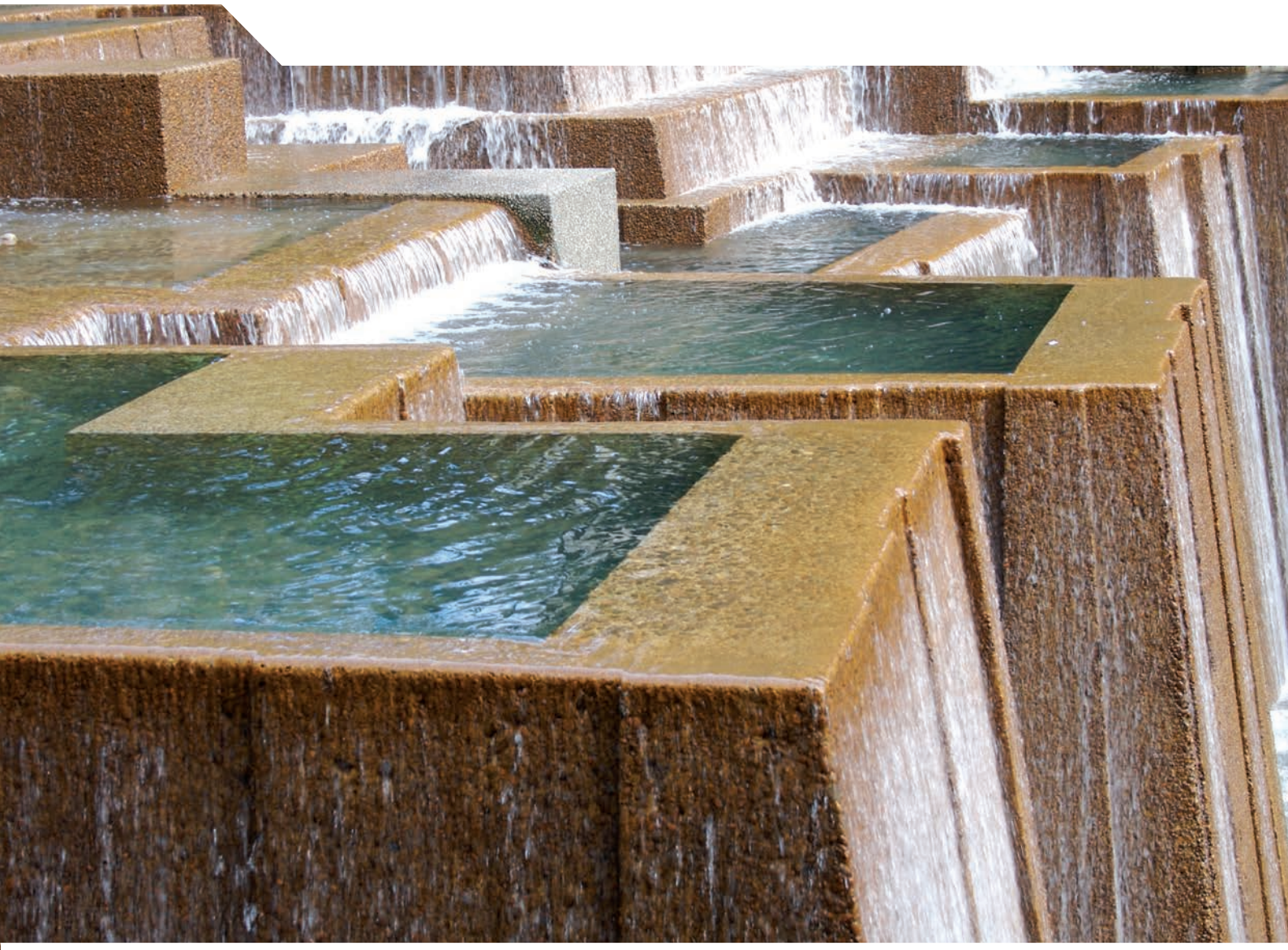
Fiscal Federalism 2016

MAKING DECENTRALISATION WORK



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Fiscal Federalism 2016

MAKING DECENTRALISATION WORK

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Foreword

Almost 35% of public money is spent at the sub-national government level. State and local governments shape education, healthcare, infrastructure and other key policy areas, affecting productivity and the sustainability of public finances. The funding of public services through taxes and transfers is not only a key determinant of a country's growth, but most importantly it is a critical driver for the advancement of the well-being of its citizens.

The economic and financial crisis that hit much of the world in 2008 exposed major weaknesses in fiscal frameworks and the co-ordination between different administrations within countries. Without reforms to fiscal relations, many governments will continue to struggle. The relations between national and sub-national governments, often the bedrock of a country's institutions, require a review so that growth for all and in all jurisdictions is to take off again.

This book draws on the work of the OECD Fiscal Network and the discussions of its delegates, presenting a compilation of some of the most salient policy issues in fiscal federalism. It concludes that, although spending and revenue decentralisation has seen progress over the last two decades, it has become skewed and the vertical fiscal imbalance has increased. One of the book's chief findings is the importance of taking decentralisation forward coherently if public finances are to become more efficient, equitable and sustainable. The book also emphasises that property taxation can contribute to a strategic shift away from the taxation of labour towards less distorting taxes. It offers guidance on how reforms to tax and transfer systems can make governments more accountable to their citizens. And, in the current context of tight public finances, it highlights an emerging concern – how sub-national governments should monitor and manage debt.

Angel Gurría

Secretary-General

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Executive summary

This 2016 edition of *Fiscal Federalism* seeks to analyse and propose reform options in the area of intergovernmental fiscal frameworks and sub-central public finance. The policy issues that it addresses are of a structural and macroeconomic nature, covering both the spending and the revenue sides of the budget. After an introductory chapter summarising trends and developments in decentralisation since 1995, the book goes on to examine:

- fiscal constitutions and how they shape intergovernmental fiscal relations and outcomes;
- the recurrent tax on immovable property and how it may underpin moves towards a more efficient, inclusive tax system;
- how a shift from intergovernmental transfers to own taxation may help increase the accountability and efficiency of governments;
- how sub-national governments should monitor and manage debt;
- the spending power of sub-national governments.

Key findings and recommendations

- *Chapter 1, "A bird's eye view of fiscal decentralisation"*, is the introductory chapter to the 2016 edition of *Fiscal Federalism*. It finds that, although the OECD area is more decentralised than two decades ago, decentralisation has also become more unbalanced. While sub-national jurisdictions account for 32% of government spending on average, only 15% of tax revenues accrue to them, which increases the importance of intergovernmental transfers. However, sub-central tax autonomy – the power to determine tax bases and rates – has also grown. Recurrent taxes on immovable property are on the rise and, more than 20 years on, have overtaken income taxes again as the biggest sub-national tax source. Sub-national governments are responsible for almost two-thirds of public investment – a share that has risen slightly over the last two decades, even defying the tight budget constraints after the 2008 crisis. While sub-national debt rose rapidly at that time, it is now generally evening out, although persistent rises in some countries' levels of debt could be a cause for concern.
- *Chapter 2, "Fiscal constitutions"*, compares the fiscal constitutions of 15 federal countries and the European Union. A fiscal constitution is the set of rules and frameworks which guide fiscal policy and are enshrined in a country's fundamental laws. They govern sub-national autonomy and responsibility, sub-national influence over federal fiscal policy, and intergovernmental budget frameworks. The chapter concludes that decentralisation hardly matters for such fiscal policy outcomes as deficits and debt. What does, though, is the coherence of institutional arrangements – i.e. the extent to which they fit together. To make fiscal constitutions more coherent, therefore, reform should seek to align sub-national tax and spending powers and strengthen sub-national

budget constraints – by building insolvency frameworks, for example, or implementing good intergovernmental budget practices.

- *Chapter 3, "Reforming the recurrent tax on immovable property"*, reviews property tax systems in OECD countries and suggests guidelines for reform. While the importance of property taxation began to decline in the early 1980s, it regained prominence in the wake of the 2008 crisis as it underwent reform. Immovable property tax is a good tax for funding local governments and among the least harmful to economic growth. It acts – albeit modestly – as an automatic stabiliser and can even be progressive. Yet it is unloved by voters and taxpayers because it is highly visible and not directly linked to ability to pay. To make property tax reform politically palatable, property taxation should cover all kinds of land, be based on regularly updated property values, and offer tax cuts to low-income groups. And it should rely on a good administrative and judicial framework. There is growing demand for a proper redesign of property taxation that is economically and fiscally successful.
- *Chapter 4, "Taxes versus grants: what revenue source for sub-national governments?"* analyses trends and policy options in the composition of sub-national governments' revenues. Many countries have decentralised spending responsibilities and widely fund them through intergovernmental transfers. While equal access to public services is the most common rationale for such grant systems, they are generally much larger than required by equalisation. Moreover, rather than smoothing out sub-central revenue fluctuations over the cycle, grants often tend to exacerbate them. Indeed, there is some evidence that they may widen rather than narrow economic disparities between jurisdictions in the long run. Governments seeking to make fiscal relations more efficient and inclusive should increase the share of sub-national governments in total tax revenue – e.g. by increasing property taxes or devolving some personal income taxation – and reduce and redesign the grant system to tie it more closely to actual sub-national needs.
- *Chapter 5, "Monitoring sub-central government debt: trends, challenges and practices"*, examines how OECD countries monitor sub-central debt and makes a number of recommendations. As a result of the global financial crisis and ensuing stimulus packages, median sub-central government debt grew from 6% to 10% of GDP between 2007 and 2012. Mechanisms for monitoring sub-central debt have consequently come into the spotlight. The chapter explores those mechanisms that central governments in the OECD use to monitor sub-central debt and explains the chief challenges. It also surveys the main sub-central insolvency procedures. A well-functioning debt monitoring mechanism should ensure economic stability and sound fiscal management, be flexible enough to cope with unforeseen events, and safeguard sub-central financial capacity to deliver public services, particularly public investment. Monitoring mechanisms should also be carefully designed so as not to induce pro-cyclical policies.
- *Chapter 6, "The spending power of sub-central governments"*, assesses the spending power of sub-central governments in a number of policy areas. Sub-national governments have limited discretionary powers over a range of budget items such as education, childcare, elderly care or transport. Traditional indicators – like the sub-central share of total government spending – may be misleading as they underestimate the impact of central government regulation on sub-central spending. Wide discrepancies between spending shares and spending power hint at opaque accountability in all tiers of government. Moreover, the more central government locks in sub-central spending, the more it has

to help in the event of financial difficulty. Finally, in some instances low spending power undermines the ability of sub-central jurisdictions' to meet fiscal targets. Reform should focus on devolving greater power to sub-national governments over their own spending.

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Chapter 1

A bird's eye view of fiscal decentralisation

This chapter offers a succinct overview of fiscal decentralisation in OECD countries and identifies common trends. To that end, it seeks to answer a few crucial questions. How does decentralisation evolve overall? Which countries have undertaken intergovernmental fiscal reforms, and which were the most common and important? What was the impact of the 2008 crisis on sub-central deficits and debt? How did sub-central power and responsibilities evolve in the aftermath of the crisis? Is there a "new normal" in intergovernmental fiscal relations and sub-national public finance, and what does it look like? To answer these questions, the chapter reviews the evolution of the main fiscal indicators, such as spending and revenue decentralisation, tax autonomy, the tax and spending composition of sub-central governments, the size and structure of the intergovernmental grant system, and deficit and debt developments at the sub-national level. Finally, the chapter looks beyond purely financial decentralisation indicators.

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.

Introduction

This chapter seeks to provide a condensed, nuanced account of fiscal decentralisation trends in OECD countries. To that end, it fully exploits the wealth of data collected by the OECD Fiscal Network.[1] It assesses the level and evolution of current government spending, investment, and tax revenues. It also looks at intergovernmental grants together with deficits and debt at the sub-central government (SCG) level. While decentralisation ratios can yield a first impression of the role of SCGs, they sometimes also convey an oversimplified, or even distorted, picture of the true extent of sub-central autonomy. To paint a more fine-grained picture of how intergovernmental fiscal relations really work, the chapter also considers an additional set of institutional indicators that measure tax autonomy, spending power and the conditionality of intergovernmental grants. Finally, the chapter briefly introduces a set of non-financial decentralisation indicators that gauge the power and influence of SCGs in specific policy areas.

