and they set their own tax rates. The lack of a uniform tax base has, however, made it difficult to enforce out-of-state collection without increasing significantly compliance costs, and thus hindering interstate commerce. The Supreme Court has ruled that it is illegal for states to attempt to enforce the collection of sales taxes from enterprises that do not have a physical presence in that state (Herd and Bronchi, 2001). This has created significant distortions in competition across jurisdictions, while the provision allowing companies to claim exemption from upstream sales tax at the point of sale has not worked well, resulting in tax cascading and tax exporting.27 To reduce the barriers to trade caused by differential sales tax regulations, thirty-eight states are currently involved in the Streamlined Sales Tax Project, which is an effort to modernise and simplify sales taxes. In particular, the Project’s proposals will incorporate uniform definition of tax bases. In Canada, where a dual federal value added tax system (GST) and provincial sales tax co-exist, some harmonisation across provinces has also taken place.28

49. Value added taxes, which in principle alleviate the cascading problem associated with turnover and sales taxes, can also be administratively cumbersome and create economic distortions when managed in a decentralised manner. This may explain why some countries with a strong federalist tradition (Australia and Switzerland) have opted for a central government VAT system in the 1990s, with no discretionary powers at a subnational level. In most countries where VAT revenues account for a share of subnational government resources, tax bases and rates are determined centrally (Austria, Belgium, Germany, Mexico and Spain). In Japan also, prefectures piggy-back on the national VAT and the so-called local consumption tax amounted to about 16 per cent of their tax revenues in FY 2000. They have, however, no powers to set the base or rates (all apply a 1 per cent surtax VAT rate). In contrast, Brazilian states do have discretionary powers over VAT rates. This has increased the scope for tax evasion and fraud, made the system cumbersome to administer and comply with, and raised the contentious issue of how VAT revenues should be shared across jurisdictions. Similar issues have arisen between countries within the EU area, in particular after the removal of border controls (Box 3).

27. Residents of states with high sales taxes undertake more mail-order purchases -- as well as internet purchases -- than those living in states with low sales taxes. Moreover, this system gives out-of-state retailers a competitive advantage over in-state retailers and deters mail-order and electronic commerce sellers from having a physical presence in a large number of states (Herd and Bronchi, 2001).

28. Three Canadian Atlantic Provinces agreed to harmonise their sales tax with the federal GST from 1997. Comprehensive Integrated Tax Co-ordination Agreements (CITCAs) are used to achieve consumption tax harmonisation (in terms of base and rate structure) under the CITCAs. The federal government applies a 15 per cent tax rate, rather than the 7 per cent GST rate applying in non-participating provinces, and turns over to the participating provinces their shares based on aggregate consumption estimates (OECD, 1997).
Box 3. Issues in implementing a decentralised VAT system

A central question in designing a decentralised VAT system is what to do with trade between jurisdictions. Two principles could be applied -- the destination or origin principles. Not only do they differ in their treatment of inter-jurisdictional trade, but they have different impact on incentives for tax fraud and evasion, on administrative and compliance costs, and on the distribution of VAT revenues.

Under the destination principle, consumption taxes are levied where the products are consumed. Goods and services travel tax-free across jurisdictions. In the absence of internal barriers, the destination principle increases the scope for tax fraud, since it creates strong incentives to overestimate exports (zero-rated) and understate imports (since VAT should be paid). Administrative co-operation could help to reduce it. In the EU area, where the destination principle is in place for the business sector, the system is, however, administratively cumbersome and has been identified as a barrier to trade across countries.

The origin principle implies that goods and services are taxed where they are produced. It has advantages in that it can be applied without borders. Since goods do not travel tax free, the potential for tax fraud is lower.

Sharing of VAT revenues across jurisdictions. To ensure that VAT receipts accrue where consumption takes place, a mechanism to redistribute VAT revenues across regions/countries is required when the origin principle applies. This redistribution issue has been contentious at the EU level and in Brazil. With the elimination of customs controls within the EU area in 1993, a move from the destination to the origin principle was envisaged. This would have induced significant changes in the distribution of VAT resources across countries. EU countries with a trade surplus vis-à-vis the EU area would have collected extra revenues compared to the existing regime of zero-rating for exports while deficit countries would have lost VAT revenues. In Brazil, the consistent implementation of the origin principle would result in a regressive redistribution of VAT revenues to the relatively prosperous south where imports enter to the poorer north which is the main exporting region. To mitigate this regressive effect, rates on exports from wealthier states to poorer ones are taxed at a lower rate than goods moving in the opposite direction. This has, however, made the Brazilian system quite complicated (McLure, 2000) and prone to tax fraud.

Personal income taxes

50. Personal income tax revenues account for a substantial component of sub-central government financial resources in a large number of countries (including Austria, Belgium, Canada, Czech Republic, Germany, Japan, Nordic countries, Poland, Spain, Switzerland and the United States). In Japan, they accounted for 27 per cent of total tax revenues of subnational governments in 2001. Such a reliance on personal income tax could be seen as broadly in line with the “benefit principle” since core public services provided by subnational governments serve resident individuals (in particular, education, health care and social welfare). However, it could make it difficult to secure a minimum or average standard of merit goods in poorer jurisdictions with a weak taxing capacity.

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29. In Japan, the inhabitant tax consists of three components, each with a different tax base: per capita, income and interest income. Most tax revenue comes from the second component. A progressive rate structure is applied to this harmonised tax base, with a relatively high minimum taxable income level.
51. Maintaining a redistributive role of the tax system may be extremely challenging with a decentralised personal income tax and mobile taxpayers. In this setting, every subnational government has an incentive to lower top marginal rates in order to attract wealthy citizens so as to maximise tax revenues and minimise social spending. In fact, very few countries have made it possible for lower levels of government to alter the progressive rate structure. In Austria and Germany, they have no autonomy to set the personal income tax base and rates though part of the personal income tax revenues collected within subnational government boundaries accrues to them. Belgian regions are not entitled to institute surtaxes or rebates which would diminish the progressivity of the federal personal income tax. In Spain, the recently reformed personal income tax system provides more flexibility to subnational governments but still requires the Spanish regions to impose a progressive (though loosely defined) rate structure. The difficulties in maintaining a progressive income tax at a local level has been recognised in the Nordic countries. There, subnational governments are allowed only to set a flat tax rate on personal income (subject to band limits set by the central government in Iceland and Norway). In the United States, states have much more freedom in setting the personal income tax base and rate structure. Nine states levy only limited or no individual income taxes and six apply a flat rate.

52. Local governments may not fully take into account the national externalities resulting from their income tax policies. An increase in local tax rates will lower incentives to work, save and seek education and thus affect the national growth potential. It can further result in lower tax revenues and higher spending for other government tiers (vertical fiscal externalities): higher local tax rates, by reducing work efforts, could result in lower social security contributions and central government tax revenues, combined with higher welfare benefits. Rather limited or non-existent tax autonomy can serve to prevent subnational governments setting personal income tax “too high” from a national perspective. The upward bias issue for local income tax has been an important cause of concern in Denmark and Sweden, where, contrasting with Iceland and Norway, there is no ceiling on local personal income tax rates. In 1996, to avoid an upward drift in personal income tax rates, the Swedish central government introduced “a tax on local government tax”, for any municipality increasing its tax rate but this tax was abolished in 1998 on constitutional grounds. In Denmark, a “tax freeze” was instituted in 2002 as an agreement between the central government and the County Council Association regarding their tax levels, with financial sanction in case of violation.

Corporate income taxes

53. Corporate income tax revenues account for a rather large part of total subnational government tax revenues in several OECD countries (Canada, Czech Republic, Finland, Germany, Japan, Switzerland, Turkey and the United States). In Japan, local corporate income taxes account for 20 per cent of local

30. A 50 per cent surtax on municipal tax increases was decided in 1996, by which individual municipalities were to pay half the revenue raised from increases in their income tax rates to the central government. However, in 1998 the Supreme Court ruled that this violated the municipalities’ constitutional right to impose income taxes.

31. Since the West Zealand County violated the agreement by raising taxes by 0.4 per cent, the central government announced in November 2002 that block grants to all counties would be reduced in 2003. In case of the tax freeze agreement being violated at the county level, block grants will be adjusted both at an individual county level and collectively in the first two years. In the first round, counties raising their tax rates will have their block grants reduced by 50 per cent of the amount of extra tax revenues, while counties lowering their tax rates will have their block grants increased by 50 per cent of the amount of lost tax revenues. In the second round, block grants will be cut for all counties, this collective punishment amounting to half of the net extra tax revenues resulting from changes in the counties’ tax rates and distributed proportionally across counties. From the third year, all net extra tax revenues resulting from changes in county tax rates will be confiscated through a reduction in general block grants.
A high reliance on local corporate income taxes has raised a number of issues, including: the high volatility of the associated revenues, the potential for tax competition, high administrative and compliance costs and distortions in production and trade patterns within the countries. The volatility of corporate income tax revenues compared with other tax revenues (Table 5) is problematic for subnational government financing needs since their core expenditure is often either largely unresponsive to the economic cycle (e.g. education) or tends to increase during downturns (e.g. social assistance transfers). During upswings, it may give rise to spending that may be difficult to prune in less favourable times. Constraints on subnational government recourse to borrowing further limit their ability to smooth revenues over the cycle. Recognising these drawbacks, Norway abolished the corporate income tax-sharing arrangement between municipalities and the central government in 1998. In the context of its Economic Surveys, the OECD has further recommended reducing subnational government reliance on corporate income tax in a number of countries (including Finland and Japan).
### Table 5. Volatility of tax revenues

