IMPROVING PRODUCTIVITY AND INCLUSION AT NATIONAL AND SUBNATIONAL LEVELS:
HOW CAN EFFECTIVE PUBLIC GOVERNANCE HELP?
(Note by the Secretary-General)

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Background Document

Item 3 - Enhancing Productivity for Inclusive Growth

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IMPROVING PRODUCTIVITY AND INCLUSION AT NATIONAL AND SUBNATIONAL LEVELS: HOW CAN EFFECTIVE PUBLIC GOVERNANCE HELP? ¹

Introduction

1. The public sector has an important influence on overall economic productivity and on inclusiveness. On average, governments provide just over a quarter of the goods and services consumed in the economy each year, including those services that the government provides directly via its own staff and indirectly through outside contractors. OECD governments are responsible for almost 70% of final consumption expenditures on health goods and services and for about 85% of final consumption expenditures on education.² Up to 20% of GDP, measured in terms of gross value added,³ is accounted for by the public sector. The public sector also accounts for a large share of the labour force (over 25% in some countries). Its sheer size means that the public sector is a very important factor, both directly and indirectly, in the productivity-inclusiveness debate. In addition, its role in the regulation of economic activity and the financial support it provides to parts of the economy and society make it even more relevant.

2. While the links between governance and inclusive growth were examined in depth in the 2015 report The Governance of Inclusive Growth, the relationships between governance and productivity are still largely unexplored. This note presents a first exploratory overview of the different ways through which public sector governance can affect productivity in the context of inclusive growth, namely in three ways: i) by aligning vision, incentives and delivery mechanisms across the policy-making cycle; ii) by establishing sound regulatory, procurement and public investment practices; and iii) at the regional and local level, by addressing coordination capacity and framework conditions.

I. Increasing the productivity and inclusiveness of government

3. Pursuing policies that promote both productivity gains and inclusiveness requires a whole-of-government approach that aligns vision, incentives and delivery mechanisms across the policy-making cycle. This section identifies three specific areas where governments can become more effective in order to increase the productivity and inclusiveness. These include:

- performance measurement;

¹ The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

² There is much variation amongst OECD countries -- in countries such as Mexico, Switzerland, Chile, Turkey and the United States, governments play a smaller role and in the Netherlands, Norway, Sweden and Denmark, governments are more prominent.

³ Gross value added is measured as the difference between output and intermediate consumption. Thus, government gross value added equals the sum of compensation of employees, consumption of fixed capital, other taxes less subsidies on production and net operating surplus (the latter being very small as government is acting as non-market producer).
• innovation in the public sector, including digital government and open government data;
• citizen participation, gender equality and diversity.

_Better understanding and measuring public sector inputs and outputs would help governments to refine policies and allocate resources better for inclusive growth_

4. Faced with fiscal constraints, improving public sector performance is high on political agendas of every OECD countries. However, efficiency or productivity gains have often been too closely associated with cost cutting, with too little regard for the impact that such cuts have on the quality of public services. Governments focus on “blunt instruments” such as staff reductions, wage and hiring freezes that generate short-term expenditure savings rather than identifying incentives that could result in durable productivity gains. In addition, the competitive pressures that push private firms to innovate and find efficiency gains are often not present in the public sector. Moreover, the objectives set for, and the outputs generated by, the public sector are often non-market public goods, many of which are difficult to quantify in monetary terms. This is particularly true for outcomes related to inclusiveness objectives.

5. OECD work on productivity and inclusiveness is a chance to explore the different ways in which the public sector influences productivity and identify steps – including better measurement – through which governments can increase this impact while keeping in mind the broad inclusive growth objectives of public policy. Qualitative information, when used in a systematic way, can also promote policy learning and is an important complement to improved performance measurement. In this connection, initiatives such as the OECD project on Civil Service Effectiveness or the United Kingdom’s “What Works” programme⁴ could be assessed to see how qualitative information can be used more effectively to improve outcomes in terms of productivity and inclusiveness.

**Box 1. The OECD Civil service effectiveness project**

The Civil Service Effectiveness project aims to develop actionable indicators of civil service effectiveness and benchmark country performance across a range of important dimensions, providing a tool for shared learning and improvement across countries further to the interest expressed at the Helsinki Public Governance Ministerial Meeting in 2015. Three priority areas were identified for indicator development over the next two years:

1. **Performance of programme delivery** (including user satisfaction): the efficiency, effectiveness and quality of policy delivery that is carried out by the civil service e.g. grant administration.

