

V. FISCAL RELATIONS ACROSS LEVELS OF GOVERNMENT

Introduction

OECD economies face the common challenge of raising public sector efficiency, and fiscal relations between central and sub-national governments are coming under increasing scrutiny in this regard. While there are apparent advantages to decentralisation, the choice between central and local provision is not clear-cut and devolution has not proceeded evenly in the OECD area over the past two decades. Decentralisation can make governments more accountable, allowing a better matching of public services to local preferences and needs. It may introduce competition across jurisdictions, thus boosting efficiency in the public sector. But it can also create co-ordination problems and may not deliver efficiency gains in activities where small-scale operation increases provision costs or in cases where the benefits and costs of an activity are felt outside the supplying jurisdiction. Moreover, nationwide policy objectives, notably those related to equity and macroeconomic stabilisation, may be more difficult to achieve with greater sub-national autonomy.

Fiscal relations between levels of government are under increasing scrutiny...

Institutional diversity – often rooted in history – makes general conclusions about best practice in intergovernmental fiscal relations difficult to draw, but a review of country experiences in this area shows that the broad issues are similar across countries.¹ These include: *i*) on the spending side, the distributional and efficiency issues raised by sub-national provision of public goods and services; *ii*) the options for financing sub-national spending, via own taxes or grants, so as to create incentives for cost-efficient provision; and *iii*) the institutional arrangements for ensuring that developments in sub-national finances are compatible with national policy objectives. At the core of the debate in these areas are the incentive structures that can, and should, be put in place to ensure that responding to local preferences is consistent with more general objectives of equitable and cost-effective service delivery, as well as overall fiscal discipline.

... raising similar broad issues across countries

Based on these sets of issues, this chapter first reviews the relative importance of central and sub-national governments in the OECD area – as evidenced by aggregate revenue and expenditure indicators – and assesses the forces promoting, or militating against, greater decentralisation in intergovernmental relations. It then focuses, in turn, on the practical issues determining the assignment of spending responsibilities to different layers of government, on the choice between different sources of finance to sub-national jurisdictions, and on the institutional arrangements required to achieve consistency between decentralisation and overall macro-economic policy aims.

1. The review of country experiences reported in this chapter is not exhaustive. It focuses predominantly on the issues that have surfaced in recent *OECD Economic Surveys*, including in-depth chapters on public spending and tax systems.

Some common lessons emerge

The chapter shows that the vertical structure of government varies considerably among OECD member countries, and that economic efficiency and equity principles are often secondary to historical and political considerations. It is thus not easy to replicate the incentive structures of one country in another. Nevertheless, country experiences, although diverse, help to highlight overall tendencies and common policy lessons and challenges. In particular:

- The sub-national share of spending has been rising faster than the corresponding revenue share, with an increasing volume of intergovernmental grants making up the difference. These trends do not necessarily reflect greater local autonomy, as central governments increasingly impose norms, minimum quality standards, and fiscal rules to ensure national conformity.
- The assignment of spending responsibilities to sub-national jurisdictions necessitates a continuing assessment of spillover and scale-economy problems, which result from the fact that political boundaries are not necessarily economically efficient. Various co-operation and joint-provision expedients are being adopted, but the problems have yet to be fully overcome.
- Matching revenue resources to spending responsibilities is one of the most intractable issues of intra-governmental fiscal relations. With own-tax resources likely to remain limited, the design of intergovernmental grants and transfers is critical for efficient sub-national service delivery. Better alignment of policy objectives between donors and recipients remains the main challenge in the design of intergovernmental grant systems.
- There is scope for improving sub-national fiscal discipline, with fiscal rules having an important role to play. But many of the problems of reconciling sub-national fiscal autonomy with national (or supranational) co-ordination have yet to be solved.

Recent trends and forces shaping fiscal relations across government levels

The role of sub-national governments varies across countries

There are significant differences across countries in the sub-national share of government spending and revenue – the most conventional yardstick for measuring fiscal decentralisation. Moreover, the importance of sub-national governments is not linked to whether a country has a unitary or federal government. Sub-national governments already account for a higher share of general government expenditure in some unitary countries, particularly the Nordic and continental European countries, than in constitutionally-defined federations, such as the United States and Germany (Table V.1).

The sub-national share in public spending is generally rising...

Recent trends point to a rising sub-national spending share.² In many countries, these trends reflect, at least in part, the re-assignment of certain functions to sub-national governments. This has applied, for example, to health care and non-university education in Italy, Mexico, and Spain; to labour market policies in Canada; to the

2. For further discussion, see also Joumard and Kongsrud (2003).

Table V.1. Selected decentralisation indicators

	Sub-national spending ^a				Sub-national revenue ^b				Sub-national discretion to set taxes ^c
	Per cent of general government spending		Per cent of GDP		Per cent of general government revenue		Per cent of GDP		
	1985 ^d	2001 ^e	1985 ^d	2001 ^e	1985 ^d	2001 ^e	1985 ^d	2001 ^e	
Federal countries									
Austria	28.4	28.5	15.5	14.5	24.6	21.4	12.1	10.8	9.5
Belgium	31.8	34.0	16.6	16.6	11.4	11.3	5.5	5.6	57.9
Canada ^f	54.5	56.5	25.0	23.3	50.4	49.9	19.4	21.0	100.0
Germany	37.6	36.1	17.2	17.0	31.9	32.4	13.7	14.3	12.8
United States	32.6	40.0	12.0	14.2	37.6	40.4	11.9	13.0	..
Unitary countries									
Denmark	53.7	57.8	32.2	31.8	32.3	34.6	18.7	20.0	95.1
Finland	30.6	35.5	17.8	17.0	24.8	24.7	13.5	13.2	89.0
France	16.1	18.6	8.7	9.9	11.6	13.1	5.9	6.8	..
Greece	4.0	5.0	2.0	2.4	3.7	3.7	1.5	1.8	..
Ireland ^f	30.2	29.5	11.8	8.2	6.4	5.3	2.0	1.5	..
Italy	25.6	29.7	13.4	14.2	10.7	17.6	4.3	8.0	..
Japan	46.0	40.7	14.4	15.2	26.8	26.0	8.9	7.8	90.3
Luxembourg	14.2	12.8	6.0	4.9	8.0	7.4	3.8	3.2	..
Netherlands	32.6	34.2	19.1	15.9	11.4	11.1	6.0	5.2	100.0
Norway ^g	34.6	38.8	22.1	22.7	22.5	20.3	13.9	13.5	3.3
Portugal	10.3	12.8	4.6	5.7	7.6	8.3	3.0	3.5	31.5
Spain	25.0	32.2	11.4	13.0	17.0	20.3	6.6	8.2	66.6
Sweden	36.7	43.4	26.6	24.8	34.3	32.0	20.9	19.7	100.0
United Kingdom	22.2	25.9	9.9	10.9	10.5	7.6	4.5	3.6	100.0
Average^h	29.8	32.2	15.1	14.9	20.2	20.4	9.3	9.5	..

a) Excludes transfers to other levels of government.

b) Excludes transfers from other levels of government and includes revenues from shared taxes.

c) Percentage of total taxes for which sub-national governments have full discretion to set statutory rates, bases or both. A value of 100 indicates full discretion.

d) Or earliest year available: 1986, for Ireland; 1987, for the Netherlands and the United Kingdom; 1990, for Japan and Luxembourg; 1991, for Germany; 1993, for Sweden; and 1995, for Austria, Belgium, Denmark, Finland, Greece, Portugal and Spain.

e) Or latest year available: 1996, for Ireland; 1997, for Canada; 1999, for Portugal; and 2000, for Japan, Luxembourg, Norway and the United Kingdom.

f) Based on SNA68 accounts.

g) The shares are defined in per cent of mainland GDP and revenue excludes income from petroleum activities.

h) Unweighted average of the federal and unitary countries.