*Standard deviation on the real growth rate of tax revenues, 1985-2001*

<table>
<thead>
<tr>
<th></th>
<th>Personal income</th>
<th>Corporate income</th>
<th>Social security contributions</th>
<th>Property income</th>
<th>Consumption</th>
<th>Total</th>
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<tr>
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<td>6.59</td>
<td>14.39</td>
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<td>2.78</td>
<td>8.87</td>
<td>3.98</td>
</tr>
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<td>18.31</td>
<td>1.54</td>
<td>2.88</td>
<td>4.61</td>
<td>2.01</td>
</tr>
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<td>8.66</td>
<td>1.68</td>
<td>6.08</td>
<td>2.69</td>
<td>1.78</td>
</tr>
<tr>
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<td>14.12</td>
<td>3.79</td>
<td>3.12</td>
<td>3.10</td>
<td>2.51</td>
</tr>
<tr>
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<td>14.52</td>
<td>9.26</td>
<td>4.33</td>
<td>3.13</td>
</tr>
<tr>
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<td>7.10</td>
<td>4.90</td>
<td>5.00</td>
</tr>
<tr>
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<td>3.12</td>
<td>18.96</td>
<td>2.27</td>
<td>1.24</td>
</tr>
<tr>
<td>Germany</td>
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<td>5.00</td>
<td>2.91</td>
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<td>4.78</td>
</tr>
<tr>
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<td>5.97</td>
<td>168.20</td>
<td>5.83</td>
<td>8.26</td>
</tr>
<tr>
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<td>21.61</td>
<td>5.15</td>
<td>27.28</td>
<td>4.43</td>
<td>3.48</td>
</tr>
<tr>
<td>Ireland</td>
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<td>16.42</td>
<td>4.81</td>
<td>7.26</td>
<td>4.10</td>
<td>3.96</td>
</tr>
<tr>
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</tr>
<tr>
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<td>3.49</td>
<td>3.69</td>
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<td>4.69</td>
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<tr>
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<td>5.60</td>
</tr>
<tr>
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<td>4.19</td>
<td>7.10</td>
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<td>4.95</td>
</tr>
<tr>
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<td>5.44</td>
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<td>7.25</td>
<td>24.80</td>
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<td>8.04</td>
<td>3.06</td>
<td>3.45</td>
<td>4.94</td>
<td>2.78</td>
</tr>
<tr>
<td>Turkey</td>
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<td>18.64</td>
<td>20.95</td>
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<td>8.52</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>6.41</td>
<td>13.81</td>
<td>4.74</td>
<td>14.21</td>
<td>2.68</td>
<td>3.78</td>
</tr>
<tr>
<td>United States</td>
<td>4.54</td>
<td>11.28</td>
<td>1.65</td>
<td>1.52</td>
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<td>2.57</td>
</tr>
<tr>
<td>OECD weighted average</td>
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<td>7.83</td>
<td>1.62</td>
<td>2.20</td>
<td>1.54</td>
<td>1.72</td>
</tr>
</tbody>
</table>

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1. Using GDP deflator. The volatility measured here reflects both tax revenues variations throughout the cycle and discretionary tax changes.
3. Over the period 1993-2001 for property income.

Source: OECD (2003), Revenue statistics.

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54. Some countries have relied on a more stable base for local corporate taxation (including France, Germany, Hungary and Italy). The taxable base often consists of the value of the company’s corporate inputs, assets or its value-added (Box 4). These forms of corporate taxes have also raised a number of concerns and several countries are reducing, or abolishing, them. First, they have often been seen as discouraging economic dynamism (employment creation, business investment and R&D) by imposing a heavy burden on newly created companies with little or no profits. Second, these taxes do not properly account for cyclical developments and may exacerbate failures in downturn episodes. Indeed, the cyclical risk is merely transferred from local governments to companies.
Box 4. Implementing a local business tax based on companies’ inputs or value added

Experiences in some OECD countries

In France, companies engaged in business activities are subject to a local business tax (Taxe professionnelle). The taxable base has long been made of the company rental value of equipment and buildings and the wage bill. This tax had been criticised for its adverse effect on employment creation and has been reformed. The taxable base has been narrowed substantially over the past decade, with the removal of the tax on the company payroll: 20 per cent of the wages paid were subject to this tax up to 1997 but this share was gradually reduced thereafter and abolished altogether as from 2003. The loss of tax revenues for subnational governments has been accompanied by increased central government transfers. The taxable base now only consists of the annual rental value of commercial and industrial buildings and equipment. The rates vary from municipality to municipality, with an upward limit (the tax may not exceed a given percentage of the company’s value added, ranging between 3.5 to 4 per cent depending on the value of the company’s turnover). Early in 2004, the President Jacques Chirac announced that the taxe professionnelle will soon be abolished.

In Germany, the local business income tax (Gewerbesteuer) is a tax on a company’s inputs, though the base is wider than the French Taxe professionnelle. Originally, this tax was conceived as a value-added tax, with the tax base made of the income of all production factors. The tax base has, however, been gradually narrowed over the past decades. The payroll component was abolished in 1980 and since 1984 only 50 per cent of interest payments on long-term debt are taxable. The imputed value of buildings and equipment was also abolished in 1997 with the loss of revenues for the municipalities compensated by tax-sharing arrangements on VAT. A reform is under discussion in the context of the Commission for reforming municipal finances set up by the federal government. One key issue is whether the local business tax should be more profit-oriented (an option preferred by businesses since it would better reflect their true income) or more “input-oriented” (an option preferred by municipalities since it would ensure more stable tax revenues).

In Italy, a regional tax on productive activities (IRAP) was introduced in 1998 to replace a number of taxes, among which the local income tax and the extraordinary tax on net assets. The tax base includes profits, interest payments, labour costs and other components of the value added. Depreciation allowances and intermediate inputs are not taxable. Regions have been given autonomy in setting rates after a two-year transition period during which the IRAP remained a tax controlled and collected by the central government. The 2003 budget law, however, prohibited rate increases after September 2003. Although when introduced it was considered as a major step towards greater regional autonomy, some doubts were raised as to the effective degree of fiscal autonomy to poorer regions where the tax base is small. Concerns have also been raised about the relatively high tax burden for the self-employed and small companies. The IRAP is now planned to be gradually phased out.

In Hungary, the local business tax is by far the most important source of tax revenue for local government (more than 70 per cent) but is widely criticized for being biased through discretionary exemptions and complex for businesses to administer. It is levied at a locally-determined rate of up to a maximum of 2 per cent on a base that resembles value added (sales revenue, excluding VAT, plus interest income less the acquisition cost of goods sold, material cost and the cost of sub-contractors). Until 2003, local governments could grant exemptions from the local business tax at their discretion, which could create a problem in localities where links between local business and local government officials are strong. The tax is also particularly unfavourable to the service sector, where labour costs predominate, and introduces a bias in favour of subcontracting (as opposed to in-house provision) as subcontracting expenses are deductible, whereas employee costs are not. Such a high reliance on the local business tax also creates undue imbalances in the resources available for local public goods as the local business tax tends to be highest in the richest regions. The Finance Ministry’s initial plans for the 2004 budget envisaged changes to the local business tax but these were not included in the final budget submission.

55. The need to split corporate tax revenues when a company operates in several jurisdictions has also posed some problems. In Finland, revenues are shared between municipalities according to the number of employees in each of them. Since municipal public services are more closely related to where

32. The 2003 budget law decreased the rate for the agricultural sector and introduced a deduction of Euro 2000 for each employee up to five employees for small companies.
people live than to where people work, this could create financial imbalances across municipalities. In Japan, measures have been taken to adjust for the concentration of tax revenues in large cities. Tax revenues from companies operating in several jurisdictions are also shared according to the number of employees in each of them but the number of employees working in the headquarters is discounted by multiplying it by \( \frac{1}{2} \). In the United States, there is no co-ordination in the apportionment formula. In determining corporate income tax on the profit earned by a company in a given state, states have long used a formula that accords equal weight to three factors: payroll, property and sales. Recently, individual states have increased the weight of the sales factor and reduced the weight on payroll and property, resulting in a \textit{de facto} partial transformation of the corporate income tax into a quasi sales tax. This is partly paid by companies and households from other jurisdictions and represents an attempt to generate economic development at the expense of other states and, in particular, the hope of attracting new employment. While, on average, the states that have lowered the payroll weight have increased employment, aggregate employment effects across the whole country are close to zero (Goolsbee and Maydew, 1998). In this context, promoting uniformity in the apportionment formula, as among the Canadian provinces, has been recommended by the OECD (OECD, 2001c).

\textbf{Subnational government use of taxing powers}

\textit{Varying intensity of tax competition}

56. The intensity and form of tax competition vary significantly across countries and tax bases, largely reflecting differences in the mobility of citizens and companies but also in the degree of discretionary powers over taxes granted to subnational governments. While competitive pressures across jurisdictions can help to limit the overall tax burden and public spending, they may also make the tax system more complex, thus raising compliance costs and introducing distortions. Competition to attract companies, and hence create employment, has often been more intense than competition to attract households. In the United States, every state has either enacted or significantly expanded one or more tax incentives in recent years with respect to business location (OECD, 2000b). This has caused other states to adopt retaliatory measures, imposing high costs, further shrinking the tax base and increasing the complexity of the tax system. Similar forces have been at play in Canada, where several provinces have instituted tax credits that reduce the cost of equity financing for businesses that have a presence in their territories above a certain minimum threshold. Such credits can segregate the capital market, providing an incentive for firms to relocate so as to access large capital pools to the detriment of economic activity in smaller provinces. In Switzerland, while corporate income tax bases have been harmonised across cantons since 2001, some of them reportedly negotiate special tax rebates and the overall tax burden on companies has tended to decline, while those on individuals have increased over the past 15 years. In Japan, the situation is rather surprising at a first glance. At least until recently, no local government applied tax rates below the standard level set in the National Tax Law while some prefectures and municipalities were applying higher local corporate tax rates (Mochida and Lotz, 1999).

57. Tax competition to attract companies has also been at play in some countries where subnational governments have no power to adjust the corporate tax base and rates but receive a share of taxes paid by companies within their jurisdiction. This form of tax-sharing arrangement creates incentives for

\begin{itemize}
\item[33.] In Finland, the need to share revenues has raised additional problems: it contributes to the delays in redistributing tax revenues to municipalities and generates some mistrust in the tax administration.
\item[34.] Investors earn a tax credit determined as a percentage of their investment, provided that the wages and salaries of the firm paid in the province concerned are above some predetermined minimum (OECD, 1997).
\end{itemize}
Subnational governments to improve the framework conditions for economic activities to develop. In Finland, municipalities compete to attract companies by building modern business centres and/or offering business premises, low-priced public services and logistic services (Joumard and Suyker, 2002b). In this context, competition across jurisdictions creates more pressures to increase public spending than to contain taxes. In Germany, tax competition sometimes takes the form of a differential interpretation of the provisions of federal tax laws by the Länder (Wurzel, 1999). The Länder indeed bear the cost of tax administration and tax auditing, but since only a small fraction of additional tax revenues accrues to them, it hardly pays from the individual Länder perspective to strengthen their audit procedures, raising the issue of which government level should collect and audit taxes.