Sub-central spending and revenue shares

The most common measures of fiscal decentralisation are the consolidated shares of SCGs in general government spending and revenue (Box 1.1). The shares vary widely from country to country, but have evolved relatively little over the last two decades or so – even after the onset of the crisis in 2008. OECD-wide in 2014, SCGs accounted for around 33% of consolidated government expenditure on average, with values ranging from 7% in Greece to 69% in Canada. The sub-central share in total own revenue averaged 19%, with Greece and Canada again lying at opposite ends of the spectrum. Spending is clearly more decentralised than revenues, with intergovernmental grants accounting for a considerable proportion of sub-central spending (Figure 1.1). Although showing decentralisation as a proportion of GDP rather than of general government spending and revenue does not change the overall picture, it does move a few highly decentralised countries with a large public sector up the decentralisation scale. In the Nordic countries, for example, the municipal sector accounts for up to 20% of GDP. Constitutional provisions account only in part for differences in sub-central autonomy, as some federal countries are more fiscally centralised than a number of unitary ones.

The OECD area has grown more decentralised over the last two decades at least, although reforms that have profoundly changed the institutional set-up of fiscal federalism are rare and confined to a few countries only (Figure 1.2). Italy and Spain, for example, embarked on a secular decentralisation process, with Spain, once one of the most centralised OECD members, becoming one of the most decentralised in the space of 20 years. Several Eastern European countries, such as Estonia, Slovakia, Slovenia and Poland, also devolved much more financial power to sub-central jurisdictions, often linked to the EU enlargement process and devolution to regional authorities. A handful of countries defied the trend and re-centralised a number of core spending functions. A case in point is Norway which, in the mid-2000s, moved both fiscal and regulatory power in

Box 1.1. **The consolidation of spending and tax revenue data**

Spending and revenue data from various databases must be "consolidated". Such consolidation is necessary in order to prevent certain categories from being accounted for twice or even three times, i.e. at the central level and at one or two tiers of sub-national government. Intergovernmental grants and tax sharing arrangements are the main reason why data on spending and revenue across governments must be consolidated.

Spending consolidation

Spending data from the OECD National Accounts must be consolidated in order to net out intergovernmental grants. Intergovernmental grants – spent at an upper tier of government and then spent again at a lower tier – make the sum of central, state or regional and local spending larger than effective overall government expenditure. In order to avoid double counting, the OECD Fiscal Decentralisation Database consolidates expenditure at a certain tier of government by calculating total spending minus that tier's intergovernmental transfer expenditure. Consolidated total general government expenditure is defined as global total expenditure by general government plus total intergovernmental property expenditure. Property expenditure is added because it consists of payments by one tier of government for a service provided by another tier, which should not be consolidated. The same procedure applies to the calculation of sub-central spending shares of individual government functions – education, healthcare, etc.

Tax revenue consolidation

Double imputation is usually less of a problem on the tax side, because tax revenues can be unambiguously allocated to a single government most of the time. This also holds true when taxes are shared across different tiers of government. Taxes collected by one tier of government are assigned to the tier on behalf of which it collects the taxes. A number of OECD countries – all federal countries plus Spain – distinguish between state and local government tax revenues, and in some figures a distinction is being made between the two levels of government. Social security contributions are merged with central government tax revenues, for simplicity and to allow for comparisons across countries of which some do not have institutionally separate social security systems.

Debt consolidation

In a few countries, the debt of one tier of government may be held by another tier and, thereby, count as an asset. In order to prevent some public debt from being counted twice, the government debt held by another tier of government should be netted out. The OECD National Accounts Statistics Database provides consolidated debt data for most OECD countries.

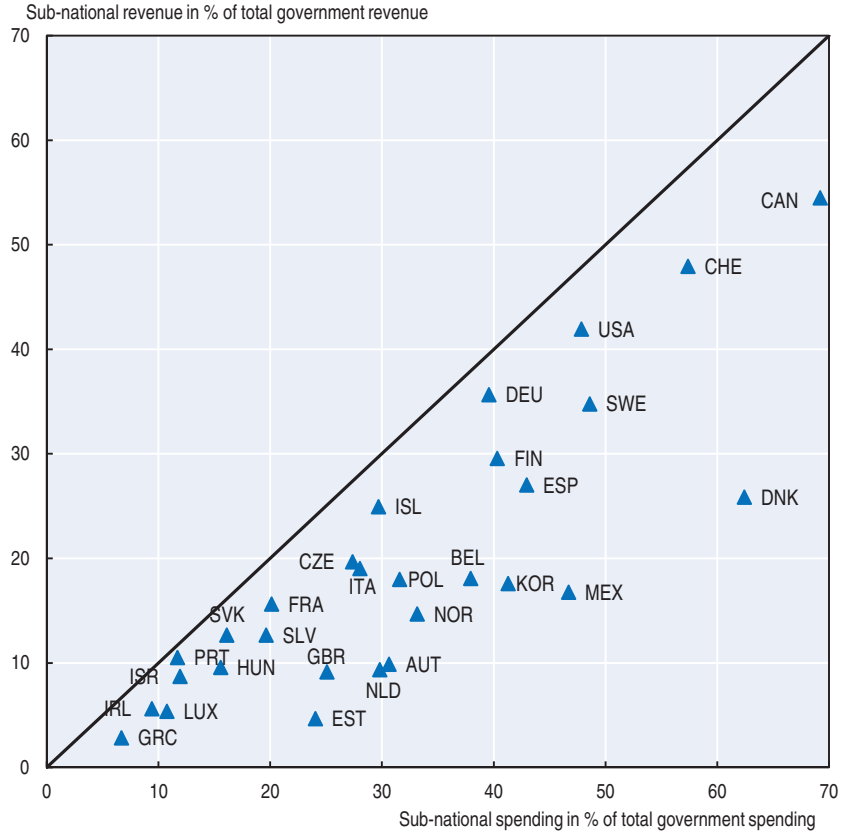
Source: OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.

hospital care from the counties back to central government. Finally, a few countries took revenue and spending decentralisation in opposite directions. Denmark in particular saw vertical fiscal imbalance – the difference between own revenue and own spending – increase by 14 percentage points, in particular after the 2007 reforms.

While both revenue and spending have become increasingly decentralised over the past 20 years, the pace of spending decentralisation has clearly outpaced revenue decentralisation, resulting in wider vertical fiscal imbalances and larger intergovernmental transfer systems (Figure 1.3).[2] Although the immediate aftermath of the crisis saw a considerable increase in devolved spending, as stimulus programmes targeted sub-central

Figure 1.1. **The fiscal power of sub-central governments varies widely from country to country**

Decentralisation ratios, 2014 or latest available year



Note: Sub-national expenditures include intergovernmental grants, while sub-national revenues do not. Latest available data for Korea are from 2012 and for Mexico from 2013. Australia, Chile, Japan, New Zealand and Turkey are not included.

Source: OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.

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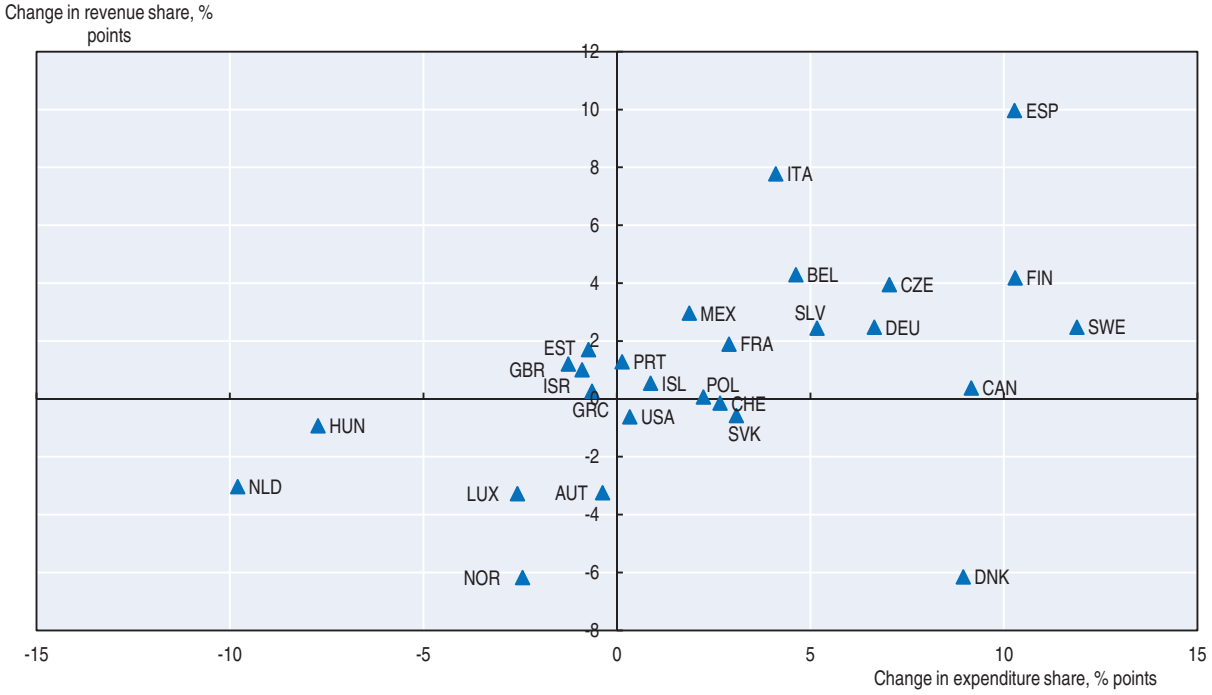
expenditure, the trend reverted in subsequent years. Sub-central revenues evolved more quietly both during and after the crisis, which suggests that they were less cyclical and/or less affected by policy changes. Tax decentralisation varies more sharply between countries than spending decentralisation which shows a lower coefficient of variation. Overall, decentralisation arrangements are edging towards an intermediate level, with a few highly decentralised countries re-centralising and several strongly centralised countries devolving more power to lower government levels, as shown by the slightly downward-sloping lines representing the annual coefficient of variation.

Simple decentralisation ratios say little about a SCG's power, autonomy or discretion over fiscal resources, and the way intergovernmental fiscal und budgetary institutions function. On the revenue side, national limits on tax bases, rates and relief reduce the extent to which SCGs can sway tax revenues. On the expenditure side, SCGs may be strongly constrained by central or federal government regulation, so losing discretionary power over various policy areas. In some countries, the transfer of financial responsibility for education, healthcare and/or social welfare was hardly more than a change in accounting procedures, while essential regulatory power over service delivery remained

Figure 1.2. **Many countries devolved more fiscal power, but a few re-centralised**

Decentralisation ratios, change 1995-2014

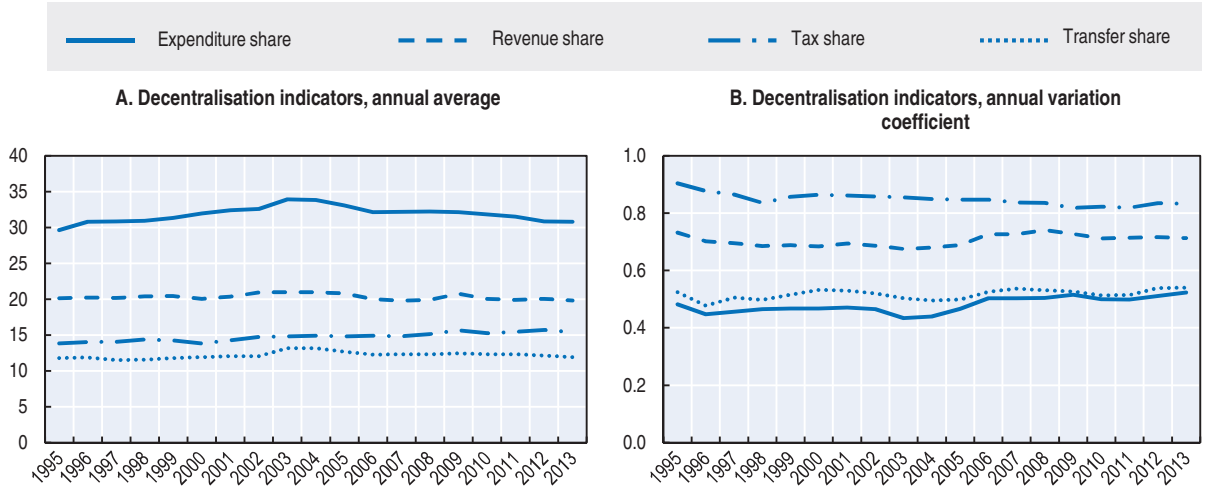


Note: Data without Ireland. Sub-national expenditures include intergovernmental grants, while sub-national revenues do not. Data for Greece cover the years 2006-14; for Iceland 1998-2014; for Mexico 2003-13; for Poland 2005-14.