2. **Productivity and value for money**: the extent to which the civil service as a whole maximizes outputs (in terms of the number of citizens it serves and the quality of service provided) with the resources it has available (number of employees and running costs).

3. **Employee engagement**: the extent to which civil servants exhibit behaviours including honesty, integrity, objectivity and impartiality, and the extent to which they are engaged with the values, objectives and work of their organisation.

Engaging in long term planning, anticipation of trends in public governance practices to build more effective institutional arrangements to increase productivity and inclusiveness

6. Pursuing strategic foresight can yield positive effect on policy choices that aim to increase productivity and strengthen inclusiveness future. As governments are facing more complex and unpredictable environment, with multiple actors taking concurrent action both domestically and internationally, they need to be proactive in scanning, gathering and analysing information to guide

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decision making and priority setting. Strategic foresight reporting helps governments look ahead to identify future risks and opportunities, to plan, prioritise and focus government policies, which helps in achieving more effective and inclusive responses to future challenges. For example, in Finland strategic foresight practices have served as a benchmark for many OECD countries. The comprehensive framework includes a once-per-term horizontal government foresight report as well as the ministries’ Futures Reviews. Presented to parliament as government proposals, they outline the government’s aims while serving as policy statements directing administrative actions. The initial proposals are assessed and discussed by the Committee for the Future in Parliament. This helps to share a common vision about the future, and to reach consensus, in order to secure commitment across the coalition parties to the issue under investigation, which could prove very useful to resolve the productivity inclusiveness nexus.

**Embedding cultures of innovation in the public sector is crucial to improve the productivity of the public sector for inclusive growth**

7. A more innovative public sector is key to increased productivity and promoting a more citizen-centred approach to government. Becoming truly innovative requires deep changes to organisational cultures and operations, a public sector that is willing to accept risk when trying to find solutions to complex problems. At the same time, innovation also promises large gains in terms of the targeting and delivery of services, thereby reducing costs, and also opens the door to greater stakeholder engagement and more inclusive policymaking processes, which also contribute to more inclusive outcomes from policy action.  

8. Public sector leaders can drive innovation and productivity by developing skilled public workforces, investing in education and human capital, implementing strategic human resource management policies, and providing sufficient opportunities to put those skills to best use through enhanced leadership. A public workforce with the right skills and motivation to address current and future public sector challenges is essential to get the highest return on this investment. Skills are also required to develop and manage an increasingly wide range of partnership and horizontal collaborations with other public and private service providers. The challenge is to attract, retain, and put these skills-sets to best use. Ongoing OECD work on public employment and management is helping to identify which skill-sets are required in a highly productive workforce and how public sector leadership can help to ensure people are given the right opportunities to contribute to effective and efficient service delivery, thereby improving productivity.  

9. Digital government has the potential to increase the efficiency of public service delivery and make policies more inclusive. OECD work on digital government shows that efforts to combine platforms and share digital services across departments and agencies promises substantial savings and potentially a more seamless and integrated service for citizens and businesses. Making a stronger link between digital government and productivity would help to generate additional support for the investments in technology and human resource development that digital government implies. At the same time, governments often lack the capacity to monitor accurately the costs and benefits of new technologies and trends. This is the case, for example, with respect to the anticipated positive impact of social media use and open data on increased quality of public participation.  

10. Open government data (OGD) and data analytics can strengthen governments’ capacity to innovate in policy design and deliver more targeted and responsive policies. The ability of the public sector to use public datasets to better understand trends in user needs and behaviour is improving every day. This should improve policy design and enable governments to tailor policies more effectively to the needs and

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preferences of specific groups or specific places. More work is needed, however, to identify and quantify the direct and indirect economic benefits that accrue from open data policies. Other techniques such as behavioural insights can also identify ways in which services can be made more effective by being more responsive to the way that citizens experience public services. This implies potential for both productivity gains and greater inclusiveness.

*Increasing citizen participation, as well as more diversity, support inclusiveness but could also have a positive impact on productivity*

11. Citizen participation in the policy cycle contributes to more inclusive public policies and should allow more targeted, responsive and, in turn, more productive public policies. In addition, greater equality and diversity in the public sector might lead to more effective policies. The *Recommendation of the Council on Gender Equality in Public Life* [C(2015)164] provides an overarching framework for policy makers to close the remaining gender gaps in public life. At the same time, the Recommendation also recognises that gender equality is an enabler of effectiveness in the public sector. Gender budgeting is one example of a gender-sensitive policy approach that can combine benefits in terms of both productivity and inclusion.