Under-utilisation of subnational taxing powers

Subnational government powers to adjust less mobile tax levels have not been fully exploited in a number of countries. OECD Economic Surveys (including those for Finland, Korea and Norway) point out that variations in personal income and property tax rates across subnational governments are surprisingly small. In Korea, most subnational governments stick to the guidelines issued by the central government for setting property-related taxes, the inhabitant tax and the tobacco tax, while in Norway the municipalities have all kept the marginal personal income tax rate at the maximum level set by law since 1979. This is all the more surprising as fiscal equalisation schemes in these two countries are based on actual tax revenues collected in their jurisdiction, and not on potential revenues (or taxable income) -- the fall in tax revenues resulting from a cut in a jurisdiction’s local tax rate is largely paid for by other jurisdictions.

The apparent absence of tax competition could reflect several factors, in addition to rather low population mobility, which contrasts with the situation in the United States. First, subnational governments may be reluctant to enter into aggressive tax competition as it could be seen as compromising fruitful economic co-operation in a number of areas. This has been considered as one possible explanation for Finland, where variation in municipal rates for personal income tax is low considering the freedom municipalities enjoy (Hemmings et al., 2003). Second, comparative information on tax levels across jurisdictions may be lacking, thus reducing pressures for jurisdictions to compete. Tax-sharing arrangements -- whereby several government tiers rely on the same tax base -- may make it difficult for individuals to assess performance at the individual government level and thus reduce subnational government accountability. Finally, central government transfers to subnational governments often contain discretionary features (Finland, Hungary, Korea and Norway), and subnational governments may be reluctant to cut local taxes because they fear becoming ineligible for these discretionary supports. In Japan, Mochida (2001) suggests that conditions for local bond issuance could further reduce local government incentives to compete on taxes since localities with a tax rate below the standard tax rate would be prohibited from issuing local bonds by the Local Public Finance Law.

Intergovernmental grants

Externalities associated with local taxation and provision of public goods, large disparities in fiscal capacities across jurisdictions combined with the society’s objective to secure minimum standards in the quality of public services across the whole country, have led many countries to rely extensively on intergovernmental grants. The design of intergovernmental grants varies significantly from one country

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36. In Norway, for instance, taxpayers are largely unaware of what proportion of their personal income tax liability accrues to local versus central governments.

37. In some countries (including Finland, Germany, Mexico, Norway, Spain and Switzerland), intergovernmental grants also aim at regional development objectives, with formula-based grants including criteria on population dispersion and topographical characteristics.
to another. However, two broad categories can be distinguished as they have a different impact on subnational government behaviour. Earmarked grants have been defended on the grounds that they could serve to internalise externalities. On the other hand, by providing strong incentives to spend in specific domains, they may result in overspending. By contrast, block grants leave sub-central government with discretion as to how to organise local provision in the most effective way. They are often seen to be the most appropriate for equalisation purposes, though earmarked grants often contain a redistributive element.

**Earmarked versus block grants**

61. Earmarked grants have been used extensively to minimise the risk of suboptimal spending in domains characterised by significant positive spillover effects or to secure minimum standards for specific services across the country. Conditions attached to earmarked grants effectively require that they be used to provide particular services. In several countries, subnational government incentives to spend in these services are increased by topping up their funding via a national/central contribution. In practice, however, measuring economic externalities or defining minimum spending levels to reach a given quality for public services -- so as to set the contribution rates from the central government at an appropriate level -- has proved to be extremely difficult. In Korea, only one-fifth of the projects financed by earmarked grants actually demonstrate spillover effects (OECD, 2003a), while in Switzerland, Confederation contribution rates to cantonal expenses primarily reflect the Confederation’s fiscal position when specific earmarked grants were introduced (Joumard and Giorno, 2002). For the United States, federal matching shares are typically much larger than justifiable by any plausible level of spillover benefits (Oates, 1999). Managing earmarked grants also entails high administrative costs (Germany, Switzerland, and United Kingdom). Furthermore, since externalities extend both between and within layers of government, extensive reliance on earmarked grants to internalise spillover effects would probably lead to a too complicated transfer system.

62. Earmarked grants have resulted in excessive spending and/or poor cost-effectiveness in many countries. In Italy, earmarked grants have largely been set by reference to the previous year’s expenditures and without reference to objective performance criteria. This has weakened incentives to contain costs and been a major source of regional over-spending (Bibbee and Goglio, 2002), prompting reforms whereby health care transfers to the regions are now partly based on demographic factors and conditional to the introduction of efficiency- and quality-enhancing measures. In Mexico, the basic education grant from the federal government to the states -- the largest earmarked grant -- is largely determined on the basis of wage costs negotiated at the central government level. This creates an incentive for states to increase the number of teachers instead of putting the weight on school enrolment or educational attainment. It has also resulted in significant variations across states in amounts transferred per pupil (OECD, 2003b). In other countries (including Czech Republic, Ireland, Poland, and Switzerland), earmarked grants are largely based on *ex post* actual costs, instead of *a priori* standard costs, dulling incentives to contain costs. Furthermore, since every expenditure eligible for matching must be defined precisely, earmarked grant systems may limit a subnational government’s ability to be innovative.

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38. Earmarked grants, however, do not always involve matching funding arrangements. In Australia for instance, the quantum of most special purpose grants is determined without relation to the level of State or local government funding.

39. See for instance Brueckner (1998). For welfare programmes, he argues that the theory indicates a qualitative need for matching grants but does not indicate the proper size of the matching rates, which cannot be computed reliably using existing information.

40. For Switzerland, administrative costs were estimated to range from 1.6 to 10 per cent of the grant for four conditional grant programmes (Jeanrenaud, 1994).
63. A potential conflict between allocative and redistributive objectives can arise from an extensive reliance on earmarked grants. Earmarked grants could have adverse distribution consequences, since subnational governments are often required to match the grants together with a certain amount of local funds. Because poorer jurisdictions may lack this matching ability, this system has been identified as benefiting wealthier jurisdictions in some countries (e.g., China). To mitigate this bias, earmarked grants have been designed to contain an element of redistribution in some countries. In the United States, the Medicaid programme managed by the states is largely financed through earmarked grants, with the federal contribution rate in state spending varying from one state to another to reflect their income per capita. In Germany, co-funding from the federal government for some investment programmes is conditional on the recipient state having a financing capacity below the federal average or its economy being subject to structural changes (Wurzel, 1999). Similarly, at the EU level, GDP per capita in individual countries and regions is a key eligibility criteria for most EU structural and cohesion funds. In Switzerland, the Confederation’s participation rate varies from one canton to another to reflect their fiscal capacity. Nevertheless, in some cases the part which the poorer cantons have to pay remains too high for them to benefit from federal grants, thus undermining the redistribution objective (Joumard and Giorno, 2002).

64. Given these problems, many countries have recently reduced their reliance on earmarked grants or redesigned them. In the 1990s, Canada, Finland, Iceland, Norway and Sweden drastically reformed their grant system, replacing most earmarked grants by general-purpose grants. In Ireland, the share of earmarked grants in local government revenue declined from over 40 per cent in the early 1990s to between 25 and 28 per cent in the late 1990s. In Japan, the reform process in this domain has been less ambitious. The 2002 budget significantly reduced the matching rate for local government spending on public works. The matching rate has been brought down from 60 to 70 per cent for some public infrastructure, to 30 per cent for public works such as river and coastal protection and agricultural roads, and to 45 per cent for ports and dams (OECD, 2003c). Earmarked grants, however, still account for almost 40 per cent of total grants received by subnational government. In addition, some elements of earmarking have been introduced in the Local Allocation Tax (LAT) -- the most important block grant in Japan -- since repayment costs (principal and interest) on bonds issued to finance some local infrastructure projects are included in the calculation of individual government needs used to set the amount of the LAT and its distribution across levels of government. The recent decision to cut earmarked grants by yen 4 trillion over the next years, compensating local governments with higher block (LAT) transfers and tax revenues, is however a step in the right direction.

41. The US State Children Health Insurance Programme introduced in 1997 provides another example. It is a partnership between the federal and state governments. Funds from the federal government are allocated to each participating state according to the number of uninsured and low-income children.

42. EU Structural and Cohesion funds (euro 195 billion and 18 billion, respectively) will account for one-third of the European Community budget for the period 2000-06. The Cohesion Fund contributes to investment, which benefits the environment and transport infrastructure in Spain, Greece, Portugal and Ireland, all of which have a per capita GDP of less than 90 per cent of the EU average. The bulk of the EU Structural Funds are directed at regions whose “development is lagging” (defined as those regions whose GDP per capita does not exceed 75 per cent of the EU average). For more information, see: [http://www.europa.eu.int/comm/regional_policy/index_en.htm](http://www.europa.eu.int/comm/regional_policy/index_en.htm).

43. In Sweden, 90 per cent of the grants were earmarked in 1992. Currently, some 25 per cent of total grants remain earmarked (Roseveare, 2002). The earmarking of housing assistance transfers accruing to the states has also recently been relaxed in Austria. Canada moved from a system of cost-sharing for health and post-secondary education to a system of block funding in the late 1970s. Cost-sharing of social assistance was changed to block funding in the 1990s.

44. As a first step, 1 trillion of yen is to be cut during FY 2004, while 0.42 trillion of income tax revenue and 0.23 trillion of additional LAT will be transferred to subnational governments.
65. Greater emphasis on outcomes (as opposed to inputs) has also been built into the grant system in some countries, with the objective of raising cost-effectiveness of earmarked grants. In the United Kingdom, Public Service Agreements (PSAs) -- setting out objective outcome-focused targets and linking funding to service delivery -- were extended to local government grants in 2000. In Canada, after abandoning the system of cost-sharing tied to specific expenditure in the 1990s, the central government made federal funding to the Provinces conditional on respect for comprehensiveness and universality in the health care system. Australia has made some grants contingent on States adhering to certain general principles of the National Competition Policy implementation targets. In Brazil, the transfer of resources to subnational governments for education and health has been conditional on the quality of services provided since the late 1990s.

66. Over time, making grants conditional on outcomes could create incentives to improve the quality of services, by rewarding co-operative behaviour. The OECD has recommended similar initiatives to improve the incentive structure of the grant system for a number of countries, including Germany for the transfers to new Länder under the Second Solidarity Pact (Wurzel, 2003) and Mexico (OECD, 2003b). It remains an open question, however, as to how central governments should react to any subnational failure to meet the objectives of such grant schemes, especially for those services which affect the whole country’s performance. Sanctioning poor performance by cutting grants would exacerbate any deterioration in the quality of services.

Fiscal equalisation schemes: an equity-efficiency trade-off?