Sources: OECD; OECD, Taxing Powers of State and Local government, 1999; OECD National accounts database; Statistics Norway.

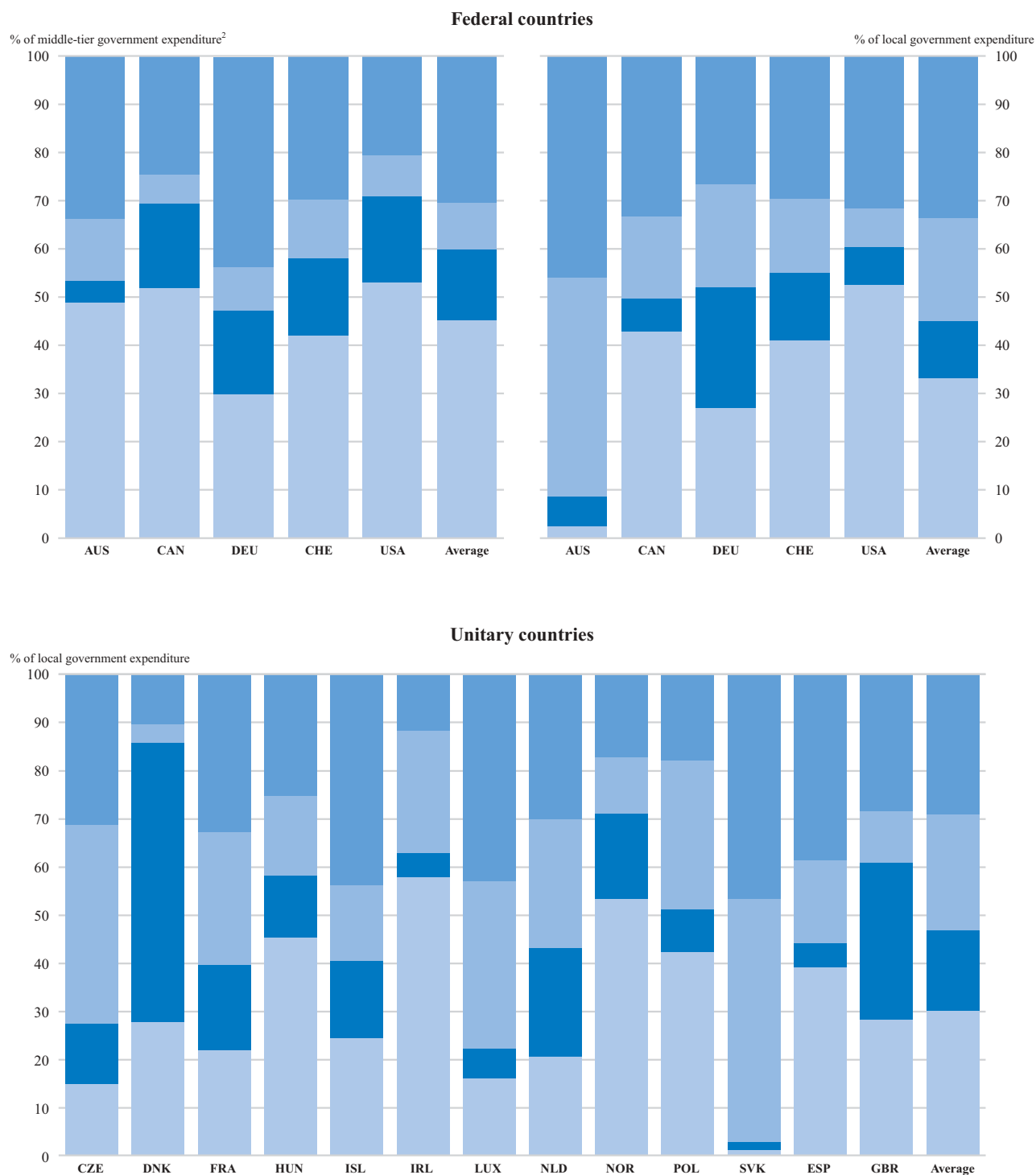
management of some welfare programs in Korea, and to primary education in Hungary. Outlays on education, health care, and social security, taken together, account for the largest share of sub-national spending in many countries, especially in the middle-tier jurisdictions of federal countries (Figure V.1). Territorial and administrative reforms, particularly in the Central European countries, have also contributed to the devolution of expenditure functions to sub-national jurisdictions. This is the case in the Czech Republic, for example, where hospital ownership is being devolved to the regional governments, and in Poland, where the 1999 public administration reform was accompanied by a significant devolution of expenditure responsibilities from the centre to sub-national governments in the areas of education, roads and health care.³

3. OECD (2003) and OECD (2002a).

Figure V.1. Sub-national expenditure composition: functional classification

1995-2001¹ averages

Education and health care Social security Housing and transport Other expenditure



1. Or latest year available.

2. States, provinces or regions.

Source: IMF, *Government Finance Statistics Yearbook*, 2002.

While the sub-national share of general government revenue (excluding inter-governmental grants) has risen only slightly on average over time, there is no unique pattern across countries. In some cases, sub-national revenue shares have increased markedly, reflecting a process of state, regional or local devolution (United States, Spain, Italy, and Denmark). In others, the share has fallen gradually, particularly in countries where sub-national governments rely more heavily on taxing relatively mobile bases, such as personal income (*e.g.* Austria, Norway, and Sweden). Though some sub-national governments are now enjoying greater autonomy in tax policy (Belgium, Mexico, and Spain), and some have seen a simultaneous rise in revenue and spending shares, others have had their tax powers curtailed (France and Germany). Sub-national revenue capacity has also been constrained in some countries because cascading taxes on retail sales and enterprise turnover – tax bases traditionally assigned to sub-national layers of government – have been replaced by value-added-type taxes, which are most often collected by the centre (Australia and Switzerland). Non-tax revenues vary considerably in importance (Figure V.2), the experience with user charges differing significantly from country to country.