12. However, more work is needed to explore the links between diversity and the effectiveness of the public service more broadly. The composition and diversity of public employment in OECD countries is an important issue as the public service represents such a large share of the labour force. OECD countries have had sometimes limited success in adapting human resources, leadership, training and career as well as employment policies to build a representative and inclusive civil service that understands and responds to the diversity of the citizens they serve. There is a need to reflect on the integration and inclusion capacity of the civil service at all levels and to identify effective practices to build an inclusive civil service. This can help governments to develop and deliver more innovative and productive policies and services, and set a high standard for the management of diversity among all employers.

**II. Strengthening the impact of the public sector on productivity in the wider economy**

13. The public sector uses a number of levers to generate outcomes across the wider economy that relate to both economic performance and equality. In particular, this section looks briefly at how the public sector promotes both productivity and inclusiveness as a regulator, a purchaser, and as an investor.

*Regulatory policy provides a crucial link between productivity and inclusiveness*

14. Governments make a crucial contribution to productivity by setting and upholding the rules and regulations that create the environment in which firms invest, innovate and trade. Much of the influence that governments have on their societies and economies occurs, in one form or other, through the medium of regulation. A sound regulatory framework can influence productivity gains and economic growth in two ways:

- First, by facilitating market entry and market exit through lowering barriers to entry, cutting red tape for new and growing businesses, and through better regulations for bankruptcy.
- Second, by improving investors’ confidence through increased clarity and transparency, reducing the risk premium and facilitating investment for key facilities, particularly in the infrastructure

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sectors. Enhanced transparency also helps to build trust and reduces the scope for costly and unproductive rent-seeking.8

15. While many studies deal with the costs of regulation much less attention has been paid to understanding and quantifying the benefits of regulation. For the policymaker, it is important to compare the estimated costs of regulation alongside the benefits of regulation, even if the latter are often not monetised. This is particularly important where regulation is intended to improve not just economic outcomes, but also social, health and safety and environmental welfare. To this end, consultation on regulation, both ex ante and ex post is a vital source of information to ensure that regulations are designed with inclusiveness in mind and implemented in such a way that impacts are monitored from an inclusiveness perspective.

Efficient public procurement can also support strategic inclusive growth objectives

16. Public procurement is a key economic activity of governments and represents a significant percentage of GDP. Purchasing by the public sector generates financial flows estimated on average at 10-15% of GDP across the world (Figure 1),9 thus, represents an important source of productivity gains from several perspectives. The Recommendation of the Council on Public Procurement [C(2015)2] highlights that good public procurement leads to greater efficiency in public spending and lower risks prevalent in major infrastructure and other complex procurement projects. Innovative procurement tools, including digital platforms and services, can increase competition and decrease administrative burdens easing access to SMEs in particular. Strategic procurement instruments such as framework agreements or contracts with options provide suppliers and their supply chains with longer-term relationships allowing for increased efficiency of business operations while also allowing for the public sector to promote key agendas in areas such as health, affordable housing or renewable energy. Public procurement can also offer an opportunity to enhance inclusion, for instance, of entrepreneurs from disadvantaged and under-represented groups through a greater use of social clauses, more training and support for entrepreneurs in the procurement process and an increased participation from social enterprises in procurement.

Better governance of infrastructure can improve social returns on investment while also encouraging more private financing

17. Government investment in physical infrastructure – from roads to communications networks that supports the delivery of effective public services – is essential for long-term economic growth and societal well-being, and hence, is the backbone of productivity. This is the case irrespective of the stage of development of a country, or of the prevailing economic culture and practice.

18. There are distinct governance challenges that the public sector will have to address if infrastructure is to achieve its potential with respect to boosting productivity and securing well-being. First, evaluating the infrastructure needs requires the ability to gather evidence to identify the relevant needs across sectors and regions. Second, a prioritisation of these needs should take place based on planning, processes and tools that allow an aggregation of the many project dimensions and preferences of stakeholders. Third, in the project preparation phase, suitable procedures and skills in terms of technical design, affordability and value for money issues need to be applied. Fourth, in the construction phase, appropriate skills and systems should be available to ensure that project assumptions are delivered upon or that changes are subject to appropriate scrutiny. Fifth, in the operational stage of the project, the right incentives and tools for appropriate monitoring of asset performance and maintenance should be in place as well as mechanisms for reflection on the service provided.
3. Enhancing productivity and inclusion: cities and regions

19. Many policies that matter for productivity and inclusion are designed and implemented at subnational scales. This is notably the case in the area of public investment and infrastructure. Large cities and agglomeration economies have a significant impact on labour markets and productivity. There is also a cumulative contribution of many small and intermediate regions to aggregate growth. The role of multi-level governance is to ensure that all levels of government contribute to this process.