67. There are significant differences in the design of fiscal equalisation schemes. In many countries, they take the form of the direct allocation of a share in nationally collected taxes. In others, formal fiscal equalisation schemes do not exist. In the United States for instance, they were abolished for states in 1981. However, redistribution across jurisdictions can stem from many channels. As noted above, earmarked grants often contain means-tested elements. Progressive federal income taxes also introduce some form of redistribution across jurisdictions, by taking more from jurisdictions with wealthier inhabitants. Specific rebates on national taxes and/or social security contributions for poorer and/or remote jurisdictions also exist in many countries (France, Italy and Norway). In addition, national social insurance schemes -- and in particular unemployment insurance -- rarely set differentiated risk premiums across regions. In Canada, the national Employment Insurance programme further discriminates in favour of high unemployment regions by making it easier to qualify for benefits with the same contribution rates (OECD, 2001d). In the United States, the extended benefits provisions of the federal-state unemployment insurance system also provide an additional 13 weeks of benefits to unemployed workers in states that have recently experienced a sharp increase in unemployment. The situation in Japan lies at the other extreme, at least for the health insurance system, with a low degree of risk pooling across jurisdictions. For a given income level, health insurance premiums for the schemes run by municipalities vary from one to seven partly reflecting large variations in health risks (Imai, 2002). On the other hand, public works subsidised by the central government have often been concentrated into low-income and rural areas.

45. In 2000, PSAs were concluded between the central government and 20 local authorities as a pilot exercise, containing a package of 12 key outcome targets. If they perform well, local authorities will be rewarded through financial benefits and increased autonomy. The government intended to extend local PSAs to 130 of the largest jurisdictions in 2002 (Van den Noord, 2002).

46. For Germany, Wurzel (2003) have suggested that the Solidarity Pact II with the new Länder could make funding by the federal government conditional on the presentation of appropriate outcome-oriented evaluations of infrastructure investment projects. For Mexico, the Territorial Development Policy Committee has recommended that education and health transfers from the central government to subnational governments be based on output and outcomes -- rather than input indicators or past expenditures.
68. The impact of fiscal equalisation schemes on economic efficiency has been an important issue in many countries. Equalisation could promote efficiency for at least two main reasons. First, inter-regional transfers may avoid regional disparities becoming self-perpetuating and help to promote growth in the rest of the country/area. Within the EU area, EU structural funds have for instance played an important role in the modernisation and restructuring of Greece, Ireland, Portugal and Spain, allowing advances in the convergence process and “crowding in” private investments as well as employment. Second, fiscal equalisation transfers could be considered as a prerequisite for effective fiscal competition, by allowing levels of public service to be compared at similar resource levels. By reducing ex ante disparities across jurisdictions in providing comparable levels of public services at comparable taxation levels, they act to level the playing field between poor and rich jurisdictions and/or between jurisdictions with differences in costs of providing public services reflecting exogenous reasons (including population density, geographical factors and endowment in natural resources). In the absence of equalisation transfers, rich jurisdictions or those with cost advantages would dominate and competitive pressures would be lower. In a number of countries, large cities also receive some financial compensation through fiscal equalisation schemes to account for the higher costs of producing services and/or the demand from neighbouring jurisdictions (spillover effects). This puts them in a fairer position to compete on the quality of public services and/or the level of taxes with suburban jurisdictions.

69. Individual country OECD Economic surveys, however, have revealed cases where fiscal equalisation schemes have failed to improve public sector efficiency and/or reduce regional disparities. In Italy for instance, an over-dependence on transfers appears to have obstructed development in the poorer regions, while equalisation of per capita resources produced no convergence in service quality and gave no incentives for better governance (Bibbee and Goglio, 2002). Similarly in Germany and Japan, the high level of investment in poorer areas has had little success in achieving convergence of economic performance (Wurzel, 1999 and OECD, 2000c). At the same time, by impeding changes in cost differentials and reducing migration flows across regions, fiscal equalisation transfers may hold back growth in more dynamic regions and hinder necessary adjustment in less dynamic ones.

70. Fiscal equalisation transfers may also create poverty traps and reduce subnational government tax collection efforts. Of particular concern are schemes that largely offset changes in local governments’ own revenues by fiscal equalisation transfers. The risk of poverty traps associated with fiscal equalisation

47. According to the European Commission, EU structural funds contributed about ½ per cent per year to economic growth in these countries between 1989 and 1999. The cumulative effect added about 10 per cent to GDP in Greece, Ireland and Portugal and over 4 per cent in Spain (http://europa.eu.int/comm/regional_policy/intro/regions10_en.htm). On the impact of infrastructure investment partly financed by EU structural funds in Portugal, see Bronchi (2003). Recent OECD work (OECD, 2003d) also reveals that the modernisation of a country’s infrastructure may promote trade in services.

48. As an example, richer subnational governments deriving substantial revenues from natural resources (Canada and Norway) should, in principle, only lower their tax rates if they are able to improve the cost-efficiency of their public spending programmes.

49. In Germany, the inhabitants of the city Länder are weighted at 135 per cent in the equalisation scheme, whereas the larger Länder are weighted at 100 per cent. The 2001 Austrian Finanzausgleichsgesetz mandates that the population of cities with more than 50,000 inhabitants be weighted at 233 per cent before calculating inter-regional transfers according to population criteria (Fenge and Meier, 2002). In Australia, the grant system accounts for the estimated spillover in demand for the Australian Capital Territory from residents of adjacent communities.

50. As a general point, such an efficiency loss would need to be evaluated in the context of regional development objectives (such as retaining people in sparsely populated areas, e.g. in Norway).
schemes – fiscal equalisation schemes reduce subnational government incentives to introduce growth-promoting policies – has been considered an important issue in some countries, including Australia, Austria, Canada and Germany. In Austria, Schneider (2002) estimated that, on average, 55 per cent of additional revenues from the communal tax (which is the most important of a local government’s own taxes) are compensated by a loss of equalisation grants. In extreme cases, Austrian local governments can lose up to 144 per cent of the additional tax yields resulting from a larger tax base of the municipality. This reduces local government incentives to adapt local conditions so as to facilitate new companies within their jurisdiction (see also OECD, 2001e). In Canada, it has been argued that equalisation can adversely affect economic expansion in the “have-not” provinces, particularly the lowest-income Atlantic Provinces and, therefore, stand in the way of badly needed regional adjustments that would reduce horizontal imbalances. While such schemes offer few fiscal rewards for developing a local tax base, disincentive effects could be muted by policy makers’ efforts to attain other objectives, including employment creation.

71. In Japan, fiscal equalisation schemes maintain some incentives for subnational governments to develop their tax base. First, they are based on taxable income, calculated using standard rather than actual tax rates. Thus, local governments will not lose equalisation grants if they raise their tax rates. Second, equalisation is partial since the calculation of the equalisation grant (LAT) excludes 25 per cent of municipal and prefectural tax revenues, corresponding to the so-called reservation ratio.51 Some empirical analysis, however, suggests that this may not be sufficient for middle-income jurisdictions, in particular with regard to the automobile tax (Nishikawa and Yokoyama, 2002).

72. Countries have implemented two strategies to reduce potential disincentive effects associated with fiscal equalisation schemes, implying in each case some compromise with equity objectives. In the new Spanish transfer system from the central government to the regions, transfers are designed to fill the gap between revenues and expenditure needs for each region for a base year (1999) and will not be adjusted to reflect actual growth performance of individual regions. The OECD has recommended that Germany adopt a similar approach, so as to increase the incentive structure of the equalisation system by relying more on “equalising lump sum transfers”, i.e. fixed over a multi-annual period.52 A consequence of this “freezing” of the grant system is likely to be that the equalisation component will gradually be reduced and eventually lost. Another approach has recently been followed by Italy, where a new equalisation scheme based on national VAT receipts was introduced in 2000. It abolished almost all transfers to the regions. The VAT fund is intended to equalise up to 90 per cent of the differences in standardised per capita revenues (contrasting with the previous system with full equalisation), leaving room for incentives to develop local tax bases. Partial equalisation schemes are also in place in Japan and the Nordic countries, though with significant variations among them.

**Macroeconomic management in a decentralised setting**

73. Several macroeconomic management issues emerge in a decentralised fiscal policy setting. One key issue is how to ensure the sustainability of public finances while maintaining a stabilisation role for fiscal policy. A number of countries have experienced fiscal slippage at the subnational government level.

51. These “reservation ratios” are regarded as an allowance for the uncertainty of estimation and an incentive for local tax collection effort. For prefectures, the reservation ration has recently been increased from 20 to 25 per cent.

52. It should be noted, however, that transfers under the “Solidarity Pact” for the new Länder in Germany are already independent of each individual Land’s growth performance. In addition, the reform of the inter-state equalisation system – to be effective in 2005 – introduces a “premium” designed to reward Länder whose increase in tax receipts (measured against the preceding year) exceeds the average revenue increase of all Länder combined (Wurzel, 2003).
In Japan, local government debt has soared rather rapidly over the past decade (Figure 5) to reach about 30 per cent of GDP in the early 2000s. This surge cannot be seen as a result of a lack of co-ordination across levels of government since subnational government budgets have been closely monitored by the central government (through the Local Public Finance Programme) which tightly regulates subnational government issuance of bonds. Furthermore, local government recourse to debt finance has often been encouraged, at least indirectly, by the central government, as central government grants partly cover subnational government loan repayment costs. The 2000 Omnibus Decentralisation Act – in particular the removal of some restrictions on local government access to the bond market – and recent initiatives to reform the grant and local tax systems are, however, likely to change this setting. This will call for new mechanisms – such as fiscal rules, improved availability and quality of data on local public finance, giving a disciplining role to financial markets – to ensure consistency between subnational government fiscal behaviour and macroeconomic objectives.

74. Against this background, this section discusses the use of fiscal co-ordination mechanisms between the different tiers of government and provides an overview of different country strategies. The questions addressed include: Is there a role for subnational fiscal rules, such as balanced budget or “golden” rules, expenditure ceilings, or limits on the ability to raise money on the financial market? And to what extent could market mechanisms enhance fiscal discipline? Problems of transparency, related to the availability and consistency of relevant public finance data across government levels are also of importance here.
Figure 5. Local public debt in Japan

Overall fiscal discipline could be at risk

75. Several factors make it difficult to secure fiscal discipline in a decentralised setting. One problem is that subnational governments do not take account of all effects at the national level in their decision-making. Higher public spending could have adverse spillover effects on the rest of the economy. Financed through subnational borrowing, it may affect lending conditions for other public and private agents. Financed by higher taxes, it can undermine incentives to work and invest. Strategic behaviour could also develop in a decentralised setting. In many countries, the central government has provided discretionary financial support to subnational governments running into financial difficulties (Finland, Germany, Norway, Italy and Sweden) or has bailed them out (Brazil, Italy and Mexico). Expectations of a “rescue package” create a moral hazard problem and make it more likely that subnational governments implement fiscal policies which are unsustainable. In Sweden for instance, an empirical survey of municipalities’ behaviour revealed that those which previously received discretionary financial support failed to comply later on with the balanced budget requirement as they expected their deficit to be covered by future grants from the central government (ESO, 2002).