Source: OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.

StatLink http://dx.doi.org/10.1787/888933341782

Figure 1.3. **Decentralisation has increased and converged slightly across countries**



Note: When there were no data for 2013, 2012 data were used. Sub-national expenditures include intergovernmental grants, while sub-national revenues do not.

Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

StatLink http://dx.doi.org/10.1787/888933341793

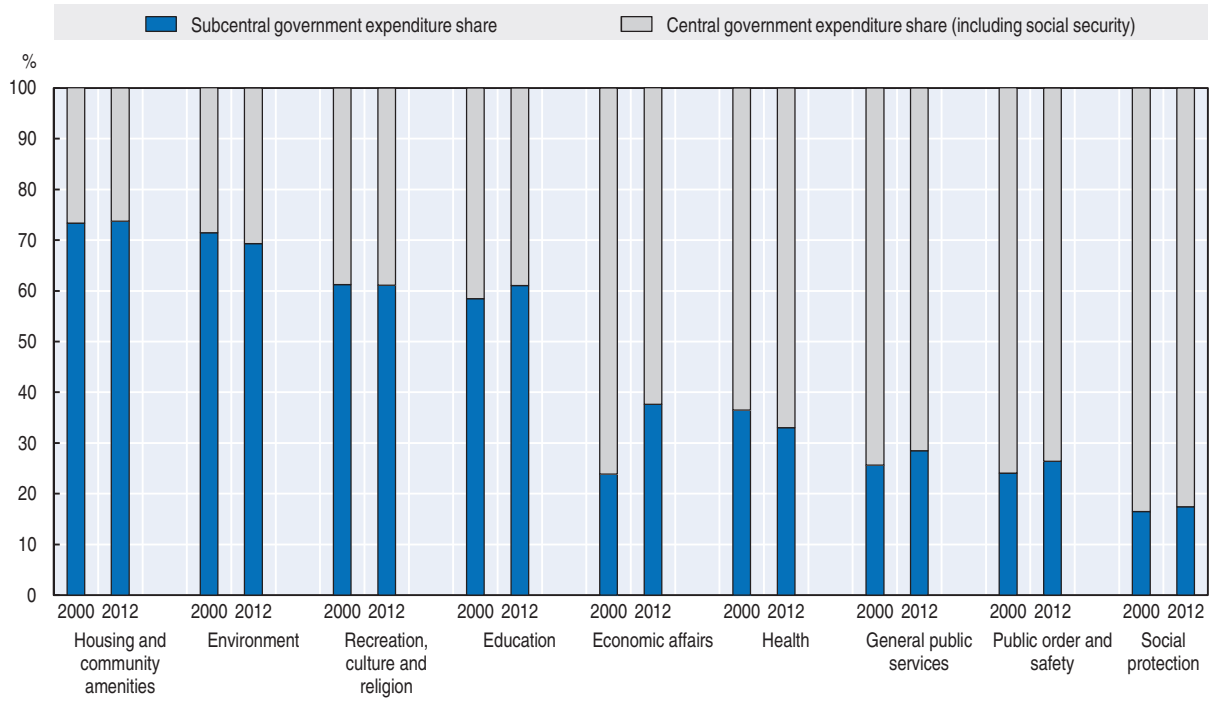
with or was even tightened at the central government level. Very few fiscal measures adopted to tackle sub-central crisis symptoms changed the institutional set-up of fiscal relations. Taken at face value, sub-national revenue and spending shares might be

misleading in some instances. They nevertheless provide a starting point for further examination of intergovernmental fiscal relations and sub-national public finance (see Chapter 6 on spending power).

Policy areas under sub-central responsibility

The various policy areas on which governments spend money are decentralised to different degrees (Figure 1.4). Housing and community services – a typical sub-central service – are the most devolved, with SCGs accounting for more than 70% of spending, followed by the environment, and education, then leisure, culture and religion. Healthcare appears less centralised, although the average hides sharp differences between countries. The composition of sub-central responsibility varies with the degree of overall decentralisation in a country (Figure 1.5). In highly centralised countries, the bulk of sub-central spending is confined to general economic and public services – chiefly in housing, local development, and primary and secondary education. In more decentralised countries, spending structure and policy responsibility are different, with healthcare and social welfare accounting for a larger share of sub-central spending. Education remains a core local government responsibility.

Figure 1.4. **Some policy areas are more decentralised than others**



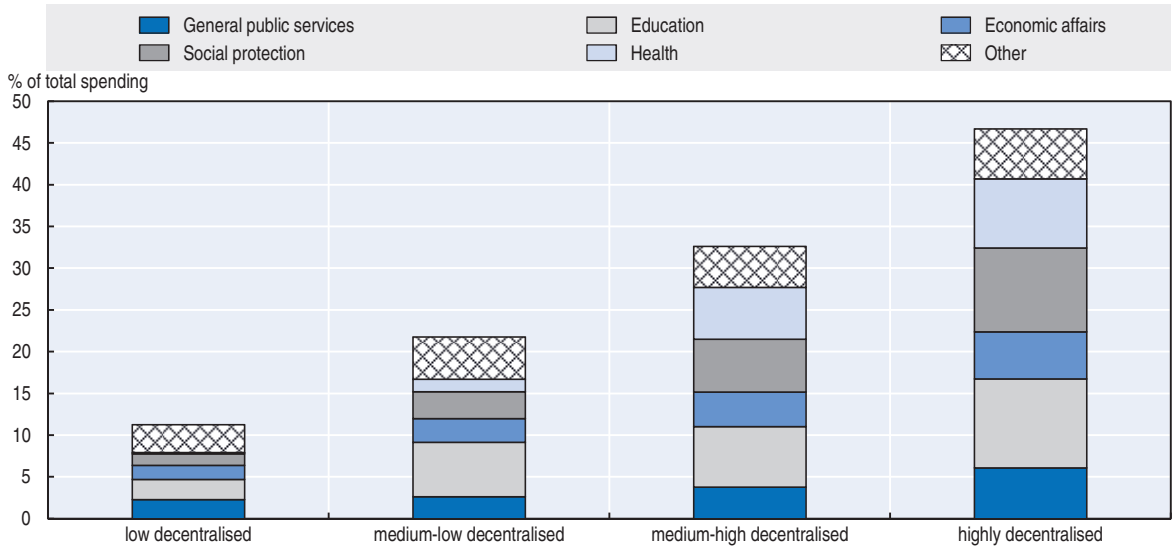
Note: For Germany, unconsolidated expenditure was used. 2011 data were used for Austria, Korea, Israel and the United States.
Source: *OECD National Accounts*, *http://dx.doi.org/10.1787/na_glance-2015-en*.

StatLink http://dx.doi.org/10.1787/888933341804

A number of countries have made sizeable changes to the assignment of functions since 2000. They have decentralised education and SCG spending now makes up more than 60% of all education expenditure. Health care responsibilities, by contrast, have been re-assigned to central government, although there have also been reforms that go in the opposite direction. The most salient shift took place in economic affairs – mostly transport –,

Figure 1.5. **The sub-central spending composition changes with the degree of decentralisation**

2012 or latest available year



Note: For Korea, Israel, Austria and the United States, 2011 data were used. The four categories are formed so as to contain a similar number of countries.

Source: OECD National Accounts Database, http://dx.doi.org/10.1787/na_glance-2015-en.

StatLink http://dx.doi.org/10.1787/888933341817

where SCGs have gained considerably more influence. Again it should be stressed that spending and changes in the spending shares of certain functions do not necessarily imply a change in effective responsibility. Several countries have reassigned government functions to sub-national jurisdictions, while introducing an array of additional regulations that have kept effective SCG spending under tight supervision. Assessing true spending power requires a more refined set of indicators, as shown in Chapter 6, "The Spending Power of Sub-central Governments".

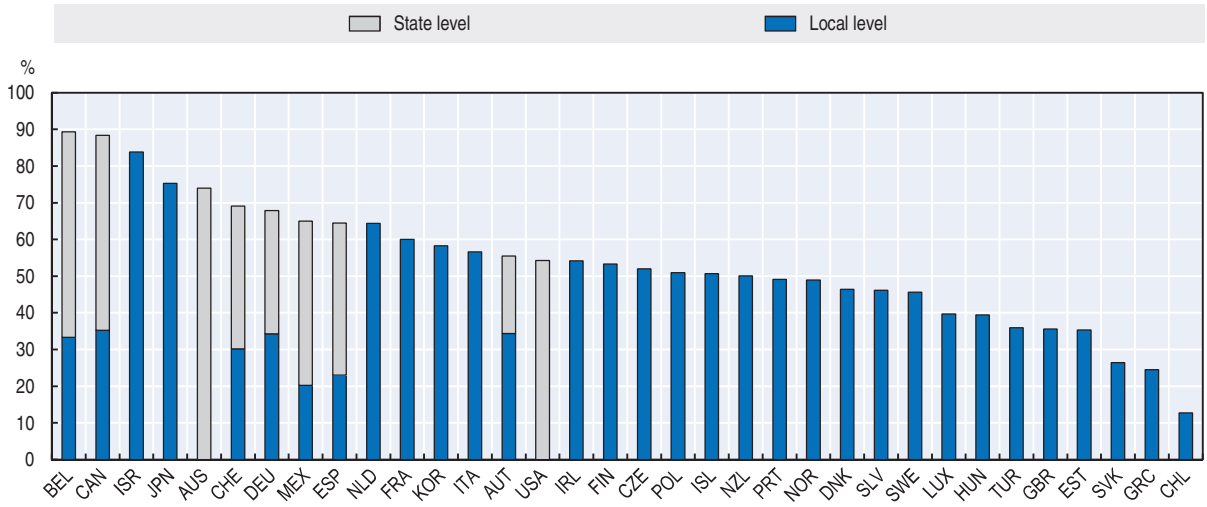
Investment across government levels

Investment, or capital spending, is a major expenditure category at the sub-national level. SCGs account for almost two-thirds of capital spending, although the percentage varies widely across countries – from more than 90% in Belgium to barely 10% in Chile (Figure 1.6). The share of sub-national spending is greater in federal than in unitary countries although, again, that high share tends to overstate sub-national responsibility for investment since central government grants often provide the resources for sub-national government capital spending. Given the importance of investment for long-term productivity growth, measures that foster SCGs' capital spending have become the focus of economic and fiscal policy (OECD, 2013 and OECD, 2015). In 2014 the OECD endorsed a Recommendation on effective public investment across levels of government.

Public capital expenditure as a share of all government expenditure has declined over the last decade – particularly in the aftermath of the economic and fiscal crisis which saw countries use public investment as a key adjustment variable during consolidation episodes. However, SCGs' share of that expenditure has risen slightly due to factors that include: declines in central government capital spending, transfers of responsibility for investment to lower tiers of government, and increases in the cost of SCG investment

Figure 1.6. **The sub-central government level accounts for most public investment**

Ratio of sub-central to general government investment, 2013



Source: OECD (2015), *Sub-national governments in the OECD*: Key data (*http://dx.doi.org/10.1787/region-data-en*).

StatLink http://dx.doi.org/10.1787/888933341821

relative to central government investment projects. The sharp decline in overall investment when stimulus packages came to an end around 2010 affected sub-national jurisdictions, albeit in different ways – the share of sub-national spending rose further in federal countries, but tended to fall in unitary countries. While measurement issues make precise cross-country comparisons difficult, empirical evidence suggests that decentralisation could boost investment (Blöchliger et al., 2012; Kappeler et al., 2013).