... while trends in sub-national own-revenue shares differ

Quantitative indicators of decentralisation may be misleading as to the degree of responsibility enjoyed by sub-national jurisdictions, since their shares in general government expenditure and revenue are not necessarily matched by autonomy or discretionary powers in tax, expenditure and regulatory matters. The centre is often solely responsible for designing policies and setting standards, with the sub-national governments acting as its agents in service delivery and program implementation. Intergovernmental grants and transfers remain an important source of finance for sub-national provision, and in some countries these are predominantly conditional (*i.e.* earmarked for particular spending purposes with conditions attached to the use of funds). A case in point is non-tertiary education in many countries (*e.g.* Italy, Mexico, and Norway), where sub-national governments are responsible for service delivery and the central government sets curricula as well as wages, and also trains teachers. Standards are set predominantly by the centre in the case of health care, although sub-national jurisdictions are becoming important providers in many countries.

Autonomy is not well reflected in spending and revenue shares

Looking forward, intergovernmental fiscal relations are likely to be affected by the fiscal consolidation needed in many countries, particularly in the face of demographic trends.⁴ Population ageing is exerting upward pressure on spending which may affect sub-national governments more adversely than the centre, as in Canada, for example, where the provision of health and age-related care is assigned to regional and local jurisdictions. This is also the case in Norway, where the central government's commitment to raising the supply and quality of elderly care and kindergarten facilities, which are municipal responsibilities, reinforces existing pressures on public spending at the sub-national level.⁵ More generally, faced with mounting spending pressures, higher levels of government may attempt to off-load some of their expenditure responsibilities to lower levels of government. Current arrangements with respect to revenue raising responsibilities and the volume and design of intergovernmental transfers may prove inadequate in light of these prospective developments.⁶

Sub-national budgets will face future spending pressures

4. See OECD (2001a), for estimates of the fiscal consequences of ageing, including pension and health care costs.

5. OECD (2002b).

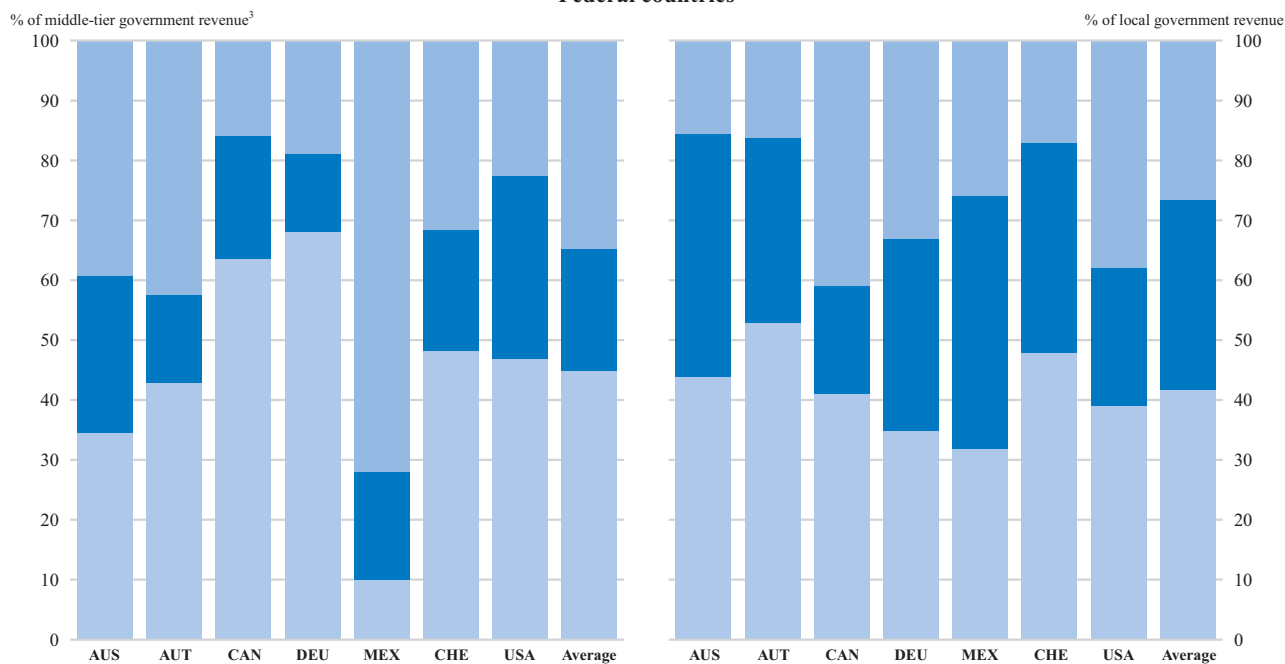
6. See Tanzi (1999), for further discussion on pressures for reforming intergovernmental fiscal relations over the medium term.

Figure V.2. Sub-national revenue composition

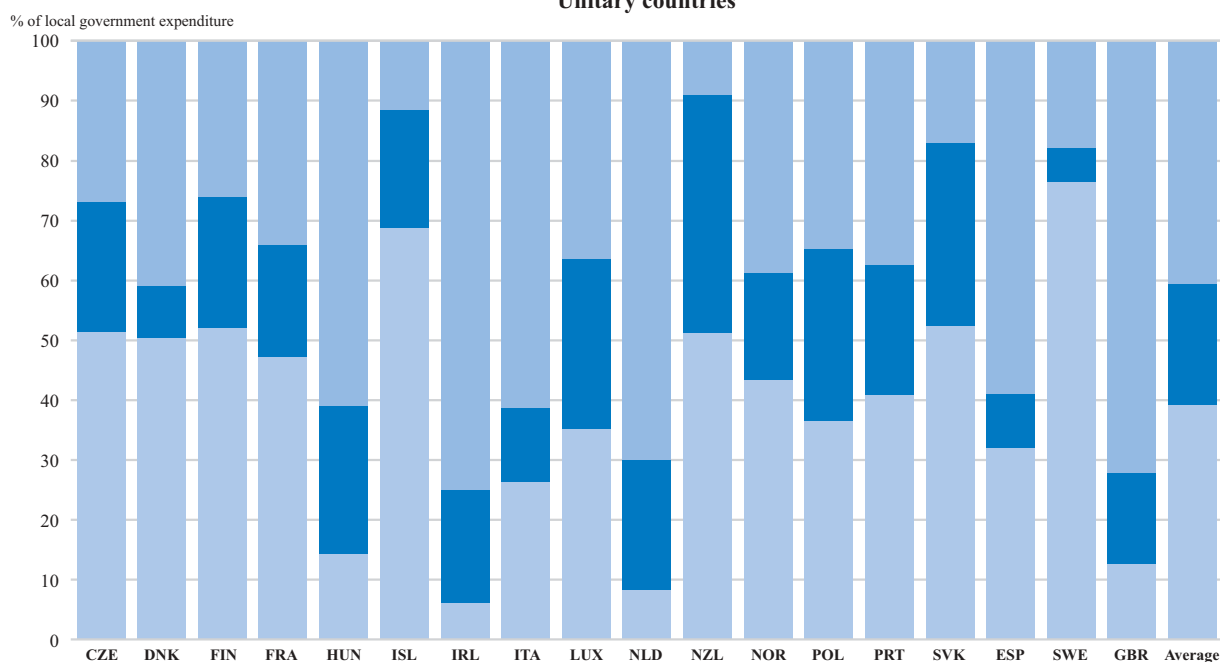
1995-2000¹ averages

■ Tax revenue ■ Non-tax revenue² ■ Grants

Federal countries



Unitary countries



1. Or latest year available.

2. Non-tax revenue includes operating surpluses of public enterprises controlled by sub-national governments, property income, fees, sales and fines, contributions to government employee pension funds and capital revenues.