Strategies to secure fiscal discipline vary

76. To address the risks of a loose fiscal policy, countries have relied on a wide array of instruments. Country approaches can roughly be divided into four “stylised” categories (Table 6 and annex, which presents a more detailed overview of strategies in selected countries):53

- In some countries, the central government exercises tight control on subnational government fiscal behaviour by imposing strict administrative controls. In Greece and Turkey for instance, subnational government budgets are controlled by higher levels of government while any local authority borrowing is subject to approval by the central government in Ireland, Japan, Korea and the United Kingdom. Combined with little subnational taxing power, this leaves subnational authorities with limited fiscal autonomy.

- At the other extreme, a limited number of countries have maintained extensive fiscal autonomy at a subnational level, while relying on market forces to secure fiscal discipline. In Canada, Czech Republic and the United States, financial markets play a major role in enhancing fiscal discipline. In Canada and the United States, many intermediate government tiers have voluntarily adopted some sort of balanced budget rules to improve their credit rating.54 Direct

53. The classification of country approaches into these four categories is not always clear-cut. In particular, the distinction between “administrative control” and “fiscal rules” imposed by the central government involves an element of judgement. A system of fiscal rules imposed on subnational governments, combined with close monitoring and enforcement by central authorities, could be easily described as a system of “administrative control”. The classification in this paper is thus based on various sources of information, including the degree of autonomy of subnational governments in drawing up their budget (e.g. right to borrow) and the degree of revenue-raising powers.

54. A majority of 45 states in the United States require the governor to present a balanced budget, while 40 states require that legislature passes a balanced budget and 34 states require the governor to sign a balanced budget. In addition, most states have ceilings on debt issuance and about 30 states have tax and expenditure limitations. A general referendum is also required to approve major taxation initiatives in Colorado, Michigan and Missouri in the United States (National Association of State Budget Officers, 2002). In Canada too, general referenda on tax changes are required in Ontario, Manitoba, Alberta and the Yukon and nine provinces and territories apply some sort of fiscal rules (Kennedy and Robbins, 2001).
A co-operative approach offers several advantages. First, it gives a political platform for discussions in an area of significant public interest and importance. It may also help to strengthen political commitments, and hence fiscal discipline, through a consensus-building strategy. Peer-pressure may further act as a control mechanism, with local awareness of the macroeconomic implications of policy choices, making circumvention less likely. On the other hand, it may be difficult to reach an agreement on common fiscal policy objectives and, not least, sufficient enforcement mechanisms. In Germany, for example, a Domestic Stability Pact was finally agreed in 2002 after having been on the agenda since the mid-1990s. No sanction applies in case of non-compliance in Germany. In Austria, the financial sanction is subject to the unanimous decision of a body consisting of representatives from all government tiers. In Denmark, a system implying financial sanctions in case of non-compliance was abolished in the late 1980s.

Similarly, within the EU area, the Council -- composed of one representative at ministerial level from each member state -- decides whether to endorse the early warning procedure and sanctions in case of individual country fiscal slippage.
after the Local Government Association threatened to withdraw from the negotiations (Lotz, 1991). In some cases, subnational governments are represented through an association, which may lack legal authority to enforce the agreement, putting it at risk. As an example, local government income tax rates have increased by 5 percentage points in Denmark since the mid-1980s, of which only ½ percentage points were foreseen in the agreements with central government (Daugaard, 2002). Furthermore, political compromises may also result in inconsistencies and loopholes in the negotiated agreements, undermining its role as a steering instrument. In particular, there is a risk that agreed fiscal objectives -- once they are binding -- could be waived or changed in the subsequent negotiation round.

A variety of fiscal rules have been implemented

78. A large variety of fiscal rules for subnational governments exist. Fiscal rules targeting the overall budget deficit (including Austria, Belgium, Finland, Sweden and Spain) or the operating deficit (including France, New Zealand and Norway) are most frequently used (Table 7). A deficit target has the advantage of simplicity and of being easily understood by the wider public, but could fail to prevent debt accumulation due to off-budget items. A recent survey on Swedish municipalities, for example, revealed a very low correlation between deficit and debt accumulation. In some other countries, the fiscal rule takes the form of a ceiling on subnational debt (Hungary, Portugal and Poland) or debt service (Brazil). These targets may be better suited to addressing considerations of long-term sustainability and inter-generational equity. A debt ceiling can still be circumvented, however, by sales of assets, outsourcing of debt to local public enterprises outside the governmental sector, or by selling and leasing back fixed capital. When assessing long-term fiscal sustainability, debt targets should, in principle, be defined in net terms, but the value of publicly-held assets is uncertain and volatile, making a net debt target unreliable.

Table 7. The use of fiscal rules and sanctions in selected countries

<table>
<thead>
<tr>
<th>Sanctions in case of non-compliance</th>
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<tbody>
<tr>
<td>Deficit target&lt;sup&gt;1&lt;/sup&gt;</td>
</tr>
<tr>
<td>Operating deficit target&lt;sup&gt;2&lt;/sup&gt;</td>
</tr>
<tr>
<td>Debt ceiling&lt;sup&gt;3&lt;/sup&gt;</td>
</tr>
<tr>
<td>Expenditure ceiling</td>
</tr>
</tbody>
</table>

1. Usually takes the form of a balanced budget requirement.
2. May also take the form of a "golden rule".
3. Limits on debt service, debt-to-revenue ratio or debt-to-GDP ratio.

Source: Annex.

79. An important drawback of both debt and deficit targets is that they can be satisfied through higher spending and taxes, with attendant negative consequences for economic growth affecting all jurisdictions. This points towards restrictions in taxing autonomy at a subnational level (in most countries, see above) and/or an expenditure target (implemented in Belgium and Germany). However, expenditure and debt levels may justifiably vary between different government bodies, making a common ceiling less

56. See OECD (2002d) for a discussion of fiscal rules at the national level.

57. Based on data from Swedish municipalities for the years 1987-99, Söderström (2002) calculates a correlation of only -0.101 between the financial balance and the change in local debt.
useful and more difficult to implement on the subnational level than a deficit target. And, as with a deficit constraint, an expenditure target does not necessarily prevent debt accumulation as spending can be pushed below the line. To prevent mere pro forma consistency with the rules, constraints may be needed on both flows and stocks. Hence, in practice, multiple fiscal regulations are usually applied to subnational governments, with fiscal rules being combined with restrictions on taxing rights and/or borrowing constraints.

**Fiscal rules: a trade-off between credibility and flexibility**

80. The delicate trade-off between credibility and flexibility in designing fiscal rules is also an issue at the subnational level. Rigid fiscal rules focusing on the overall annual budget position or debt holding are attractive because they are well defined, simple to understand and to communicate, and because they are transparent and can be readily assessed. These advantages have been considered as important criteria in designing optimal fiscal rules (Box 5). The drawback is that they may lack the flexibility to cope with unexpected events or cyclical downturns, reducing their credibility when they come under strain. A too flexible fiscal rule, on the other hand, could be easy to circumvent and may fail to secure fiscal discipline. Subnational authorities may even misuse the flexibility provided to increase spending and indebtedness during upturns, augmenting future adjustment problems.

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**Box 5. Designing fiscal rules**

The literature on fiscal rules has suggested that an “optimal” fiscal rule should meet several -- and sometimes conflicting -- criteria (see for example OECD, 2002d; Kopits and Symansky, 1998; and Buti et al., 2002).

- Fiscal rules should be adequate relative to the final goal. To achieve fiscal consolidation, for example, the overall debt level should be targeted, or an indicator strongly correlated with, debt accumulation. Similarly, an expenditure ceiling might be best suited to curb public spending.
- Fiscal rules should be consistent with other policy objectives. Conflicts between fiscal targets and other main policy goals are likely to undermine the fiscal rule as a steering instrument as subnational governments may try to find ways around it.
- The fiscal target and possible escape clauses should be well-defined. A target on the overall budget deficit or debt level may, in this respect, be better than a more sophisticated target focusing on the structural position or excluding special expenditure or debt categories (e.g. a golden rule), since such targets may suffer from measurement weaknesses.
- The framework should be transparent. In particular, the division of responsibilities across governments should be clearly stated and the availability and quality of data should be assured. Increased transparency helps to make the rule less easy to circumvent by ad hoc measures and creative accounting techniques and may alleviate the trade-off between accountability and flexibility in designing fiscal rules.
- Rules should be simple to understand. By being easy to communicate, simple fiscal rules may be more appealing to the public than complicated ones and, thus, may gather stronger popular support.
- Fiscal rules should be flexible and able to handle unexpected events, cyclical downturns (letting automatic stabilisers work) and reasonable investment needs. This can be obtained by focusing on cyclically-adjusted targets, introducing a medium-term framework or specifying escape clauses.
- Fiscal rules should be enforceable. This may call for a simple and well-defined fiscal rule. However, a too simple fiscal rule may risk prescribing a harmful fiscal policy reaction in certain circumstances, eroding the political and public support for the rule.

81. Some degree of flexibility has been built into the fiscal framework in most countries. In some, the fiscal rule mainly functions as an ex ante budget restriction, and not as an ex post requirement on subnational accounts (including Germany, Italy and some US states). In other countries, the fiscal rule has to be complied with over the medium term, usually two to four years (including Finland, Norway, Sweden,
some Canadian provinces and Swiss cantons). Furthermore, certain expenditure categories -- public investment in particular -- have been excluded from the fiscal target in a number of countries (including France, Italy, New Zealand and Norway). Others have combined simple fiscal rules with mechanisms to increase flexibility. Escape clauses, providing flexibility under special circumstances, have been introduced in Austria, Brazil, Italy, Poland and some Canadian provinces and in the EU Stability and Growth Pact. In the United States, all but five states have budget stabilisation funds (“rainy day funds”) and most have contingency funds set aside to provide for unforeseen expenditures. At the EU level, several countries have also introduced more ambitious fiscal targets than the 3 per cent deficit ceiling and the “close-to-balance budget” over the cycle enshrined in the Stability and Growth Pact. This partly reflects the need to cope with fiscal pressures stemming from an ageing population, but it is also designed to provide more flexibility for the operation of automatic stabilisers.