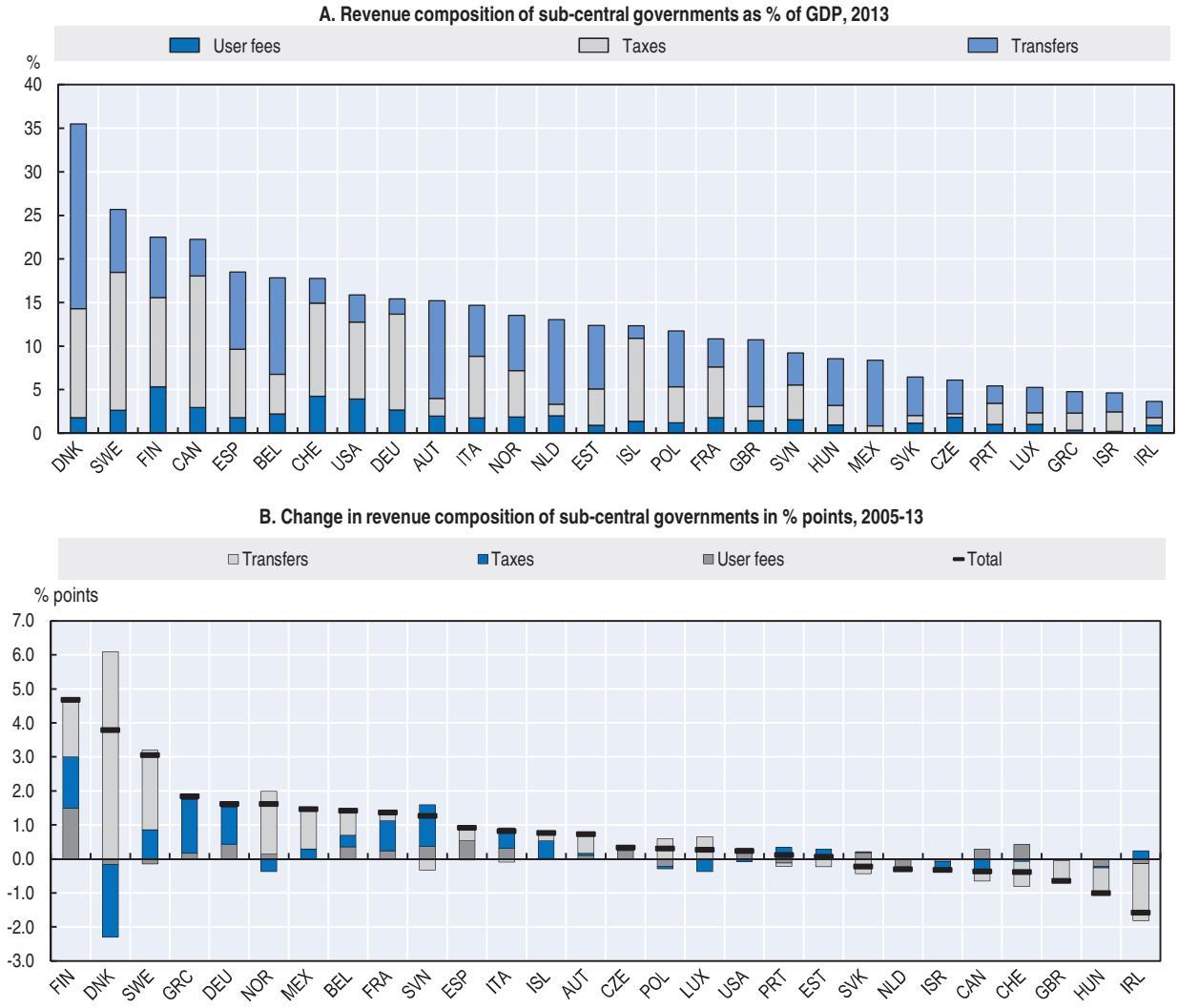
Sub-central revenue composition

The sub-central revenue mix: Taxes, grants and user fees

Sub-central government revenues consist essentially of three resources: taxes (whether their own or those shared with other tiers of government), intergovernmental grants, and user fees, i.e. income from the provision of public services. In a few countries, property income (revenues from assets such as royalties and rents) are also important. The sub-central revenue mix is thus quite different from that of central government which depends mainly on taxes.

Although sub-central revenue mixes vary widely across OECD countries, they have changed little over time apart from in a few Nordic countries (Figure 1.7). OECD-wide, 42% of SCG revenue is covered by own and shared taxes, 44% by intergovernmental grants, and 14% by user fees. From country to country, however, the relative shares of the revenue sources differ considerably. While taxation accounts for almost 90% of SGC revenue in Iceland, it yields only 10% in the Netherlands, where the reliance on fees and intergovernmental grants is correspondingly higher. Federal countries allocate a slightly higher tax share to SCGs than unitary countries on average, and SCGs with a lower tax burden tend to charge more user fees. The make-up of SCG revenue has remained largely stable, with a slight increase in sub-central transfer dependency, more reliance on user fees, and less taxes.

Figure 1.7. **The sub-central government revenue mix varies widely, and transfers now play a greater role**



Note: 2006 instead of 2005 for Greece. Australia, Chile, Japan, Korea, New Zealand and Turkey are not included because one or more of the relevant data points are not available.

Source: *OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.*

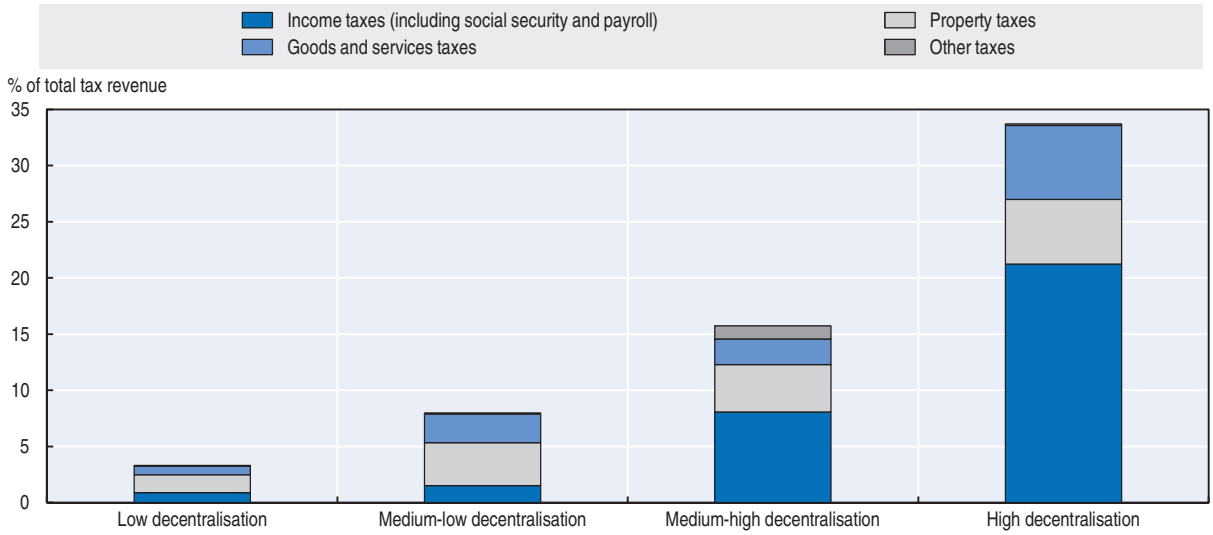
StatLink http://dx.doi.org/10.1787/888933341835

The sub-central tax mix: More than just property taxes

The mix of sub-central taxes, i.e. those assigned to sub-central governments, depends largely on how decentralised a country is. The tax that SCGs in strongly centralised countries administer most widely is the property tax and, more specifically, the recurrent tax on immovable property (or real estate tax) which is almost exclusively sub-central. The tax mix evolves with decentralisation, mostly because immovable property taxes are difficult to raise as spending responsibilities increase. Thus, the greater expenditure decentralisation is, the more SCGs rely on income and, to a lesser extent, consumption taxes. The sub-central tax mix has changed slightly over the last 20 years, with a decline in property taxes from 33% to 31% of SCG tax revenue and a rise in the share of consumption and income taxes – especially personal income tax (Figure 1.8).

Figure 1.8. **The sub-central tax mix is more varied at higher levels of decentralisation**

Sub-central tax composition by degree of tax decentralisation, 2013



Note: 2012 data for Australia, the Netherlands, Mexico and Poland.
Source: *OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.*

StatLink http://dx.doi.org/10.1787/888933341844

Various factors can explain the relatively small share of revenue from property taxation especially in the more decentralised countries. To begin with, the tax base, i.e. property and cadastral values, has not been updated for years – even decades – and a variety of measures such as tax caps, abatements and exemptions are gnawing at local property tax revenue. Moreover, the dwindling significance of manufacturing with large physical plants may also explain weak property tax revenues. Higher property taxes could bolster SCGs' public finances with relatively few negative economic side effects (see Chapter 3, "Reforming the Tax on Immovable Property"). Indeed the share of revenue from property taxation has been on the rise since 2009. So, too, though, has revenue from personal income tax, which has become more widespread at the sub-central level, with several countries having assigned a share of tax revenue to sub-national jurisdictions. Finally, changes in the share of sub-central consumption taxes are mostly a consequence of more tax-sharing arrangements.

Tax autonomy

The term "tax autonomy" captures various aspects of the freedom that SCGs have over their own taxes, such as the right to introduce or abolish taxes, set tax rates, define the tax base, and grant allowances or relief to individuals and firms. In many countries, taxes are not assigned to one specific government level but shared between central and sub-central governments. Although such tax-sharing arrangements prevent single SCGs from controlling tax rates and bases, SCGs may collectively negotiate sharing formulae with central government.

In an attempt to measure the wealth of explicit and implicit institutional tax arrangements, the OECD Fiscal Network drew up a taxonomy of degrees of SCG taxing power. They are rated from highest to lowest in five main categories (plus an auxiliary level) and a number of sub-categories (Table 1.1):

- in "a", SCGs enjoy full power over the rates and bases of their own taxes;

- SCGs in category "b" may set tax rates only – essentially surcharges and "piggy-back" taxes;
- "c" denotes power over the tax base only – i.e. the right to grant businesses and households tax credits and relief;
- "d" refers to different types of tax-sharing arrangements;
- "e" means no taxing power at all;
- category "f" denotes non-allocable taxes.

Table 1.1. **Degrees of sub-central taxing powers**

Categories and indicators

a1	The recipient SCG can set the tax base, tax rates and any reliefs without needing to consult a higher level government.
a2	The recipient SCG can set the tax base, tax rates and any reliefs after consulting a higher level government.
b1	The recipient SCG can set the tax rate, and a higher level government does not set upper or lower limits on the rate chosen.
b2	The recipient SCG can set the tax rate, and a higher level government does set upper and/or lower limits on the rate chosen.
c	The recipient SCG can set some tax reliefs (tax allowances and/or tax credits) but not tax rates.
d1	There is a tax-sharing arrangement in which the SCGs determine the revenue split.
d2	There is a tax-sharing arrangement in which the revenue split can be changed only with the consent of SCGs.
d3	There is a tax-sharing arrangement in which the revenue split can be changed unilaterally by a higher level government, but less frequently than once a year.
d4	There is a tax-sharing arrangement in which the revenue split is determined annually by a higher level government.
e	Other cases in which the central government sets the rate and base of the SCG tax.
f	None of the above categories a, b, c, d or e applies.

Source: OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.