3. States, provinces or regions.

Source: OECD, *Revenue Statistics*, 1965-2002.

Defining the extent of sub-national autonomy

Sub-national fiscal autonomy depends on complex trade-offs...

Expenditure, revenue and borrowing competencies can be assigned to a lower level of government on a scale which declines from complete devolution (full sub-national autonomy) to delegation, where the sub-national government retains little autonomy in policymaking and service delivery, and therefore acts as an agent of the centre.⁷ Decisions on how much autonomy should be allocated to sub-national governments are based predominantly on two sets of considerations.

- The political boundaries of sub-national jurisdictions may not be economically efficient. Since the benefits of public goods and services cannot easily be circumscribed to a limited geographical area, the supplying jurisdiction may be too small to achieve low provision costs. For example, in several countries, health care facilities have been closed in small jurisdictions in search of greater cost effectiveness (*e.g.* Canada, Finland, France, and Italy).
- Decentralisation brings government closer to the people, but it also creates an information gap between the centre and the sub-national jurisdictions entrusted with fiscal powers, which can cause problems where policy objectives differ between layers of government, as they often do. For example, sub-national jurisdictions may not be willing to share the burden of fiscal consolidation with the higher levels of government. The benefits of decentralisation, in terms of better responding to local preferences, thus have to be balanced against equity and stabilisation objectives, which are determined nationally.

... and on appropriate contracts and incentives

In practice, because of the complex trade-offs involved, the assignment of fiscal competencies among different levels of government is not clear-cut and depends on the institutions that can be put in place to overcome co-ordination problems. The main challenges in this respect are the design of an appropriate contractual framework for service delivery between different layers of government, and among different jurisdictions within the same layer, as well as the monitoring and enforcement of these contracts. Country experience suggests that creating the correct incentives poses significant problems of design.⁸ For example, conditional grants and transfers schemes – possibly the most common forms of contract to be written among different layers of government – drive a wedge between the benefits and costs of provision, and consequently strengthen the incentives facing sub-national providers to supply more of the service in question.

7. Because intergovernmental fiscal relations are complex and multi-dimensional, a comprehensive taxonomy of fiscal, political, and administrative arrangements among different layers of government is subject to considerable debate. See Bird (2000), for a distinction between deconcentration, delegation, and devolution as different forms of decentralisation.

8. The governance problems involved here may be seen in terms of “principal-agent” considerations, where what matters is the response of different layers of government to incentives for efficient, cost-effective service delivery in the face of inter-jurisdictional competition and decentralised information and authority (Persson and Tabellini, 1996; Seabright, 1996; Qian and Weingast, 1997; Oates, 1999). These are: *first*, contracts are often hard to write because it is difficult to clearly define the benefits and beneficiaries of specific programs. *Second*, it is hard to monitor compliance because policy objectives may not be quantifiable and may depend on factors that are beyond the policymaker’s control. *Third*, contracts may fail to strengthen incentives because they may not be easily enforceable.

*Similar principles apply to
supranational fiscal
institutions*

Incentive and enforcement problems apply, though in somewhat different form, whether central authority derives from a federal system or from nation states, as under the principle of “subsidiarity” adopted by the European Union. The European Union’s Stability and Growth Pact is an example of the “upward devolution” of fiscal powers to a supranational instance where a decentralised fiscal set-up might put strains on monetary union. 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 case of the European Union, its own budget is too small to allow for the pursuit of union-wide macroeconomic stabilisation objectives, so that the stabilisation function has to be left to the member states, subject to centrally-imposed parameters, which are supposed to ensure a collectively beneficial fiscal outcome.

The assignment of expenditure responsibilities

*Economies of scale inhibit cost-
effectiveness in smaller
jurisdictions...*

The decentralisation of expenditure functions to sub-national governments is constrained by the ability of smaller jurisdictions to make the most of economies of scale in service delivery. In education, smaller jurisdictions tend to have higher teacher-student ratios, without having a discernible impact on education performance. In some Central European countries (Poland and the Czech Republic), excess capacity remains in the education and health care sectors, putting an additional burden both on sub-national budgets and on the central government, via inter-governmental grants. Public procurement is another case in point. It may be less cost-effective in smaller jurisdictions, due to higher information and transaction costs, and sub-national governments seldom rely on competitive tendering for public procurement (e.g. Denmark, Norway, Japan, and Switzerland).

*... while territorial spillovers
may lead to under-provision*

The other major constraints governing the allocation of spending powers are territorial spillovers, by which the inhabitants of adjacent jurisdictions can benefit from spending in another. Such externality effects are relevant in the provision of health care, education, and social assistance services, and may result in the under-provision of services or stretch local budgets beyond their means. The provision of infrastructure and health care in large metropolitan areas that straddle local government boundaries is a case in point. In general, externality problems make it difficult for sub-national jurisdictions to play an active role in income distribution and welfare policies. Local authorities acting in isolation may find it difficult to finance welfare programs without raising considerations of horizontal inequity. In several countries, they nevertheless enjoy considerable autonomy to set benefit levels and/or eligibility parameters (e.g. Denmark, the Netherlands, Norway, Spain, Sweden, Switzerland, and the United States). In the United States, where the population is very mobile, the welfare benefits provided by the states are set at a relatively low level to avoid the in-migration of potential claimants or at different levels for state residents compared with migrants from beyond state borders.

*There are options for
mitigating perverse incentives*

There are options for overcoming economies of scale and externality effects, without resorting to excessive micro-management of sub-national service delivery by the centre. Smaller jurisdictions have been amalgamated in many countries (e.g. Belgium, Canada, Iceland, the Netherlands, and Sweden), although political resistance may be considerable, as evidenced by the Canadian experience. In some

countries, higher layers of government have provided financial incentives to encourage amalgamations (e.g. Finland, Japan, and Norway). An important caveat is that amalgamations and the redrawing of internal borders may fail to match optimal size in all areas, since the minimum efficient size can differ – as between, waste disposal and hospital care, for example. That said, cost-effectiveness can be enhanced through horizontal co-ordination, particularly purchaser/provider split arrangements and the joint provision of services. Examples of horizontal co-ordination are numerous. In Brazil, local government consortia, particularly among neighbouring municipalities, have been established in the area of hospital administration. Joint service supply organisations are encouraged by the central government in Hungary. Cross-boundary compensation for provision costs is available for hospital care in Denmark and Sweden, where patients are allowed to choose treatment outside the jurisdiction in which they reside. Municipalities in Norway frequently co-operate in such sectors as waste disposal, water supply, and energy (through the joint ownership of power plants), but less so in core spending domains such as primary education and elderly care, partly reflecting the absence of appropriate compensation schemes between jurisdictions.