Fiscal rules have been supported by enforcement mechanisms

82. A number of enforcement mechanisms are in place across countries to strengthen subnational incentives to comply with fiscal regulations. In Austria, Brazil and Slovak Republic, subnational governments failing to reach the fiscal target can be fined, while in Italy and Spain, a region causing the country to breach EMU fiscal rules would have to pay the associated penalty. In Denmark, grants to the counties were cut in 2003 in response to a violation of the agreed tax freeze. Similarly in Portugal, state transfers were to be reduced in 2003 if spending ceilings are exceeded or if financial information is not provided in time. The use of financial sanctions raises problems. In particular, it may not be time-consistent. In addition, fining a subnational authority already facing financial problems could be politically difficult or even unconstitutional. In fact, subnational governments in financial distress usually receive increased financial support. In addition, a major requirement for the effective implementation of sanctions is independent arbitration. But it is not obvious that this requirement is met in many countries, in particular when the application of sanctions requires unanimously approval in a body consisting of all involved governments (e.g. Austria) or has to be approved through a majority in Parliament (Brazil and Denmark). Alternatively, financial sanctions may be imposed on the representatives of subnational government. In Brazil, a comprehensive set of sanctions was introduced in the aftermath of three major state debt crises in the 1990s, including fines or impeachment and imprisonment for individuals responsible for violating the rules (World Bank, 2002).

83. A number of countries have introduced some type of “administrative” sanction or procedure. Subnational authorities in Norway for example, are placed under central administration in cases of non-compliance, while in Belgium and Brazil, central authorities may limit subnational borrowing. A number of countries have introduced auditing or co-operative bodies to deal with subnational authorities who fail to comply with fiscal targets. In Finland and Spain, defaulting authorities are obliged to present a plan for correcting any fiscal deficit, while Italy and France have introduced co-operative bodies to deal with subnational governments which fail to comply with the regulations. Administrative sanctions imply costs in terms of loss of reputation and administrative freedom and are more likely to be implemented than

58. “Rainy day funds” are, however, rarely able to fully meet the costs associated with an economic downturn (National Association of State Budget Officers, 2002).

59. Sanctions have also been introduced to enhance the credibility of fiscal rules decided upon at the subnational level. In Canada, for example, four provinces have legislated penalties for not achieving the fiscal targets, in the form of a significant cut in wages for ministers or members of the executive council (Kennedy and Robbins, 2001).

60. In Norway, a municipality that has not been able to cover an operating deficit over the subsequent two years must obtain the approval of the Ministry of Local Government and Regional Development before raising any loan or enter into a long-term contract (e.g. renting offices).
financial sanctions. On the other hand, designing such sanctions is difficult, partly because of information asymmetries. Differences in municipality size, as well as historical and cultural aspects, also make it difficult to design sanctions that fit all subnational authorities.61

Problems have emerged: fiscal slippages and cyclical developments

84. Efforts to co-ordinate fiscal policy across government levels have encountered fairly widespread problems. In Norway, 18 per cent of municipalities had a deficit each year during the period 1980-98, on average (Borge and Rattsø, 2002), and currently 95 out of 434 municipalities and five out of 19 counties are facing administrative sanctions due to non-compliance with the balanced-budget requirement. Likewise, in Sweden and Finland, only approximately two-thirds and three-quarters of the municipalities, respectively, achieved balance in 2001. Fiscal rules have in some cases been circumvented by creative accounting techniques. In Italy, local deficits have partly been financed by arrears to suppliers. Similarly in China, subnational governments have borrowed from local banks, enterprises, and wealthy individuals although they are not, in principle, allowed borrowing on their own account. Country experiences thus reveal both the difficulty in designing and implementing appropriate fiscal regulations and the need for them to be regularly reassessed and, if necessary, reformed. In Australia, for example, the co-operative framework was rearranged and strengthened in the mid 1990s in response to the increased use of sophisticated financing techniques, such as financial leases, to circumvent Loan Council borrowing limits. And, as a consequence of local bankruptcies in the aftermath of transition, Hungary tightened borrowing restrictions in 1995.

85. Despite the flexibility embodied within existing fiscal frameworks, coping with cyclical developments has not always been satisfactory. In Switzerland, cantons and municipalities have displayed a pro-cyclical fiscal policy in the past three decades (Joumard and Giorno, 2002), while both Canada and the United States have invariably experienced periods of pro-cyclical fiscal policy at the subnational level. In some countries (including Finland, Hungary and Norway), temporarily higher tax revenues have been transformed into permanently higher subnational spending while lower revenues have been reflected in a deterioration in the subnational government fiscal position and/or higher intergovernmental transfers (e.g. Spain up to the 2002 reform). In Japan, fiscal equalisation grants are pro-cyclical since they increase in line with total tax revenues. Evidence over the past decades, however, suggests that fiscal equalisation grants have had an asymmetrical behaviour: rising tax revenues have increased the grants but slower revenue growth has not led to a full downward adjustment (OECD, 2001g).

86. Letting automatic stabilisers work in a decentralised setting has been made possible in several countries where central government grants and/or tax shares are adjusted over the cycle to smooth variations in subnational tax revenues. In Denmark and Norway, subnational government grants and tax shares are adjusted through the annual budget process to reflect macroeconomic developments. In Finland, the central government has tended to offset the rise in municipal tax revenues in the late 1990s when the economy was booming by reducing state grants (Figure 6).

61. In Switzerland, for example, cantonal governments have in a few cases forced the amalgamation of a municipality unable to repay its debt with a neighbouring one.
Figure 6. Finance resources of municipalities: tax revenues and central government grants in Finland
Volume indices, 1980 = 100

1980 82 84 86 88 90 92 94 96 98 2000 02 04

Total Tax revenues Central government grants

1. 1995 constant prices using the deflator for government final consumption expenditure.

Source: OECD National Accounts, Statistics Finland and the Association of Finnish Local and Regional Authorities.

Market mechanisms could play a role in enhancing fiscal discipline

87. Market mechanisms could play a more prominent role in enhancing fiscal discipline at the subnational level. In Canada and the United States, for example, credit ratings in bond markets seem to act as a disciplining factor at all levels of government (Poterba and Ruben, 1997). Financial markets also play a part in disciplining subnational authorities in countries like Czech Republic, Hungary, Finland and New Zealand, as subnational debt is not guaranteed by the state. In Norway, restrictions on subnational borrowing were relaxed in 2000 in an attempt to increase the role of the financial markets in disciplining subnational government fiscal behaviour.

88. For financial markets to exert effective discipline on subnational government borrowing, several conditions need to be satisfied.

- Subnational authorities should not have privileged access to borrowing in any form. One implication of this is that public loans should be obtained in the private market, and not from

62. According to Poterba and Rueben (1997), those states with weak anti-deficit provisions face, in the US market for tax-exempt bonds, borrowing costs ten to fifteen basis points higher than similar states with stricter anti-deficit rules. Furthermore, a state with binding tax limitation rules would face, on average, a borrowing rate fifteen to twenty basis points higher than those which do not have a tax limitation law. A state with an expenditure limitation law will, in contrast, face a borrowing rate several basis points lower than that of states without any fiscal limits.

63. Since 2000, subnational budgets and borrowing no longer have to be approved by the central government as long as the authorities comply with the overall fiscal guidelines. As a consequence, credit institutions are likely to get stronger incentives to check local finances before lending money (Borge and Rattsø, 2002).

64. See Lane (1993) for a thorough discussion on market discipline and Balassone et al. (2002).
publicly owned credit institutions with administratively-decided interest rates, and should not be guaranteed by higher levels of government.

- Adequate information on the borrower’s existing liabilities and repayment capacity must be readily available, so that potential lenders can correctly discriminate between borrowers. Information shortages impair the market’s usefulness as a steering mechanism as reactions might be too slow or too abrupt and disruptive, with possible contagion effects on other subnational authorities.

- No bailout of subnational authorities facing problems must be anticipated. In practice, however, this is not politically tenable in many countries because of equalisation objectives. There are very few examples of subnational governments going bankrupt and causing huge losses for their creditors.

- The borrower must respond to market signals. In practice, this may not be the case as short election periods may foster a short-sighted conduct of fiscal policy.

An alternative way to strengthen the role of market mechanisms would be to create a market for tradable deficit permits or taxing rights. A trading mechanism would recognise that fiscal policy slippage -- in terms of deficit or higher subnational taxes -- creates negative externalities, by putting aggregate financial stability or efficiency goals at risk, while minimising the compliance costs of achieving a global target. Such schemes have serious drawbacks, however, which limit their practicality. The initial allotment of permits could be contentious and the supply of permits difficult to change in response to economic shocks without penalising those jurisdictions that have exercised greatest discipline or bought permits at high price. More fundamentally, in a thin market, the price of such permits could be volatile and would not necessarily reflect spillover costs or be high enough to prevent a subsidiary level government from running into an unsustainable fiscal position. It should, however, be noted that a system of transferable deficit rights is in place in Austria. Based on agreed fiscal targets for each individual Land and for municipalities as a group in each Land, a mechanism is in place allowing the transfer of an overshoot to another participant. Such transfers are likely to take place by political agreement between the parties involved, and may include some sort of compensation, although this is not made public. As an alternative economic instrument to limit tax hikes, central authorities could put a tax on subnational tax increases and a subsidy on tax cuts. In Sweden from 1996, any tax increases by subnational authorities resulted in a cut in central government transfers amounting to half of the extra revenues raised from the tax increase. This system of a “tax on taxes” was, however, abolished on constitutional grounds in 2000.

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65. In the United Kingdom, the Public Works Loan Bank has been the most significant source of loans to local government (Watt, 2002). The reliance on public banks has been common in Brazil, Finland, Germany, Italy, Mexico and Sweden.

66. In the Czech Republic, a municipality (Rokytnice) recently went bankrupt and some of its assets were auctioned off by creditors.

67. A system of deficit permits has been suggested by Casella (1999) in the context of the EU stability and Growth Pact. Tradeable tax rights have been discussed in Denmark (Dansk Økonomi, forår 2002).