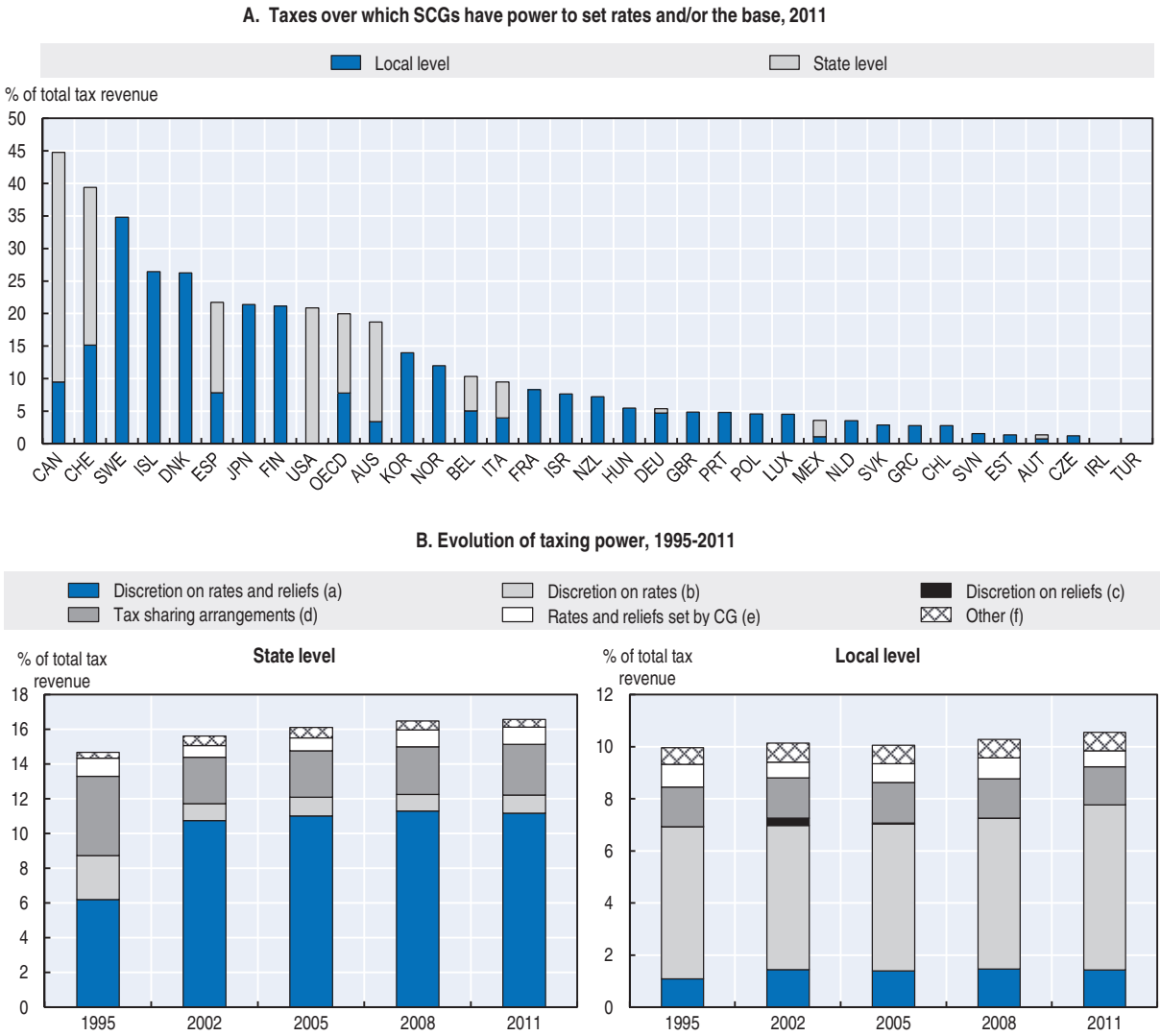
In order to better capture complex institutional details the OECD Fiscal Network further divided the five categories into sub-categories: two for categories "a" and "b", and three for "c". It gave special attention to tax-sharing arrangements, where the four "d" sub-categories denote the various institutional arrangements for determining jurisdictions' and governments' shares of total tax takes. Altogether 13 categories were established to capture the various tax autonomy arrangements in OECD countries. And, since category "f", or "non-allocable taxes", was hardly used, they seem to reflect the tax-power picture accurately.

Although tax autonomy varies widely from country, most SCGs have some discretionary power over their own taxes (Figure 1.9). On average, the share of tax revenue over which SCGs – i.e. regional and local government – have full or partial discretion (Categories A, B and C) amounts to more than 70%. However, the degree of tax autonomy varies between the two tiers of sub-central government: while regions often enjoy the high tax powers of Category A, local governments are allowed to levy supplements on selected regional or central taxes only (Category B). From 1995 to 2011, tax autonomy increased, particularly in Category A, at the expense of tax-sharing systems. During that period, the overall share of total tax revenue over which SCGs have full or partial policy discretion rose from 9% to more than 12% at regional level and from 7% to 8% at the lower-tier local level.

Intergovernmental transfers

Intergovernmental transfers – or grants – plug the gap between sub-central spending and sub-central own revenue, often referred to as the "vertical fiscal imbalance". OECD-wide, grants have grown in size – from 11% to 12% as a share of general government spending and from 6% to 7% as a share of GDP between 2000 and 2010. Apart from offsetting the expenditure-revenue imbalance, transfers serve to equalise interregional income and fiscal disparities and steer SCGs towards spending for certain purposes.

Figure 1.9. **Sub-central taxing powers vary, but are generally on the increase**



Note: The letters "a" to "f" refer to the tax autonomy categories described in Table 1.1. The figure for the state level in panel B contains federal countries only. Tax autonomy of local governments in the United States varies across the states and is not assessed.
Source: *OECD Fiscal Decentralisation Database* and *OECD Revenue Statistics*, *http://dx.doi.org/10.1787/data-00262-en*.

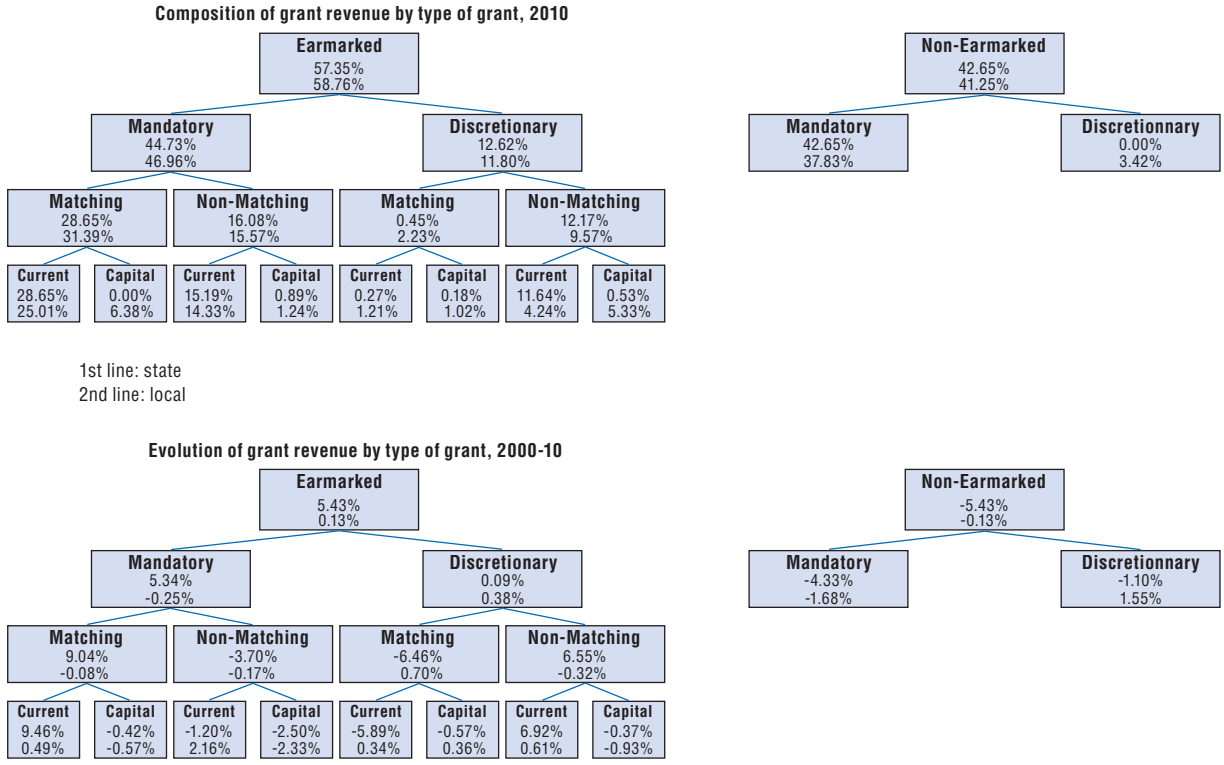
StatLink http://dx.doi.org/10.1787/888933341855

In order to reflect the variety of grant systems and the incentives they trigger, the OECD Fiscal Network established a taxonomy of intergovernmental grants in 2003. The main dividing line runs between earmarked and non-earmarked grants. As for the categories "matching" and "non-matching", they denote how grants are connected to sub-central spending (Figure 1.10). A third distinction assesses the conditionality of intergovernmental grants. Overall, in 2010 upper-level governments earmarked around half of all transfers, while the other half was disbursed with no conditions attached. Shares of each category vary widely across countries but have changed little over time, with a slight trend from earmarked towards non-earmarked grants.

The size and make-up of grant systems are useful indicators for gauging fiscal relations, such as effective sub-central autonomy, degrees of overlap in public service delivery, and spending pressure at central and sub-central levels. Yet the above classification

Figure 1.10. **The composition of intergovernmental grants**

Level 2000 and evolution 2000-10



Note: The first line in each cell shows averages of upper-tier SCGs (regions or states) for federal OECD countries and the second line local government averages for all OECD countries.
Source: OECD Fiscal Decentralisation Database, www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm.

might not fully reflect true SCG autonomy since the grant system design has evolved in recent years.

- *First*, grants and regulation are replacing rather than complementing each other. Several countries have reformed their grant system and abolished earmarked grants, while tightening their regulatory frameworks. Denmark, for example, abolished conditional school grants for paying teachers and refurbishing school buildings and introduced a general purpose grant. At the same time, it increased central regulatory control over the municipal education authorities (Blom-Hansen, 2013). The same shift from tightly earmarked towards more general grants was observed in the Netherlands, which compensated with a stronger central-over-local regulatory framework (Boerboom and Huigsloot, 2010).
- *Second*, the emerging category of performance-based grants is difficult to assess using the OECD Fiscal Network's taxonomy. The reason is that results-based grants are thought to match outcomes rather than spending, while still allowing for budget flexibility. Consequently, they fit none of the taxonomy's categories (Boadway and Shah, 2009).

Sub-central deficits and debt

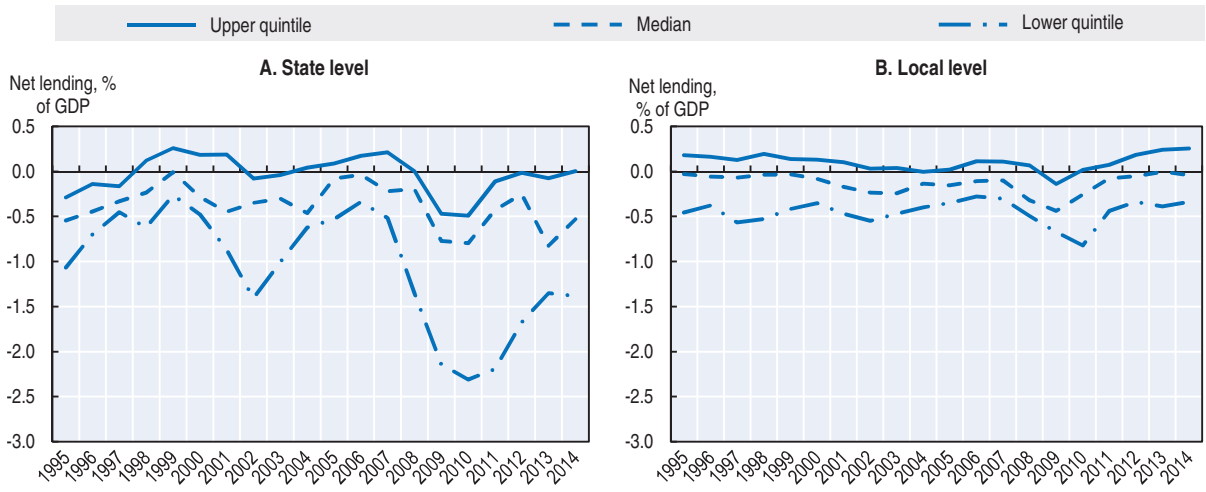
Deficits are largely back to normal

Sub-central public finances have been affected by three large troughs in the last 20 years. The first occurred around 1995, the second shortly after the turn of the

millennium, and the third in the wake of the economic and financial crisis in 2008. Developments at the SCG level largely followed general government patterns, although sub-central fiscal policy is much less volatile. Generally speaking, with the exception of a few sub-central governments in the OECD area that grapple with severe fiscal problems, deficit and debt sustainability is a central rather than a sub-central policy issue.