To prevent conflict or inequalities, the centre can impose norms, in terms of standards, prices and coverage of services, and eligibility criteria, to ensure adequate service delivery by sub-national providers. In this vein, the central government sets school curricula in Denmark, Spain, and Mexico, and public wage policies in Germany, Italy, Norway, and Portugal. Alternatively, to achieve a greater degree of sub-national autonomy, functions may be transferred to a higher level of government, as in the case of Switzerland, where active labour market policies are now assigned to the cantons, with central government supervision and financial support, rather than the local authorities. In Ireland, the management of sewerage facilities will be transferred from the towns to the counties in 2004.

The central government may still impose norms

Financing sub-national service delivery

Extent of local tax autonomy

Financing arrangements need to be taken into consideration in the assignment of expenditure functions among different layers of government. A common constraint applying to the decentralisation of revenue sources is that the tax bases that are in principle best suited for management by sub-national jurisdictions – *i.e.* those that are relatively immobile, evenly distributed geographically, and that generate relatively stable revenue over the cycle – are few, and their yield seldom sufficient to finance sub-national spending.⁹ In any case, the mix of sub-national tax revenue varies significantly in the OECD area (Figure V.3). Property taxes, which are an attractive revenue source for local governments, because the base is relatively immobile, have problems (in terms of keeping property valuations up to date, for example), contributing to their relatively small role in many countries.

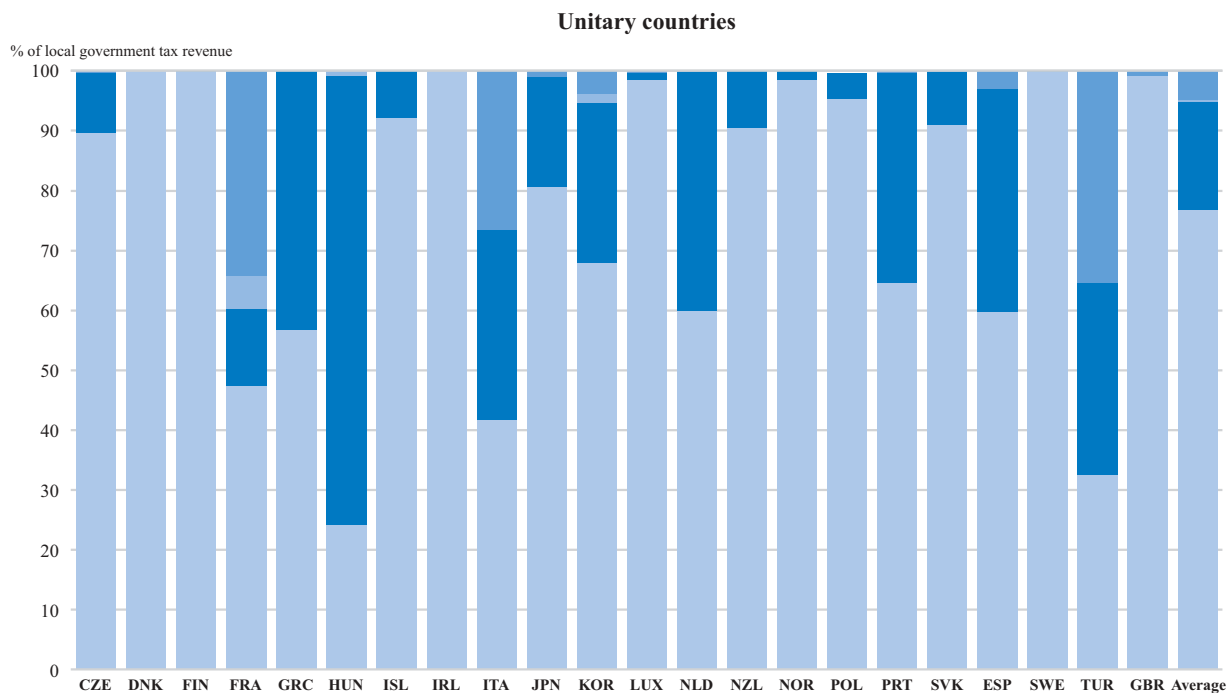
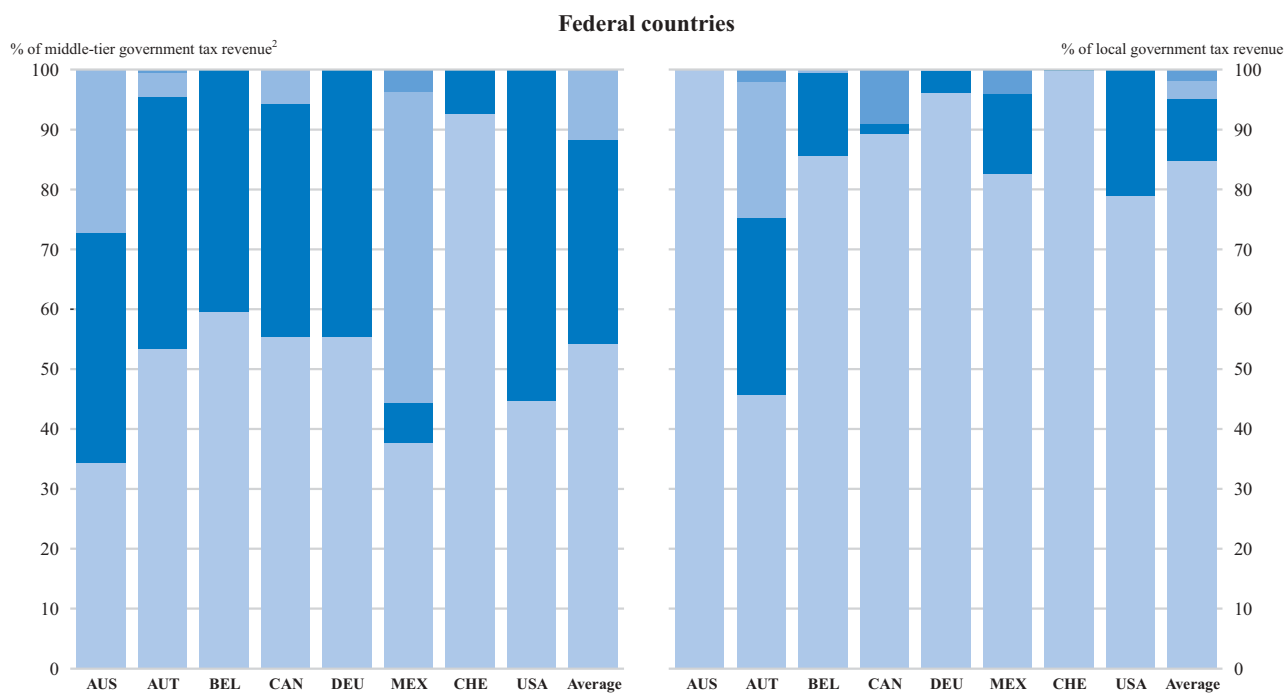
Financing arrangements need to be consistent with spending assignments

9. See Bird (1992), Inman and Rubinfeld (1996, 1997), and McLure (1997), for further discussions on the assignment of revenue sources among the different layers of government.