20. As highlighted in the Recommendation of the Council on Effective Public Investment Across Levels of Government [C(2014)32], there are many co-ordination, capacity and framework conditions that can reinforce better governance at regional and local level. Such actions can result in a ‘governance premium’ that improves the productivity of public action which in turn can translate into better outcomes for people and firms. This is particularly true for policies aimed at SMEs and entrepreneurs, for which local conditions such as access to finance and connectivity are important. This section therefore considers what policies at both national and subnational levels can do given:

- productivity and well-being trends across urban and rural regions, and
- the influence of subnational government organisation and capacity on such trends.

National policies need to consider their place-based impacts on productivity

21. Gaps in productivity between frontier and lagging regions have been widening across the OECD area, although they have stabilised after the crisis due to a growth slowdown in the most advanced regions. Indeed, over the period 1995-2013, the GDP per worker of the top OECD regions grew on average by 1.6% per year, while those at the bottom by 1.3%. The same gap is found for the bottom 75%, indicating that this is not just a problem for lagging regions, but the non-frontier regions more generally (Figure 2). This growth differential, when cumulated over the same period, generates an increase of almost 50% in productivity gaps between the frontier and the most lagging regions. These disparities result in part from agglomeration forces that both increase productivity in regions that contain large cities and the income inequality among residents in the same metropolitan area. “Place-based” policy solutions are therefore needed to facilitate a “catch-up” in productivity levels – and as a result in material living standards – between frontier and lagging regions.

22. Urban and rural places are interconnected through different types of linkages (demographic, labour market, public service and environmental considerations). Integrated policy approaches and governance arrangements, such as rural-urban partnerships, can further strengthen these linkages, albeit poorly designed policies may simply exacerbate the urban-rural divide. For example, land use planning and transport, along with housing and commercial development policies, are highly complementary policy fields. If these are not well-co-ordinated, they can generate possible trade-offs between productivity growth and inclusion. In particular, commuting costs in the form of time and money influence the distance by which workers can readily reach jobs, thus limiting access to jobs for some.

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10. See also OECD (2016) The Productivity-Inclusiveness Nexus [C/MIN(2016)3].
11. Calculations based on data from the OECD Regional Database.
12. Calculations based on data from the OECD Regional Database.
13. For examples of country and regional practices to promote rural-urban linkages, see OECD (2013a).
Figure 2. Productivity growth of “frontier” regions outpaces those of lagging regions

Averages of top 10% (frontier), bottom 75%, and bottom 10% (lagging) regional GDP per worker, TL2 regions

Notes: Average of top 10% and bottom 10% TL2 regions, selected for each year. Top and bottom regions are the aggregation of regions with the highest and lowest GDP per worker and representing 10% of national employment. Due to lack of regional data over the period, only 19 countries are included in the averages.

Improving subnational government organisation and capacity can support productivity and inclusion by enhancing service provision

23. There are around 137 500 subnational governments in the OECD, and higher income countries appear to rely to a greater extent on them for delivering policy and public services. Subnational governments collectively accounted for 40% of public expenditure, 50% of public procurement, 59% of public investment and 63% of public staff expenditure across the OECD in 2014. Efforts to boost fiscal, administrative and human capacities at subnational level may occur with a given set of subnational competencies or may be accompanied by either greater de-concentration of national representatives in different regions and cities or decentralisation to subnational governments themselves. Furthermore, while there is no optimal size of a municipality or a region, the scale of these different subnational governments and the way that they are organised and co-ordinate their action has an impact on productivity of the public sector itself as well as its ability to provide an environment for firms that facilities their productivity growth.

24. There is indeed a productivity penalty associated with administrative fragmentation, as measured by the number of jurisdictions. Cities face particular challenges with respect to administrative fragmentation as often a metropolitan area includes many local jurisdictions. Out of the 281 largest metropolitan areas of 500 000+ inhabitants in the OECD, one-fourth contain at least 100 municipalities,

and that rises to one-third when considering those that have at least 60 localities. Considering 430 metropolitan areas across 5 countries, a clear negative relationship is found between productivity and the number of local governments per inhabitant (Figure 3). In fact, a doubling of the degree of fragmentation results in a penalty of 6% for productivity. That penalty is halved when there is a governance body for the metropolitan area (Ahrend et al., 2014). A given level of municipal fragmentation has a greater negative impact on growth in urban regions, due to the higher density of interactions, than in rural areas (Bartolini, 2015).