The last economic and financial crisis shook both central and sub-central budget positions. Yet sub-central government deficits in virtually all OECD countries have now largely recovered despite a small trough in 2013 (Figure 1.11). OECD-wide, general government deficits grew from around 1% of GDP in 2007 to 8% in 2009, before sliding back to 4% in 2014. SCG balance sheets were close to balance in 2007 before slumping to a deficit of around 2%, then recovering to less than 1% of GDP in 2014.The 2008 crisis hit most SCGs with deficits of a size that those at local level had not experienced since the beginning of the 1980s and higher-tier jurisdiction since the 1990s. SCGs that had larger deficits *before* the crisis also experienced greater deficit increases *during* the crisis. Those in federal countries were more exposed than in unitary ones, where they were shielded by intergovernmental transfers that compensated for lower own revenues (Foremny and von Hagen, 2012). The way in which deficits and debt evolve thus seems to be related to the institutional environment in which fiscal policy decisions are taken (see Chapter 2).

Figure 1.11. **Sub-central government deficits in 2014 were nearly back to earlier levels**



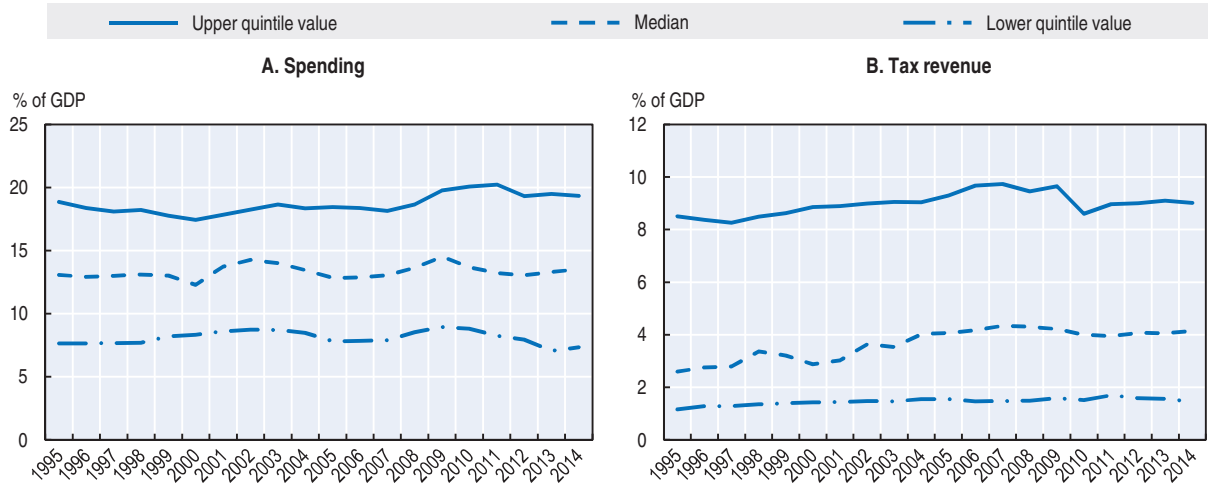
Source: OECD National Accounts Database, http://dx.doi.org/10.1787/na_glance-2015-en.

StatLink http://dx.doi.org/10.1787/888933341860

Sub-central spending is falling, while revenues remain stable

Spending and revenues evolved differently over the cycle, especially after the onset of the 2008 crisis. After being inconspicuously flat in the decade prior to the 2008 crisis, sub-central spending as a share of GDP rose considerably after 2007, reflecting both outright GDP declines in many countries and the effect of stimulus programmes (Figure 1.12). When consolidation started in 2010 it fell back again. Sub-central tax revenues slowly increased during the decade to 2008 and have remained almost stable since then, suggesting that SCG own-source taxes – often property taxes – are less responsive to the cycle than central governments' (see Chapter 3, "Reforming the tax on immovable property"). Intergovernmental transfers – a significant revenue source for SCGs in many countries –

Figure 1.12. **Spending has fallen since consolidation started in 2010, while tax revenues have remained stable**



Source: OECD National Accounts Database, http://dx.doi.org/10.1787/na_glance-2015-en.

StatLink http://dx.doi.org/10.1787/888933341871

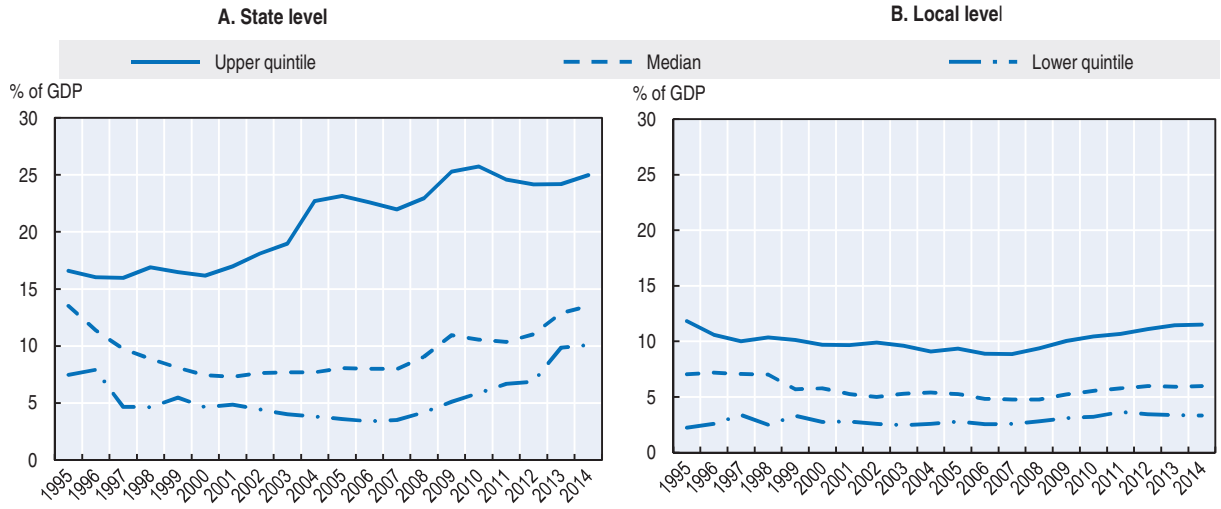
behaved unobtrusively (and are not, therefore, shown, in Figure 1.12). Overall, the return to lower deficits has so far been achieved mainly through SCG spending cuts, while own revenues and intergovernmental transfers have remained broadly the same. Again, the overall picture hides sharp differences between countries – as shown by the deciles – and even between SCGs in the same country.

Debt has still not entirely stabilised

After a relatively long period of stable or declining debt-to-GDP ratios, sub-central debt jumped to new record levels, following the surge in crisis-related deficits post-2008. It is now stabilising, but – as in earlier crisis periods – at higher levels than before the downturn, and has recently risen again (Figure 1.13). The liabilities of state and regional governments amounted to around 18% of GDP on average in 2014, with the highest-tier SCGs in some countries – particularly Canada, Germany and Spain – showing considerably higher debt ratios. As for local-level jurisdictions, their liabilities stood at around 8% of GDP in 2014, with the debt ratios of some – especially in Japan – as high as 35% of GDP. Debt and the need to manage it well is likely to be the "new normal" for many sub-central governments in coming years.

Debt creates externalities across all tiers of government, since sustainability is determined by their joint action. Moreover, national averages may conceal the unsustainable positions of individual jurisdictions, and the financial difficulties of a few may quickly raise concerns about the fiscal health of all. SCGs' difficulties can also create financial problems for central governments, particularly where markets factor an expected bail-out to the cost of sovereign debt (Vammalle and Hulbert, 2013). SCGs experience growing difficulty in securing access to credit as a consequence of increased borrowing costs, a contraction in the volume of credit provided by financial intermediaries in high-debt countries), and a reduction in foreign investment inflows (OECD, 2015). Keeping sub-central debt at prudent levels and managing it efficiently has become a core fiscal policy objective for all government levels (see Chapter 5 which addresses the monitoring of sub-central debt).

Figure 1.13. **After a rapid rise during the crisis, sub-central debt is stabilising**



Note: Local-level jurisdictions do not include those in Australia, Chile, Mexico, New Zealand and the United States.
Source: *OECD National Accounts Database, http://dx.doi.org/10.1787/na_glance-2015-en.*

StatLink http://dx.doi.org/10.1787/888933341886

Beyond fiscal decentralisation

While this chapter approaches decentralisation from a fiscal and financial point of view, intergovernmental frameworks may also be seen from other angles. Decentralisation is a concept where the multiple facets of sub-central autonomy share a common denominator: the notion of dividing and sharing power, resources and authority between different tiers of government. Essentially what is transferred is either fiscal – e.g. the power to tax and spend – or non-fiscal, such as constitutional set-up or regulatory powers. Power may also be extended to autonomous agencies or directly to the public and private providers of public services, such as schools, hospitals and transport companies. The use of other indicators in addition to financial flows can thus usefully complement assessments of true decentralisation and power sharing.

There are a number of indicators to measure sub-national institutional and regulatory architecture. In 2014 the OECD Fiscal Network developed an indicator of constitutional decentralisation to measure how fiscal constitutions are related to economic and fiscal outcomes (see Chapter 2, "Fiscal Constitutions"). Drawing on the Programme of International Student Assessment (PISA), the OECD Directorate for Education and Skills assesses decentralisation in primary and secondary education by measuring the extent to which educational functions are assigned to lower government levels and schools (OECD, 2014). Linked to education performance, the education decentralisation indicator delivers more pertinent results than the traditional fiscal decentralisation indicators (Fredriksen, 2013). Finally, the Regional Authority Index measures the authority of regional governments in a large number of countries through ten dimensions (Hooghe, Marks and Schakel, 2010). In an empirical analysis linking decentralisation to levels of debt and how they have evolved in the regions of six OECD countries, Ahrend, Curto-Grau and Vammalle (2013) found that the Regional Authority Index yielded fuller understanding of regional debt levels than traditional decentralisation variables. To sum up, then, institutional indicators are a useful complement to policy analysis, often supplying information not contained in fiscal data.

This chapter has sought to show that fiscal decentralisation and sub-central fiscal autonomy is a multidimensional concept that cannot be easily summarized in a single indicator. Indicators include the sub-central revenue or spending share, the size and composition of intergovernmental grants, the composition of sub-central spending and revenues, levels of sub-central deficits and debt. Institutional indicators – like tax autonomy, spending power and intergovernmental grant conditionality – are also useful. Taken together, all these different indicators paint a full picture of the fiscal and institutional architecture of a country, the functioning of the different government levels and how they work together, and the policy issues that may be at stake.

Notes

1. The OECD Fiscal Network is short for the OECD Network on Fiscal Relations across Levels of Government, created in 2004. For more on the OECD Fiscal Network, go to *www.oecd.org/ctp/federalism/Presentation-Fiscal_Federalism_Network.pdf*.
2. There is no consensus regarding the accurate measurement of vertical fiscal imbalance. In general it is equated with transfer dependency, i.e. transfers received by sub-national governments as a share of their total revenue or expenditure. However, this measure neglects sub-national borrowing as a formof financial expenditure. Many sub-central governments – subject to fiscal rules restraining them – indeed borrow or sell assets to cover current or capital spending. Sub-national government borrowing can be important in accounting for the dynamics of vertical fiscal imbalances (Aldasoro and Seiferling, 2014).

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Chapter 2

Fiscal constitutions

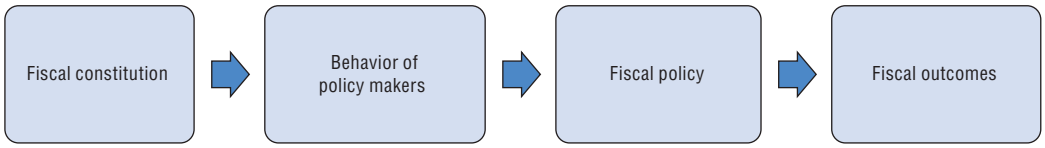
Fiscal constitutions comprise the sets of rules and frameworks that guide a country's fiscal policy and are enshrined in its fundamental laws. This chapter compares the fiscal constitutions of 15 federal countries by empirically assessing frameworks of intergovernmental relations. It looks at such aspects as the responsibility of sub-national governments for their own policies, their power to shape fiscal policy at the federal level, the strength of intergovernmental budget frameworks, and the stability of fiscal policy arrangements. The chapter also gives a detailed account of how fiscal constitutions evolved between 1917 and 2012, describes historical turning points, and identifies potential drivers of constitutional reform. It then assesses the link between constitutional frameworks and fiscal outcomes, suggesting that the coherence of constitutional arrangements – i.e. the way in which fiscal constitution elements and building blocks fit together – is a crucial factor in the long-term sustainability of public finances. Finally, the chapter suggests a number of policy reform options for making fiscal constitutions more coherent.