Figure V.3. Sub-national tax revenue composition

1995-2001 averages¹

Property, income and profits Consumption Social security and payroll Other taxes



1. 1998-2001 average for the Slovak Republic.
 2. States, provinces or regions.
 Source: OECD, Revenue Statistics, 1965-2002.

Personal and corporate income taxes are important sources of sub-national revenue in many countries, particularly the Nordic and Central European countries, Belgium, Canada, Japan, Spain, Switzerland, and the United States, although these taxes are most efficiently managed centrally. Sub-national governments are often allowed to “piggyback” on the personal income tax levied by the centre, as in the United States, by imposing a surcharge on the federal income tax (or rebates, as in Belgium). Sub-national jurisdictions are free to set their own flat personal income tax rates in Denmark and Sweden, with no mechanism in place to deal with the ensuing spillover effects. This autonomy has contributed to high rates of personal income tax, which have distorted labour supply decisions. In the case of the corporate income tax, the mobility and cyclical volatility of the tax base makes it less suitable for local revenue-raising, but largely due to historical reasons, these revenues account for a substantial share of sub-national receipts in some countries (Canada, Czech Republic, Finland, Germany, Japan, Switzerland, Turkey, and the United States).¹⁰

Income taxes are often important sources of sub-national revenue

Arguments for sub-national tax autonomy include the ensuing benefits of tax competition, which may help to offset tendencies for excessive public spending and taxation.¹¹ When sub-national expenditure is financed predominantly with resources mobilised locally, sub-national jurisdictions face stronger incentives to evaluate the benefits of an increase in spending against the costs of incremental taxation.¹² However, powers to determine sub-national tax rates appear not to be widely exploited. Autonomy in income and property taxation has not led to significant variations in tax rates among the sub-national jurisdictions in countries such as Finland, Korea, and Norway. In some cases this may be due to the fact that local tax autonomy is negated by the central government, which reduces transfers and grants when sub-national governments cut their own tax rates.¹³

Tax competition may be beneficial but in practice is not exploited...

Tax competition can also be predatory, leading to an erosion of the tax base. This is predominantly the case when sub-national governments are free to set tax bases, rather than rates. Examples are numerous. Competition among the US states and Canadian provinces to attract business and households, through for example tax credits for enterprise relocation, has resulted in the erosion of some tax bases and to an increased complexity of the tax system, hence raising transaction costs. In Brazil, autonomy granted to the states to give tax credits, deferrals, and exemptions from value-added tax has resulted in considerable erosion of this otherwise buoyant tax base. Autonomy to set retail sales tax rates, as well as regulations and legal provisions, can also distort trading patterns, and hence the distribution of the tax base. Where there is no withholding tax on extra-jurisdictional sales, this has encouraged inter-state trade in the United States.

... and may erode the tax base

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10. The harmonisation of corporate income tax legislation among the Swiss cantons has led to a reduction in the corporate tax burden since 2001, at the expense of personal income taxpayers. In Finland, sub-national governments do not have autonomy to set corporate income tax rates, but have competed to attract businesses through higher spending on facilities that are reported to enhance their locational advantages to investors (OECD, 2002c).
 11. The argument that people “vote with their feet” has been invoked, since Tiebout’s seminal work, as a natural limitation on the ability of sub-national governments to tax. For example, some Canadian provinces, notably Alberta and Ontario, have actively pursued a strategy of fiscal competition by lowering the top marginal tax rates (OECD, 2002d).
 12. The experience of Canada suggests that fiscal consolidation has been inversely related to provincial reliance on transfers from the federal government (OECD, 2001b).
 13. Where local autonomy does exist, some countries have attempted to keep a cap on the sub-national tax burden, by offsetting sub-national tax hikes through reductions in grants and transfers from the centre. A “tax on taxes” mechanism was in place in Sweden during 1996-2000. In Germany, tax competition among the *Länder* has been restricted to expedients which allow the lenient application of corporation tax provisions (OECD, 1998).

Efficiency implications of grants and equalisation schemes

Incentives for service delivery differ with the type of grant

Grant and revenue equalisation arrangements have strong incentive effects on service delivery. Grants and transfers can be of different types, depending on the autonomy enjoyed by the recipient jurisdiction in the use of funds.¹⁴ When no conditions are imposed on resource allocation, grants are referred to as non-categorical, general-purpose or block grants, which allow local preferences to be respected. This is the case, for instance, when revenues collected by the centre are shared with sub-national governments – often based on a pre-determined formula (*e.g.* German equalisation grants) or on a derivation basis – to close the gap between their expenditures and revenue capacity. At the other end of the spectrum there are categorical or specific-purpose grants, which involve some type of conditionality, such as, for example, the earmarking of transferred funds to finance specific spending programs and the requirement that the recipient jurisdiction matches at least in part the funds transferred to them by increasing their own spending on selected programs. These grants allow the central government to impose its own policy objectives on its sub-national counterparts and may help to mitigate the incentives for under-provision arising from externality effects and economies of scale.

Conditional grants may not be cost-effective...

Conditional or earmarked grants are often based on *ex post* input costs, typically wages, and may result in poor cost-effectiveness in service delivery. Furthermore, matching and earmarked grants can sometimes exceed the level at which spillover effects can be expected to be avoided (Korea and the United States), or may entail high administrative costs (Germany, Switzerland, and the United Kingdom). Non-matching earmarked grants may also encourage the recipient jurisdiction to overspend.

... and current arrangements are being redesigned

In recognition of these caveats, grant and transfer arrangements have been redesigned in many countries. Earmarked grants have been replaced by general-purpose grants in some cases (Canada, Finland, Iceland, and Sweden) and/or countries have reduced matching rates (Japan). Conditionality has also been refined. Explicit performance criteria have been introduced to strengthen the incentive structure in grant and transfer systems and to place greater emphasis on outcomes in many countries (*e.g.* Australia, Brazil, Canada, and the United Kingdom).

Poverty traps need to be avoided in the design of equalisation schemes

Income redistribution is a key objective of grant and transfer systems. However, the equalisation of fiscal resources among sub-national jurisdictions can act to lock in existing income differentials (a form of poverty trap), by reducing sub-national government incentives to introduce growth-promoting policies. To mitigate disincentive effects, some countries, such as Italy, have reduced the equalisation component of transfer and grant arrangements, thus creating incentives for poorer jurisdictions to boost their own revenue capacity and tax effort. Partial equalisation schemes are also in place in the Nordic countries. In the case of Spain, equalisation rates have been frozen over time so as to reduce the equalisation component of transfer systems as sub-national jurisdictions grow. In all cases, reforms involve some compromise with equity objectives.