25. This is one of the reasons why many OECD countries have already, or soon will, implement metropolitan governance arrangements reforms. Such reforms are typically designed to better organise spatial planning and economic development for the largest cities in a country and often result in the creation of a metropolitan authority. Four common approaches to metropolitan governance include: i) informal/soft co-ordination, ii) inter-municipal authorities, iii) supra-municipal authorities and iv) special status such as “metropolitan cities” (OECD, 2015e).

Figure 3. Fragmented metropolitan areas face a productivity penalty


15. The estimates use wages as a proxy for individual productivity and account for the direct impact of individual characteristics, such as education, age, gender, occupation, and part-time work. The number of local governments per capita is standardised for each country to have zero mean and unit variance.

16. In addition to OECD (2015e) for metropolitan governance reforms, see also Ahrend and Schumann (2014) for an overview of metropolitan area governance arrangements across OECD countries.
26. Administrative fragmentation is also associated with greater levels of segregation by income, that in turn influences access to opportunities. Across several OECD countries, a stable and positive association is found between administrative fragmentation and spatial segregation across local jurisdictions within metropolitan areas. This finding is consistent across estimates when considering a range of measures of both segregation and fragmentation (Boulant et al, forthcoming). Administrative fragmentation thus can contribute to the virtuous or vicious circles associated with segregation by income.

27. National averages typically mask stark variations between, and often within, regions in terms of unemployment rates, income levels and air quality – and these have increased since 2000 (Figure 4). This is important as disparities in accessibility to, and quality of, services within the same country can perpetuate productivity gaps and lock current and future generations in disadvantage. Such disparities are observed between urban and rural locations but also across localities in the same metropolitan area. The manner in which financing and competencies are shared between national and sub-national governments can influence the degree to which the quality and effectiveness of such public services promote well-being factors in locations with different conditions and financing capabilities. Co-ordination across municipalities or regions can be used to improve the cost-effectiveness of public services, the quality of those services, and the coherence of overall planning, among other benefits. Fragmented sub-national governance arrangements, on the other hand, can result in poor planning and transport infrastructure choices that limit the effective size of labour markets and thus access to jobs as well as critical public services such as hospitals. The extent to which governance arrangements at all levels integrate policies across sectors to tackle the multi-dimensional nature of well-being is another consideration.

![Figure 4. Well-being differences across regions](image)

**Regional disparities in well-being dimensions OECD (TL2)**

*Note:* The higher the coefficient of variation is, the higher is the degree of regional disparities.

*Source:* Calculations based on the OECD Regional Database.

17. For example, those metropolitan areas with a transportation authority had higher levels of satisfaction with public transport (14 percentage points) relative to those living in cities that did not (Ahrend, Gamper and Schumann, 2014).
Conclusion

28. This note has shown how the public sector affects productivity and inclusiveness in at least three ways: i) by aligning vision, incentives and delivery mechanisms across the policy-making cycle; ii) by establishing sound regulatory, procurement and public investment practices; and iii) at the regional and local level, by addressing coordination capacity and framework conditions. In each case, a better understanding of how the public sector influences productivity, growth and inclusiveness is an essential first step in designing appropriate policy responses. Actions to strengthen the productivity of the public sector can result in a ‘governance premium’ that improves the productivity of public action which in turn can translate into better outcomes for people and firms.

29. A range of governance mechanisms can be used to help align government action behind the shared goal of productivity and inclusiveness.

- First, Government, as one economic actor, through improved performance measurement, enhanced innovation, including digital government and open government data, as well as greater citizen participation, gender equality and diversity can continue to increase its own efficiency, effectiveness and inclusiveness.

- Second, in terms of policy design, *ex ante* impact assessments can address distributional concerns while also identifying the positive impacts that legislation, regulations and policies are expected to bring for individuals, firms and places.

- Third, public policies can emphasise “voice,” giving citizens greater scope to influence public policies. Better indicators can help the process of monitoring policy outcomes in a more responsive way.

- Finally, multilevel governance also affects productivity and well-being trends across urban and rural regions.
ABBREVIATION CODES

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