Fiscal constitutions: Frameworks for fiscal policy

A fiscal constitution is the body of fundamental rules and regulations that frame decision making in the area of fiscal policy. Fiscal constitutions cover constitutional law as well as selected post-constitutional legislation like basic fiscal and financial laws or constitutional court rulings. A fiscal constitution thus encompasses all legislation that may be amended by stringent voting rules – usually qualified majority – to offer a stable institutional framework for fiscal policy over time. It sets the rules of the public finance game, so providing a framework for policy makers and driving or deterring certain policy patterns (Brennan and Buchanan, 1980). By shaping incentives and limiting arbitrariness, the fiscal constitution determines the course of fiscal policy and outcomes in the long term (Qian and Weingast, 1997). A simplified – albeit somewhat mechanical – causal chain from fiscal constitutions to fiscal outcomes is shown in Figure 2.1.

Figure 2.1. **Fiscal constitutions shape fiscal policy**

The link from institutions to outcomes



Note: The figure neglects endogeneity, i.e. when constitutions and outcomes affect each other mutually, or when both fiscal outcomes and fiscal constitutions are simultaneously shaped by third factors.
Source: Based on Persson and Tabellini (2003) and Raudla (2010).

This chapter focuses on the fiscal constitutions of *federal and quasi-federal countries* and on how they govern *intergovernmental fiscal relations*. In federal countries, the fiscal constitution is predominantly concerned with the rules that determine power sharing between the federal government and sub-national jurisdictions at state/regional levels. Federal fiscal constitutions must define the fiscal authority of all tiers of government and how they interact in the conduct of fiscal policy. Moreover, federations often inspire constitutional reform in other places – either in countries that are on a secular path towards decentralisation, or in supra-national entities seeking to strengthen their basic framework. In these entities, almost any potential fiscal policy question has a "who should do what" or "federal" dimension, and fiscal arrangements in federal countries may show the way forward. Altogether, the chapter analyses 15 federations or quasi-federations – Argentina, Australia, Austria, Belgium, Brazil, Canada, Germany, India, Italy, Mexico, Russia, South Africa, Spain, Switzerland and the United States. The fiscal constitution of the European Union, although not a federation, is also assessed.

Assessing the fiscal constitutions of 15 federations

The building blocks of fiscal constitutions

Every fiscal constitution consists of a number of building blocks which together reflect the institutional background of fiscal policy making across all tiers of government. Five building blocks may be distinguished which, in turn, comprise a series of constituent elements (Table 2.1). A constituent element represents a constitutional rule on a specific item of fiscal policy. For instance, "tax autonomy" of the states is a constituent element, while "autonomy" is the building block encompassing tax, spending, borrowing and

Table 2.1. **The building blocks of fiscal constitutions**

Building block or arrangement	Description	Constituent elements
Autonomy	Extent to which states can conduct their own fiscal policy.	Tax autonomy; spending autonomy in certain policy areas; autonomy to borrow; autonomy to set budget frameworks.
Responsibility	Extent to which states are exposed to budget constraints and must assume responsibility for their own fiscal policy.	Bankruptcy exposure; bailout expectations; responsibility for setting fiscal rules; state revenue mix; dependence on revenue from federal transfers.
Co-determination	Extent to which states can shape fiscal policy at the federal level.	Bicameralism; constitutional courts; intergovernmental executive bodies and meetings; federal transfers.
Budget frameworks	Constraints on discretionary fiscal policymaking at all government levels.	Numerical fiscal rules; procedural fiscal rules; fiscal councils and other independent or arms-length bodies.
Stability	Ease with which constitutional rules affecting fiscal policy can be amended.	Strength of second chamber; power of constitutional courts; the voting rules needed to amend the constitution; scope of direct democracy/ popular veto.

budgeting autonomy of the states.[1] And while numerical fiscal rules are a single constituent element of the budget framework, the framework also includes procedural rules and the functioning of fiscal councils. Some constitutions also incorporate rules for local governments, which are taken into account, if relevant.

Fiscal constitutions, their building blocks and constituent elements are assessed by means of *institutional indicators* which, together, form an indicator tree (Figure 2.2). Each element – e.g. the extent of state tax autonomy – is measured by a low-level indicator (LLI). The LLIs are then aggregated into intermediate-level indicators (ILIs) which measure the building blocks. For example, one ILI denotes the building block that brings together the extent of states' tax, spending, borrowing and debt autonomy. The ILIs are, in turn, aggregated to form a summary, or composite, indicator which gauges overall intergovernmental fiscal relations in the fiscal constitution. Indicator values, which range from 0 to 1, measure whether the fiscal constitution features "more" or "less" of a certain element or building block and range from 0 to 1. The coding procedure and values are shown in detail in Blöchliger and Kantorowicz (2015).

The coherence of fiscal constitutions

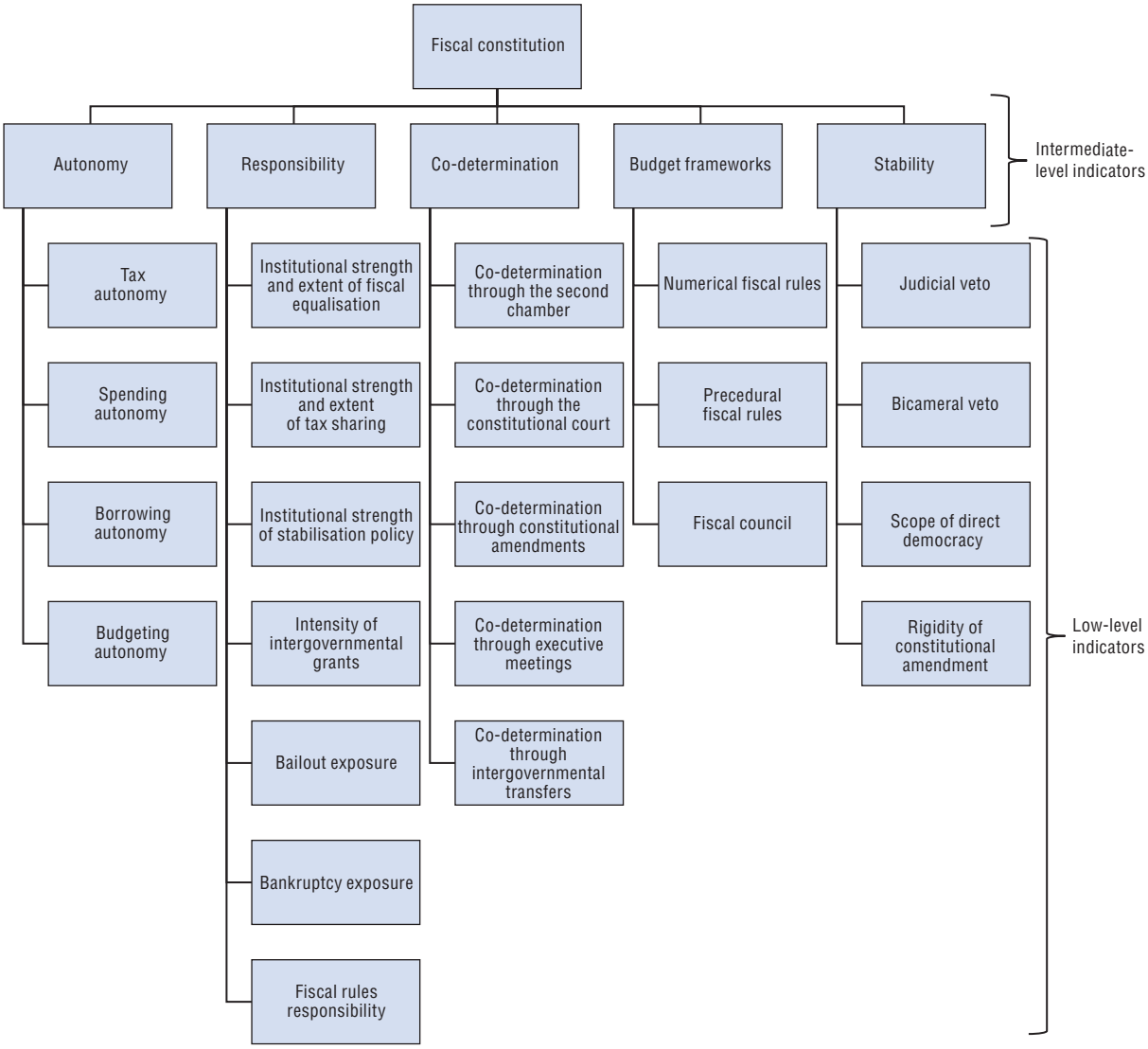
The *coherence* of a fiscal constitution is of particular importance. A coherent fiscal constitution combines institutional arrangements in a balanced manner giving states similar degrees of autonomy in various budget items (taxation, spending, borrowing etc.), for example. Similarly, it aligns a certain level of autonomy with a matching level of responsibility, or it strikes a balance between numerical and procedural fiscal rules. Conversely, a less coherent fiscal constitution combines elements and building blocks in an unbalanced way, associating extensive fiscal autonomy with little fiscal responsibility, for example, or strict numerical rules with lenient procedural rules. Coherence is measured as the variance in aggregated indicator values yielded by the random weight technique.

Fiscal constitutions from country to country

This section uses the indicator methodology described above to assess and compare the fiscal constitutions of the 15 federal countries. It considers numerous country examples to complement the empirical exercise and paint a lively, detailed picture of the world of fiscal constitutions.

Figure 2.2. **Fiscal constitutions: Indicator tree**

Low-level indicators for the assessment of building blocks (intermediate-level indicators)



Autonomy of the states

Fiscal constitutions give states very different degrees of autonomy. In some federations, SCGs are a *de facto* branch of the federal level, while in others they enjoy wide fiscal autonomy and little interference from federal government. Coherence also varies. While some countries enjoy similar degrees of autonomy in all areas of fiscal policy, others combine considerable spending and borrowing autonomy with little tax autonomy.

Tax autonomy

Tax autonomy varies wildly across federal countries, although constitutionally guaranteed autonomy in levying taxes is seen as an integral part of federalism (Riker, 1975). Some countries grant federal government the power to levy and collect only a few taxes, sometimes combining that power with a residual clause that leaves all other powers of

taxation to the states/regions. In other federations, taxation is largely a federal prerogative, often with a general clause allowing central government to change the tax system by ordinary legislation. Some constitutions are very precise about how and which taxing powers are assigned to different levels of government. Others, by contrast, are vague or simply silent.[2] In a few countries, post-constitutional legislation and constitutional courts play a crucial role in shaping tax autonomy.

A few country examples illustrate the wide institutional differences in tax autonomy. Austria's and Italy's constitutional law assigns most taxing powers to the federal government. There is slightly greater tax autonomy in Russia, where *oblasts* may reduce the rate of corporate income tax for certain taxpayers. By contrast, the federal government in Switzerland is allowed to levy only those taxes listed in the constitution, and any change in personal income tax rates requires a constitutional amendment. In some countries, constitutional voids are filled by legal interpretation. The Canadian constitution grants power to provinces with respect to natural resource and direct taxes. A creative interpretation of "direct taxes" allows the inclusion of sales taxes, so both federal and provincial tiers of government may concurrently levy all major taxes. As for Australia, judicial review has strongly shaped taxing powers. The constitutional court ruled that all consumption taxes should be considered "trade taxes and excises" – the only levies constitutionally assigned to federal government. The General Sales Tax (Australia's VAT) is thus a federal tax. Finally, constitutional tax autonomy in Mexico is undermined by a constitutional provision that makes it very costly for states to actually make use of their tax autonomy.[3]

Spending autonomy and links between tax and spending autonomy

Spending autonomy captures the extent to which states have sovereign powers of legislation and expenditure in certain policy areas.[4] Constitutional spending autonomy varies less than tax autonomy, since there is a core of public functions which, in most federations, is assigned in a similar way. Fiscal constitutions assign legislative and spending authority either exclusively – i.e. to only one tier of government – or jointly, i.e. to both federal government and states. The Austrian and Italian fiscal constitutions grant most spending prerogatives to the federal level, while the provinces and states enjoy extensive autonomy in Canada and the United States, respectively. In the United States, the constitution does not prevent states from spending in any area as long as they do not violate the Commerce Clause.[5]

Other constitutional provisions further affect the extent and coherence of tax and spending powers:

- Rather than dictate every single policy area, some constitutions offer a template for tax and spending assignments. Examples include the principle of subsidiarity, or residual power, enshrined in the constitutions of the United States, Switzerland and Germany.[6] Austria also recognises the residual law-making powers of the provinces in its constitution. Conversely, Canada, India, South Africa and Spain assign residual power to the federal government.
- Some constitutions link tax and spending autonomy – the so-called "Wicksellian Connection" –, stipulating that a given tier of government should pay for its public expenditure out of its own tax revenues. Italy includes the principle in its constitutional law, although deviating from it in practice. The German constitution applies a weaker form of Wicksellian Connection insofar as it states that funds should be commensurate with tasks.