14. See, for example, Bahl and Linn (1992), and McLure (1998), for more information.

Macroeconomic management in a decentralised setup

Decentralisation poses several challenges for macroeconomic fiscal management, most notably that of securing fiscal discipline. Sub-national jurisdictions can be assisted by the central government when in financial distress, and may not face strong incentives for fiscal rectitude. Expectations of financial assistance, as well as outright bailouts, have created disincentives for prudent fiscal management and have been at the root of several episodes of general government deficit slippage (Germany, Italy, Mexico, Norway, and Sweden).¹⁵ Overlapping responsibilities, open-ended grants and weak accountability can create an upward bias in sub-national spending, with consequences for the overall budget position. Conversely, central governments may transfer spending functions without taking full account of their costs, and these “unfunded mandates” may force sub-national authorities to raise taxes to prevent deficits in their own accounts.

Decentralisation may affect macroeconomic fiscal management

To address the risks of a loose fiscal stance, countries have relied on a wide array of instruments (see Appendix). Administrative controls are in place in some countries (Greece and Turkey), and in others (Ireland, Japan, Korea, and the United Kingdom) sub-national borrowing is subject to central government approval. In Mexico, the states and municipalities, including their decentralised agencies and public enterprises, are prohibited from borrowing abroad and can only borrow domestically to finance investment outlays up to the ceilings set by their respective legislatures.¹⁶ At the other extreme in terms of local autonomy, in a limited number of federal countries, sub-national jurisdictions may have their own balanced budget laws, as the US states. In this case, fiscal discipline is maintained by market forces.

Strategies for ensuring fiscal discipline vary...

In between, and as a general trend, administrative or legislative controls are being superseded in many countries by more comprehensive fiscal rules.¹⁷ These rules can take the form of ceilings on the overall budget balance (Austria, Belgium, Finland, Sweden, and Spain) or the operating balance (France, New Zealand, and Norway), which allows borrowing for investment purposes. In Germany, the “golden rule”, according to which budgeted deficits must not exceed investment spending, is applicable to most *Länder* as well as the federal government.¹⁸ In some countries, including Brazil, Hungary, Poland, and Portugal, ceilings have been introduced on the public debt and/or debt service outlays. Sanctions for non-compliance, which may be of different types, are instrumental to boost credibility in fiscal rules.¹⁹ But flexibility is also important. For example, escape clauses allow for deviations from fiscal targets under exceptional circumstances in many countries (*e.g.* Austria,

... with an increased emphasis on fiscal rules

15. Since McKinnon's (1997) seminal work, the introduction of hard budget constraints at the sub-national level has been regarded as a pre-condition for “market-preserving federalism”.

16. IMF (2002).

17. See OECD (2002e), for further discussion.

18. OECD (2002f).

19. The central government may withhold grants and transfers to non-compliant jurisdictions (Brazil, Denmark, and more recently Portugal), which may be banned from borrowing (Belgium and Brazil). In Austria, they are required to pay fines, and sanctions arising from non-compliance with the Stability and Growth Pact are distributed across domestic governments (OECD, 2001c). In Brazil, institutional sanctions are complemented by penalties that can be imposed on public officials, including those at the municipal level (IMF, 2001). In Canada, some provinces require the Cabinet to take a cut in salary if the fiscal targets are not met, and call for referenda before taxes can be increased (OECD, 2001b).

Brazil, Italy, and Poland) and some Canadian provinces, in addition to the European Union's Stability and Growth Pact.

***But co-operative arrangements
are also possible***

Rules imposed by the centre have played an important role in enhancing fiscal discipline at the sub-national level in Brazil, Finland, New Zealand, and Portugal. They can also be negotiated under a more co-operative approach, as in the case of Australia, Belgium, Denmark, Germany, and Iceland, whereby fiscal targets are determined among sub-national jurisdictions and with the central government. The negotiation of the Stability and Growth Pact in the European Union, which is currently under some strain, is another example of a co-operative arrangement for macroeconomic fiscal management, where incentives for compliance have been strengthened through explicit sanctions.²⁰ Fiscal consolidation efforts, which are ongoing in many countries, have also called for greater co-ordination across different levels of government to ensure consistency between national and sub-national budget outcomes.²¹

***Pro-cyclical fiscal stance may
be a problem***

The fiscal stance of sub-national jurisdictions can be intrinsically pro-cyclical (United States and Switzerland), where balanced-budget rules apply too rigidly, although the empirical evidence on this is mixed.²² In some countries, including Norway and Finland, the central government has attempted to offset tendencies for pro-cyclicality by adjusting grants and transfers in light of cyclical developments in local government revenues.

***Markets may have a limited
role in sub-national fiscal
discipline***

The role of markets in reinforcing the sub-national rectitude imposed by fiscal rules, appears to be limited, because the conditions for effective market-based discipline are rarely fulfilled in practice. In countries that have traditionally relied on the market for fiscal discipline at sub-national level, such as Canada and the United States, the self-imposed fiscal rules limiting policy discretion have actually resulted from the need to boost credit ratings.²³ Elsewhere, however, the central government often guarantees sub-national loans and bails out sub-national jurisdictions in financial distress, especially those that are deemed to be "too big to fail". Correspondingly, prudential regulations on investors' exposure to sub-national government debt are often weak, and information disclosure requirements tend to be more lenient on sub-national governments than on the central government and corporations.²⁴ Notwithstanding these limitations, a number of countries are beginning to place greater reliance on financial markets to discipline sub-national budget behaviour by removing restrictions on sub-national borrowing (e.g. the Czech Republic, Hungary, Finland, New Zealand, and Norway and Mexico more recently).

20. See Buti, Franco, and Ongena (1998), for more information.

21. Germany's Domestic Stability Pact, signed in 2002, is an example, as well as Austria's, but neither arrangement has strong penalties for non-compliance (OECD, 2002g).

22. See the discussion in Chapter IV "Fiscal stance over the cycle: the role of debt, institutions, and budget constraints".