68. In 2001, there were two such transfers of deficit rights. In one case, an overshoot of the fiscal balance target was transferred from one Land to the municipalities in the same Land, while in the other case the transfer was from the municipalities to the Land level.
Transparency should be improved

90. Transparency is crucial if fiscal rules, co-operative agreements or financial markets are effectively to discipline subsidiary government fiscal behaviour. Budget reports should be comprehensive, encompassing the information needed for the relevant trade-offs between different policy options to be assessed. An important element of fiscal transparency is an accounting system that delivers as accurate and timely a picture as possible, at both budgeting and reporting stages, of the impact of the government’s activities on its overall financial positions. In a number of countries, subnational public finance data are often available with a significant time lag (Brazil, Germany, Italy, Mexico, Poland, Portugal and Spain) and are not consistent with those for the central government (Korea and Switzerland). This makes it difficult to set a consolidated budget and, thus, to exert effective fiscal control or to determine the stance of fiscal policy. In Japan, the quality of local public finance data is also poor. For example, liabilities held by the local government special account for sewage were suddenly revealed in 2002, resulting in a significant upward revision to general government debt (by approximately 10 per cent of GDP). Financial difficulties currently faced by many local “third sector companies” (public-private partnerships) could result in a further hike in public debt. In general, measures to improve transparency – i.e. data availability and quality – are to be strongly recommended.

See OECD (2001f) for a thorough discussion on best practices for budget transparency.
ANNEX

ENSURING FISCAL DISCIPLINE AT SUBNATIONAL LEVEL

STRATEGIES IN OECD COUNTRIES

The purpose of this annex is to highlight some key features of the framework in place to co-ordinate fiscal policy across government levels in different countries. In general, the relationship between governmental tiers is complex and varies substantially across countries. In some, subnational authorities seem to enjoy relatively limited fiscal autonomy due to strong central involvement in the subnational budget process and weak revenue-raising powers. In others, subnational government discretion on fiscal affairs (the power to set spending priorities, take on loans and/or set tax parameters) is combined with different types of “control mechanisms” to co-ordinate fiscal policy across government tiers. Separating country strategies is not clear-cut and involves an element of judgement. Furthermore, this annex must also be viewed in light of possible information shortages as country surveys have put different emphasis on discussing and describing fiscal relations across government tiers, underlining the need for more work in this area.

Table A1. Fiscal framework and enforcement mechanisms for ensuring budget discipline at the subnational level

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<tr>
<th>Country</th>
<th>Fiscal framework</th>
<th>Enforcement mechanisms</th>
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<tbody>
<tr>
<td>Australia</td>
<td>• A co-operative approach: Federal and state borrowing are co-ordinated by the Australian Loan Council, taking into account each jurisdiction’s fiscal position and infrastructure needs, as well as macroeconomic objectives. Most states have adopted some sort of balanced budget rules.</td>
<td>• Market discipline: States have to borrow on their own account, and the Loan Council provides information to the financial market on public sector borrowing plans.</td>
</tr>
<tr>
<td></td>
<td>• A co-operative approach: An explicit Domestic Stability Pact was introduced in 1999 and the present arrangement, covering the period 2001-2004, was agreed upon in October 2001 According to the Pact, municipalities as a group have to balance their budget over the period 2001-2004, while regions as a group have to</td>
<td>• Peer pressure: If non-financial operating receipts are exceeded by more than 2 per cent in either direction, states are obliged to provide an explanation to the Loan Council. This explanation will be made public. The Loan Council is not formally empowered to approve any change, but it could pursue any concerns in the Loan Council.</td>
</tr>
<tr>
<td>Austria</td>
<td></td>
<td>• Peer pressure: through a co-operative framework.</td>
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<td></td>
<td></td>
<td>• Financial sanctions: Governments that fail to reach the target would have to pay a fixed and a variable fine totalling 8 per cent of the stability contribution and 15 per cent of the shortfall, respectively, up to a ceiling.70 Application of</td>
</tr>
</tbody>
</table>

70. For Länder and municipalities, temporary shortfalls of -0.15 and -0.10 per cent of GDP, respectively, are allowed. However, the average stability contribution has to be delivered for the whole period of the pact. If Austria breaches the Maastricht targets, EU sanctions will also be distributed across domestic governments.
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<th>Country</th>
<th>Fiscal framework</th>
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<tr>
<td>Austria (continued)</td>
<td>produce annual surpluses of at least 0.75 per cent of GDP. This commitment is not binding for any individual municipality, but for municipalities grouped according to the Land they belong to. The pact allocates obligations to each Land. The targets have to be complied with ex-post. The pact provides a possibility to transfer surplus/deficit rights to other governments. No specific reference is made to the financing of public investments.</td>
<td>sanctions depends, however, on the unanimous decision of a commission involving the federal government on the one hand, and the Länder and the municipalities on the other. If compliance is re-obtained within one year, the fine is returned; otherwise, the money is allocated across the complying governments.</td>
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<td></td>
<td><strong>Borrowing</strong>: No explicit restrictions on borrowing by Länder. For municipalities, borrowing is only allowed to cover extraordinary expenditures. The Länder are obliged by law to regulate local borrowing, but the regulation put in place varies significantly among different Länder.</td>
<td><strong>Escape clause</strong>: In case of a serious economic slowdown, the sanctions do not apply.</td>
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<td>Belgium</td>
<td><strong>A co-operative approach</strong>: Permissible deficit and expenditure growth levels for the different government levels are established on the basis of recommendations by the High Council of Finance. These recommendations are published in annual reports. The deficit target refers to the overall fiscal balance.</td>
<td><strong>Peer pressure</strong>: through a co-operative framework.</td>
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<td><strong>Borrowing</strong>: Regions and communities can issue bonds, but they must have the approval of central government.</td>
<td><strong>Administrative procedures</strong>: The federal government is allowed by law to limit the borrowing of regions for a period of two years, following a recommendation from the Supervisory Council and a consultation with the regional governments. The regional level monitors the municipalities’ budgets and has the power to enforce expenditure cuts or tax increases if necessary.</td>
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<td>Canada</td>
<td><strong>No formal co-ordination</strong>: A loose budget co-ordination exists via a dialogue among ministers, which takes place once a year. Most provincial and territorial governments have introduced some sort of balanced-budget legislation, while municipal governments are not allowed to show a deficit.</td>
<td><strong>Market discipline</strong>: The federal government does not guarantee subnational debt.</td>
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<td><strong>Borrowing</strong>: Provincial and territorial governments have unrestricted access to borrowing, while municipal governments can only borrow for investment projects.</td>
<td><strong>Escape clauses</strong>: In most provinces, a surplus in one year can provide an accounting reserve to be drawn on if a deficit is incurred in a subsequent year. In addition, the legislation in many provinces builds in exemptions for special events.</td>
</tr>
<tr>
<td>Czech Republic</td>
<td><strong>No formal co-ordination</strong>: Subnational governments are free to take on debt and may approve a deficit budget if municipal guaranties or collateral to cover the planned shortfall is provided.</td>
<td><strong>Market discipline</strong>: Subnational debt is not guaranteed by the state.</td>
</tr>
<tr>
<td></td>
<td><strong>Borrowing</strong>: No explicit restrictions on subnational borrowing.</td>
<td><strong>Market discipline</strong>: Subnational debt is not guaranteed by the state.</td>
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<tr>
<td>Country</td>
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| Denmark      | • **A co-operative approach**: A system of formalised budget co-operation between the central government and the Local Government Association has its roots in the early 1970s. Subnational governments have to run balanced budgets, but have substantial taxing rights. However, the central government has recently announced a tax freeze, which applies also at the subnational level.  
• **Borrowing**: Counties and municipalities have, as a general rule, no access to borrowing. However, there are important exceptions. For counties, long-term borrowing within 25 per cent of the total net outlays for investment for the fiscal year is accepted, while municipalities have free access to borrowing for investments in specified sectors that are to a large extent financed by user charges. Furthermore, the Ministry of the Interior could grant municipalities discretionary permissions to borrow. | • **Peer pressure**: The agreement between the central government and the Local Government association is not legally binding, and the association has no efficient instruments to ensure aggregate compliance.  
• **Financial sanctions**: In case of violation of the tax freeze all net extra tax revenues will be confiscated through a reduction in individual and general block grants. |
| Euro area/ EU countries | • **Fiscal rule**: The fiscal framework consists of two main requirements; the Treaty requirement to avoid excessive deficit position -- whereby a deficit above 3 per cent of GDP is considered excessive except if it is temporary and exceptional -- and the requirement of the Stability and Growth Pact to achieve and maintain a budgetary position “close to balance or in surplus” over the medium-term, but also in each year in cyclically-adjusted terms. | • **Administrative procedures**: Member states submit annual stability or convergence programmes in which they set out their short and medium-term fiscal strategies. The programmes are regularly updated and are subject to peer review and monitored by the Commission and Council.  
• **Financial sanctions**: apply only following a continued failure to take corrective measures in response to Council recommendations. They consist of a non-bearing interest deposit, to be converted into a fine (which cannot exceed 0.5 per cent of GDP) if two years later the excessive deficit persists. |
| Finland      | • **Fiscal rule**: A law requiring municipalities to achieve a balanced budget in the medium term was introduced in 2001.  
• **Borrowing**: No explicit restrictions on local borrowing. All borrowing is co-ordinated by the municipalities’ organisation and is not guaranteed by the state. | • **No sanctions**: Municipalities are obliged to make a plan of how to cover any deficit in the balance sheet. |
| France       | • **Fiscal rule**: Local governments are not allowed to show an operating deficit.  
• **Borrowing**: French local authorities are allowed to borrow in order to finance capital investments. | • **Administrative procedures**: The local central government representative annually controls local budgets. If the budget breaks legal requirements, it is sent to the Chambre Régionale des Comptes (CRC). The auditing procedure involves both an ex-ante and an ex-post check. If a deficit appears (above a given ceiling) the Regional Chamber of Accounts has to propose appropriate fiscal measures to the local government. |
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<th>Country</th>
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| Germany | • A co-operative approach: The major instrument for policy co-ordination is the intergovernmental Financial Planning Council (Finanzplanungsrat), consisting of the federal government, the Länder and representatives of the communities. A Domestic Stability Pact with spending caps for 2003 and 2004 has been agreed.  
• Borrowing: Most of the sixteen Länder have adopted a golden rule; i.e. borrowing is only allowed for investment expenditure. Municipalities can only use borrowing to finance capital investments if other financing is not feasible or appropriate and it is subject to regional approval. | • Peer pressure: The Financial Planning Council (Finanzplanungsrat) is attributed the tasks of monitoring fiscal development at all levels of governments and of making recommendations for restoring fiscal discipline in cases of non-compliance. |
| Greece | • Limited fiscal autonomy at the subnational level: Lower levels of government (prefectures and municipalities) prepare their budgets and submit them to regional representatives for the central government for approval.  
• Borrowing: All borrowing is subject to the approval of the Ministry of Economy and Finance. |  |
| Hungary | • Borrowing: Municipalities are authorised to borrow only to finance capital outlays, up to a ceiling of 70 per cent of their yearly net (after interest payments) own revenues.  
• Market discipline: Subnational debt is not guaranteed by the state. | • Administrative procedures: If a municipality is unable to pay its debt, it can be put under the direct administration of the Ministry of Social Affairs. |
| Iceland | • A co-operative approach: Regular consultative meetings between the central government and the Association of Local Authorities.  
• Borrowing: No restrictions on borrowing by subnational authorities. | • Administrative procedures: Defaulting authorities could be removed from office and replaced by a commissioner appointed by the central government. |
| Ireland | • Limited fiscal autonomy at the subnational level: Subnational governments have to run balanced budgets. These are monitored and controlled by the Department of the Environment and Local Government.  
• Borrowing: This is governed by the Local Government Act, which requires the approval of the appropriate Minister (normally the Minister for the Environment and Local Government) to any borrowing proposal. |  |

71. New borrowing by municipalities for housing development purposes has been freed from borrowing caps. Municipalities have created local holdings and utility companies, including in the area of housing and other public services, whose revenues and expenditures are off-budget and therefore outside general government accounts.
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| Italy   | • **Fiscal rule:** A Domestic Stability Pact was enacted in 1999, imposing deficit reductions *vis-à-vis* a no-policy-change baseline on subnational governments. Debt service cannot exceed 25 per cent of current revenues.  
• **Borrowing:** Regional and local authorities are allowed to borrow to finance capital investments. | • **Peer pressure:** The Pact has a co-operative mechanism, mainly in the context of the regional and mayor’s conferences, to deal with corrections of eventual overshoots.  
• **Financial sanctions:** European sanctions will be shared among non-complying governments according to their contribution to the overshoot.  
• **Escape clauses:** In case of unexpected events, borrowing limits can be relaxed. |
| Japan   | • **Limited fiscal autonomy at the subnational level.**  
• **Borrowing:** Guidelines for borrowing are set out in the annual Local Government Fiscal Plan. The Ministry of Home Affairs supervises and controls all local authority borrowing. | • **Administrative procedures:** The Ministry of Home Affairs takes control of the local government if borrowing limits are exceeded. |
| Korea   | • **Limited fiscal autonomy at the subnational level:** Subnational governments have to run balanced budgets. These are monitored and controlled by the Ministry of Government Administration and Home Affairs.  
• **Borrowing:** All local borrowing has to be approved by the central government. |  |
| Luxembourg | • **Limited fiscal autonomy at the subnational level:** Municipalities are not allowed to show an operating deficit. Municipal accounts are scrutinised by the District Commissioners and audited by the municipal audit division of the Minister of the Interior.  
• **Borrowing:** Loans exceeding certain limits are subject to the approval of the Minister of the Interior. | • **Administrative procedures:** The Constitution provides for a system of local government control exercised by the Grand Duke, the Minister of the Interior and central government through the District Commissioners. The Grand Duke can annul any general or specific act of local government that is contrary to the law or the public interest and can declare void both regulatory acts and specific decisions of the council, board or mayor. |
| Mexico  | • A system of administrative control has gradually been replaced by a system relying more on the financial markets to secure subnational fiscal discipline. State authorities approve their own budgets and control local government budgets and accounts.  
• **Borrowing:** States are allowed to borrow domestically to finance capital investments, while borrowing by municipalities is subject to the approval of state authorities. | • **Market discipline:** Subnational debt is not guaranteed by the central government. New rules were introduced in 2000 to limit states’ access to borrowing, increase transparency and to strengthen the central government’s commitment not to bailout subnational authorities. |

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72. The deficit governed by the rule is on a cash basis and excludes health, capital spending and interest payments on the expenditure side and central government transfers on the revenue side. The pact was continued under the financial laws for both 2000 and 2001. The latter included for the first time the obligation by regional and local governments to show, *ex ante*, that budgets submitted for approval to local and regional assemblies meet the targets assigned to them (Bibbee and Goglio, 2002).
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| Netherlands | • **A co-operative approach**: Regular meetings are held between central authorities and the Dutch Association of Municipalities on financial issues. Subnational governments have substantial taxing rights, but have to run balanced budgets. These are closely monitored and controlled by higher levels of government. Provincial authorities are obliged by law to take over the financial control of a municipality if it has a budget deficit which is likely to be sustained in the subsequent years.  
  • **Borrowing**: Subnational authorities are free to borrow as long as they run balanced budgets (on an accrual accounting basis). | • **Administrative procedures**: Central authorities will only help a municipality in financial distress if the municipality itself has taken sufficient measures to increase its income through higher taxes. In exchange for the financial help, the municipality surrenders its financial independence. |
| New Zealand | • **Fiscal rule**: Local authorities are required by law to set operating revenues at a level sufficient to cover operating expenses in any financial year (with a relatively narrow exception to run deficits). Local authorities are largely self-funded and the central government has no formal role in reviewing or approving the budgets of local authorities.  
  • **Borrowing**: No restrictions on borrowing. | • **Market discipline**: Subnational loans are not guaranteed by central government. |
| Norway   | • **Fiscal rule**: Counties and municipalities are not allowed to show an operating deficit. If a budget deficit is recorded *ex-post*, this has to be covered over the subsequent two years.  
  • **Borrowing**: No explicit restrictions on subnational borrowing. | • **Administrative procedures**: If a county or municipality does not manage to cover an operating deficit over the following two years, any resolution to raise a loan or to enter into a long-term contract (*e.g.* tenancy agreement) is not valid until the Ministry of Local Government and Regional Development approves it. The Ministry publishes on the web, the list of subnational governments under administration. |
| Poland   | • **Fiscal rule**: The constitution prohibits the public debt from exceeding 60 per cent of GDP, and the Act on Public Finance requires that both central and subnational authorities take steps to stabilise debt at less than 50 per cent of GDP. Subnational governments are also subject to specific limits on their debt and debt service expenditure, which may not exceed 60 per cent and 15 per cent respectively of their total revenues. | • **Administrative procedures**: Subnational governments are required to submit their draft budgets to Regional Clearing Chambers (RIOs), which are agencies of the central government. The RIOs assess the draft budgets to ensure that each subnational government has the means to finance any proposed deficit and make an overall assessment of the sustainability of their liabilities. If the opinion of the RIO is negative, the budget in question must be amended as it directs.  
  • If debt exceeds 55 per cent of GDP, the Council of Ministers must present to Parliament a fiscal consolidation plan aimed at lowering the public debt. If the public debt reaches 60 per cent of GDP, no new state guarantees may be issued and the council of Ministers must submit a fiscal consolidation plan to Parliament, while subnational governments must pass balanced budgets.  
  • **Escape clauses**: The procedure could be bypassed in the case of an emergency. |
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<th>Country</th>
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| Portugal        | **Fiscal rule:** The Local Finances Law states that current spending cannot exceed current revenues and sets a ceiling on annual debt servicing and short-term loans. In addition, the annual Budget Law may set ceilings on the level of indebtedness according to the Budgetary Stability Law approved in July 2002.  
**Borrowing:** Local authorities are free to borrow in order to finance fixed capital investments. | **Financial sanctions:** According to the Budgetary Stability Law, central government transfers can be reduced or suspended if subnational governments exceed the limits on indebtedness or if financial information is not provided in time. |
| Slovak Republic | **Fiscal rule:** Municipalities and higher territorial authorities have to balance current spending against current revenues. From 2005, subnational debt and debt service (principal and interest) cannot exceed 60 and 25 per cent, respectively, of current revenues of the previous year.  
**Borrowing:** Subnational authorities are only allowed to borrow to finance fixed capital investments. Approval from the Ministry of Finance is required if credits amount to more than 75 million SKK. Subnational debt is not guaranteed by the central government. | **Administrative procedures:** Municipalities that are unable to pay their liabilities can be placed under central administration.  
**Financial sanctions:** The Ministry of Finance can impose a penalty amounting to one million SKK on subnational authorities failing to comply with the fiscal requirements.  
**Market discipline:** Subnational debt is not guaranteed by the state. |
| Spain           | **Fiscal rule:** According to the Budgetary Stability Law enacted in 2001 all governments are obliged to maintain at least a balanced budget.  
**Borrowing:** Borrowing by regional governments should be used to finance capital expenses. Authorisation from the Ministry of Finance may be required if annual debt service and repayments exceed 25 per cent of current revenues. The central government can set additional limits and constraints on subnational borrowing for reasons of macroeconomic policy. | **Administrative procedures:** In cases of non-compliance, the Law requires the faulty region to present a financial plan to make up for the deficit over-run. This plan must be approved by the Fiscal and Financial Policy Council.  
**Financial sanctions:** If the financial behaviour of a Region were to cause Spain to breach EMU fiscal rules, that region would have to take care of European sanctions. |
| Sweden          | **Fiscal rule:** Local government budgets are not allowed to show a deficit. If a deficit occurs, it may be carried over, but has to be repaid within two years.  
**Borrowing:** No restrictions on subnational borrowing. |  |
| Switzerland     | **No formal co-ordination:** But informal co-ordination takes place between the Confederation and the cantons for the preparation of the budget.  
**Borrowing:** Borrowing by cantons and communes is restricted to investment projects and requires popular referenda for approval. | **Subnational fiscal policy is subjected to the scrutiny of citizens through popular referenda.** |
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<th>Country</th>
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| Turkey       | • Limited fiscal autonomy at the subnational level: Local budgets and accounts are monitored by central government.  
• Borrowing: Loans exceeding certain limits are subject to the approval of the central authorities. |                                                             |
| United Kingdom | • Limited fiscal autonomy at the subnational level.  
• Borrowing: Subnational borrowing is subject to approval by central government. |                                                             |
| United States | • No formal co-ordination: However, most states have introduced balanced budget rules as a legal requirement.  
• Borrowing: No centrally imposed restriction on borrowing by the states. | • Market discipline: The federal government does not guarantee subnational loans. |

73. The administrations of Scotland, Wales and Northern Ireland “have freedom to make their own spending decisions on devolved programmes within the overall totals” (Watt, 2002).
BIBLIOGRAPHY