23. See Poterba (1994, 1996), for more information.

24. See OECD (2001d), for a review of best practices in budget transparency.

Appendix: Summary of sub-national fiscal frameworks

Country	Fiscal framework	Enforcement mechanisms
Australia	Co-operative approach. Federal and state borrowing is co-ordinated by the Loan Council. Most states have adopted some sort of balanced-budget rule.	Market discipline. State borrowing is not guaranteed by the central government. Peer pressure. The states are required to explain overruns in the borrowing allocations set by the Loan Council.
Austria	Co-operative approach. A Domestic Stability Pact requires the municipalities (taken together) to balance their budgets, and sets a surplus target for the <i>Länder</i> (taken together). Borrowing. No restrictions on borrowing by the <i>Länder</i> . Municipal borrowing is regulated by the <i>Länder</i> .	Peer pressure and financial sanctions. Non-compliance fines are reimbursed if compliance is restored within one year, or allocated across the complying jurisdictions, otherwise. Escape clause: in the event of a serious economic slowdown.
Belgium	Co-operative approach. Targets for the headline balance and expenditure growth are set for the different levels of government. Borrowing. Regions and communities can borrow subject to central government approval.	Peer pressure and administrative sanctions. The federal government can cap regional government borrowing for two years. The regions monitor municipal finances and can impose expenditure cuts and/or tax increases.
Brazil	Fiscal rule. Fiscal Responsibility legislation sets ceilings on debt and debt service obligations and requires annual targets for revenues, expenditures, the primary balance, and indebtedness at all levels of government. Borrowing. Sub-national governments are free to borrow if in compliance with fiscal responsibility legislation.	Sanctions. Contracts or administrative decisions that are in breach of fiscal responsibility legislation are nullified, while individuals responsible for violations are subject to fines and governors and mayors may also risk impeachment and imprisonment. Escape clauses: in the event of a severe recession and/or natural disasters.
Canada	No formal co-ordination. Most sub-national governments have balanced-budget rules. Borrowing. No restriction on provincial and territorial borrowing. Municipal borrowing is subject to a golden rule.	Market discipline and administrative sanctions in some provinces. The federal government does not guarantee sub-national debts. Escape clauses. In most provinces, surpluses can be carried over to finance a deficit in a subsequent year. Legislation in many provinces builds in exemptions for special events.
Czech Republic	No formal co-ordination. Borrowing. No restrictions.	Market discipline. Sub-national debt is not guaranteed by the central government.
Denmark	Co-operative approach. Formal co-operation between the central government and the Local Government Association. Sub-national governments face a balanced-budget constraint but have substantial taxing rights. Borrowing. Long-term borrowing is allowed up to a ceiling. Municipalities face a golden rule.	Peer pressure and financial sanctions. The agreement between the central government and the Local Government Association is not legally binding. In the event of violation of the tax freeze, all additional net tax revenues will be confiscated through a reduction in block grants.
Finland	Fiscal rule. Municipalities face a balanced-budget constraint over the medium term. Borrowing. No explicit restrictions on local borrowing, which is not guaranteed by the state.	No sanctions
France	Fiscal rule. Local governments are not allowed to run an operating deficit. Borrowing. Local governments are allowed to borrow subject to a golden rule.	Administrative sanctions. If in breach of the deficit constraint, corrective measures are proposed to the non-compliant jurisdiction by the Regional Court of Accounts.
Germany	Co-operative approach. A Domestic Stability Pact is in place. Borrowing. Most of the <i>Länder</i> face a golden rule. Municipal borrowing (subject to a golden rule) requires regional government approval.	Peer pressure. The Financial Planning Council monitors fiscal developments at all levels of government and makes recommendations for restoring fiscal discipline in the event of non-compliance.
Greece	Limited fiscal autonomy at the sub-national level. Borrowing. Local government borrowing requires ministerial approval.	
Hungary	Borrowing. The municipalities can borrow subject to a golden rule and ceilings.	Market discipline. Sub-national debt is not guaranteed by the central government.
Iceland	Co-operative approach through inter-governmental consultations. Borrowing. No restrictions.	Administrative sanctions. A municipality in default can be put under the direct administration of the Ministry of Social Affairs.
Ireland	Limited fiscal autonomy at the sub-national level, and balanced-budget constraint. Borrowing. Subject to ministerial approval.	Administrative sanctions. Non-complying authorities can be removed from office and replaced by a commissioner appointed by the central government.

Country	Fiscal framework	Enforcement mechanisms
Italy	Fiscal rule. A Domestic Stability Pact sets ceilings on expenditure and the primary deficit of sub-national governments. Borrowing. Regional and local authorities face a golden rule.	Peer pressure and financial sanctions. The Pact requires inter-governmental consultations. European sanctions will be shared. Escape clauses: in the event of unexpected events.
Japan	Limited fiscal autonomy at the sub-national level. Borrowing. Guidelines for borrowing are set in the annual Local Government Fiscal Plan.	Administrative sanctions. The Ministry of Home Affairs takes control of the local government if borrowing limits are exceeded.
Korea	Limited fiscal autonomy at the sub-national level, and balanced-budget constraint. Borrowing. Central government approval is required.	
Luxembourg	Limited fiscal autonomy at the sub-national level. Municipalities are not allowed to run an operating deficit. Borrowing. Loans exceeding a certain threshold are subject to ministerial approval.	Administrative sanctions. The Grand Duke can annul local government regulatory acts that are contrary to the law or the public interest.
Mexico	Administrative controls have gradually been eliminated. Borrowing. Golden rule for domestic borrowing.	Market discipline. Sub-national debt is not guaranteed by the central government.
Netherlands	Co-operative approach through inter-governmental consultations. Balanced-budget (on accrual basis) rule at sub-national level. Borrowing. No restrictions.	Administrative sanctions. Central authorities can assist municipalities in distress if they give up their financial autonomy.
New Zealand	Fiscal rule. Local governments are not allowed to run operating deficits. Borrowing. No restrictions.	Market discipline. Sub-national loans are not guaranteed by the central government.
Norway	Fiscal rule. Counties and municipalities are not allowed to run operating deficits. <i>Ex post</i> deficits can be carried over for up to two years. Borrowing. No restrictions.	Administrative sanctions. Borrowing and long-term contracts (<i>e.g.</i> tenancy agreement) are not allowed while in breach of the deficit provisions.
Poland	Fiscal rule. Sub-national governments are subject to specific limits on indebtedness, debt service outlays, and spending. Borrowing. No restrictions.	Administrative sanctions vary according to the level of indebtedness. Escape clauses. The procedure could be bypassed in the case of an emergency.
Slovak Republic	Fiscal rule. Sub-national governments are not allowed to run current budget deficits. Borrowing. Subject to a golden rule and ministerial approval, if above a threshold.	Administrative sanctions. Municipalities in default can be placed under central government administration. Market discipline. Sub-national debt is not guaranteed by the central government.
Spain	Fiscal rule. All levels of government face a balanced-budget constraint. Borrowing. Subject to a golden rule and ministerial approval depending on the debt service burden.	Administrative sanctions. A fiscal consolidation plan is required for non-complying jurisdictions. Financial sanctions. European sanctions are shared with non-complying jurisdictions.
Sweden	Fiscal rule. Balanced-budget rule with two-year carry-over for local governments. Borrowing. No restrictions.	No sanctions.
Switzerland	No formal co-ordination. Borrowing. Sub-national borrowing is subject to a golden rule and popular referenda.	Sub-national fiscal policy is subjected to social control through referenda.
Turkey	Limited fiscal autonomy at the sub-national level. Borrowing. Loans exceeding certain thresholds are subject to central government approval.	
United Kingdom	Limited fiscal autonomy at the sub-national level. Borrowing. Subject to central government approval.	
United States	No formal co-ordination. Most states have balanced-budget constraints. Borrowing. No restrictions.	Market discipline. The federal government does not guarantee sub-national loans.

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