- Although some constitutions have hardly kept pace with the great evolutionary changes in the way that governments spend money, they contain provisions that have been flexible enough to adapt to new public expenditure requirements. Many explicitly enumerated federal powers listed in the United States' constitution are quite specific to the late 18th century. Yet the power to "build post roads" enabled the federal government to create the highway network of the 20th century.

Borrowing and budgeting autonomy

Borrowing autonomy refers to a state's ability to borrow on financial markets and/or from public institutions. Federal governments use various instruments to limit SCG borrowing. In the most extreme cases, they are not allowed to borrow. The German constitution, for instance, forbids new state borrowing outright if the state's budgets are not structurally balanced. There are also less exhaustive borrowing restrictions. The Mexican constitution prohibits the states from borrowing from abroad, while Brazil requires federal approval of state-level borrowing. Several countries use differentiated deficit and debt rules when restricting the power of sub-national states/regions to add further debt, while some – like Brazil – might even restrict or entirely ban borrowing from state-owned banks. In Switzerland and the United States, there are no federal restrictions on state borrowing.

Budgeting autonomy evaluates the extent to which sub-national jurisdictions are able to set their budgets according to their own rules. Federal involvement in the state's budgeting process varies considerably. Some countries, such as Argentina and Germany, explicitly forbid any federal interference in SCG budgeting. By contrast, some constitutions, like those of South Africa and Spain, allow the federal level to intervene in the substance of the sub-national budgets. Similarly, a number of countries have fiscal rules that reduce sub-national budgeting autonomy. Failure to comply may bring about further federal intervention in SCGs' budget processes, as in the Brazilian and Italian constitutions.

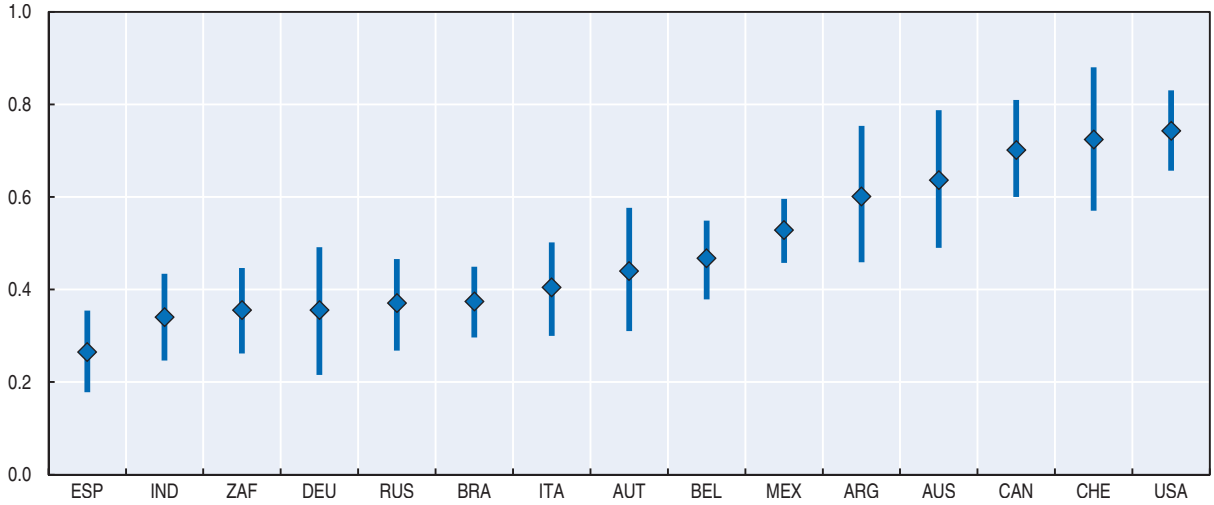
Fiscal autonomy indicator values across countries

Fiscal autonomy – sub-national tax, spending, borrowing and budgeting autonomy – varies widely from one country to another. It is greatest in the United States, Canada and Switzerland (Figure 2.3), moderate in Australia, Argentina and Mexico, and low everywhere else. Fiscal autonomy *coherence*, as denoted by the vertical bars in the figure, also varies. Fiscal autonomy is relatively well balanced in Mexico, where the states enjoy moderate autonomy in all fiscal policy areas, but less so in Argentina, Australia, Austria and Germany. The Argentinian fiscal constitution, in particular, combines low tax autonomy with substantial budgeting and borrowing powers.

Some federal governments restrict sub-national tax, spending and borrowing powers to a considerable degree. Others leave plenty of scope for spending and borrowing, while simultaneously allowing wide-ranging tax autonomy. Both types of institutional settings are coherent. Imbalance between the different forms of autonomy, though, may result in incoherent institutional frameworks and even in undesirable fiscal policy outcomes. In Argentina and Germany, for example, restricted sub-national tax autonomy, allied with extensive borrowing autonomy, has led the states to behave opportunistically and fall short of their budget targets (Tommasi, Saiegh and Sanguinetti, 2011).

Figure 2.3. **Fiscal autonomy of the state level**

Intermediate-level indicator representing building block 1



Note: The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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Fiscal responsibility of the states

Fiscal responsibility refers to the extent to which sub-national tiers of government have to bear the consequences of their fiscal actions. While autonomy measures the extent of their freedom to conduct their policies, responsibility measures whether they internalise their costs. Responsibility is a central building block in fiscal constitutions since it determines the extent to which states and regions can derail the fiscal position of general government and make fiscal outcomes unsustainable. Responsibility is thus comparable to the concept of budget constraint. An SCG's responsibility is determined by measuring the likelihood of bankruptcy or bailout, the status (imposed or self-imposed) of fiscal rules, and the strength and size of such transfer mechanisms as grants and equalisation payments. If such constraints are of similar strength, then responsibility arrangements are coherent.

Bailout and bankruptcy exposure

Not being bailed out in the event of bankruptcy is arguably one of the strongest sticks federal governments can wield to enforce sub-national fiscal responsibility. No-bailout clauses and exposure to default are thus core measures for ensuring the strength and credibility of budget constraints. The likelihood of default, the prevalence of insolvency frameworks and the probability of bailout are likely to affect SCG's long-term behaviour. The extent to which they assume their responsibilities hinges on constitutional provisions as well as on actual experience:

- *Constitutional provisions*. Fiscal constitutions contain rules for dealing with SCGs in fiscal distress. Some countries, like South Africa, forbid state/regional default outright, while others such as Brazil and Switzerland have provisions for an orderly default and an insolvency framework. Bail-out provisions are particularly critical and differ considerably from country to country. The Brazilian and Spanish constitutions forbid them, while those of Argentina and Germany enable them, and the Italian constitution requires them. And, although, some fiscal constitutions do not contain explicit bail-out

provisions, they offer alternatives such as federal borrowing guarantees which are akin to an implicit bailout.

- *Historical experience*. The credibility of no-bailout rules is shaped by a country's experience of past defaults and how the federal government reacted. The experience of defaults may long affect sub-national behaviour. The defaults of several states in the United States in the 1840s and the federal refusal to bail them out may have restrained states' fiscal policy and shaped collective behaviour to this day. On the other hand, the bailout of two German *Länder* in the 1990s fuelled further bailout expectations and may have contributed to the fiscal profligacy of some *Länder* in later years.

Constitutional courts shape bailout expectations extensively. In Germany, a federal court ruled in favour of the Länder of Saarland and Bremen in 1992, pointing to the solidarity principle enshrined in the constitution which it saw as an implicit bailout guarantee (Feld and Baskaran, 2010). In a similar case in 2006, the court adopted an opposite tack and denied the *Land* of Berlin a bailout on the grounds that it was able to cope itself. A Swiss federal court in 2003 confirmed the non-bailout rule after the bankruptcy of a municipality, thereby cutting the financing costs of the *cantons* (state level).[7]

Responsibility for fiscal rules

Fiscal rules can act as a signal to creditors that an SCG is following a prudent fiscal policy (Fall et al., 2015). While fiscal rules are a complement rather than a substitute for well-functioning fiscal frameworks, they help demonstrate that state finances are on a long-term sustainable track. Financial markets tend to reward prudent fiscal behaviour with lower yields (Schuknecht, von Hagen and Wolswijk, 2009). In that respect, a self-imposed rule is supposed to be a stronger sign of responsibility than a fiscal rule imposed by the federal government. An imposed rule assumes that the federal government is ultimately responsible for sub-national finances and that states can shift the fiscal burden onto other governments. Moreover, self-imposed rules create ownership, which is likely to increase the probability that states follow them.

The extent to which states self-impose fiscal rules varies across countries. While in Canada, Switzerland and the United States federal governments have no power over state fiscal policy, they do in Brazil, Germany and Russia. In countries like Argentina, Austria and Spain, the different tiers of government negotiate rules, which affords SCGs more leeway, though not full responsibility. In the United States, self-imposed rules are a strong anchor for state fiscal policy. Following a series of defaults during the 1840s and 1870s, virtually all the states enshrined relatively tight fiscal rules in their constitutions, which has provided them with a rules-based framework for sustainable fiscal policy to this day.[8]

Revenue responsibility

Revenue responsibility is the extent to which states draw on their own revenue sources. It is inversely related to external financing from the federal government – the greater the transfers, the lower the responsibility. High reliance on transfers and other common pool resources may ease the budget constraints on sub-central governments, create moral hazard, and distort tax enforcement (Rodden, Eskeland and Litvack, 2003). Fiscal constitutions usually comprise four types of federal support to the states:

- *Fiscal equalisation*. The purpose of equalisation is to narrow differences in fiscal capacity between states. It may be enshrined in the constitution – in Canada and Switzerland, for

example – or in secondary legislation only, as in Australia and Mexico. While countries like Australia and Germany require almost full equalisation of regional disparities, others (e.g. Mexico and Spain) require them to be equalised to a certain degree only. Some constitutions, like that of South Africa, require an independent council for equalisation policy.[9]

- *Tax sharing*. In a number of federal countries, certain taxes are shared between tiers of government. Some constitutions, such as those of Argentina and Germany, have tax-sharing rules that apply to the major taxes, while ordinary law has provisions for tax sharing in Australia. Although there was a tax-sharing system in place in the United States in the 1970s and 1980s, but was easy to abandon because it was not enshrined in the constitution. The South African and Spanish constitutions require an independent body to set and adjust tax shares.
- *Stabilisation*. Transfers for stabilisation purposes constitute another way of co-financing sub-national jurisdictions. Like tax-sharing arrangements, federal stabilisation policy may be enshrined in constitutional law, as in Germany and Italy. Alternatively, ordinary law may carry provisions to that effect, as in Australia and Canada. However, constitutional provisions attach a different thrust to stabilisation. While some, like those of Italy and Russia, stipulate that stabilisation "must" be pursued, others advise that it "should" be pursued (e.g. Germany and Spain).
- *Other intergovernmental transfers*. Federal governments often support state activities through different forms of intergovernmental grants. The German and Swiss constitutions prescribe grants, while ordinary legislation shapes them in countries like Mexico and the United States. Some constitutions, e.g. those of the United States (again) and Belgium, have extensive provisions for grant systems, while Australia and Canada hardly mention grants or intergovernmental collaboration.

Generally, transfer systems are complements to each other rather than alternatives. In other words, more equalisation tends to go together with more stabilisation and more tax sharing.

Fiscal responsibility indicators across countries

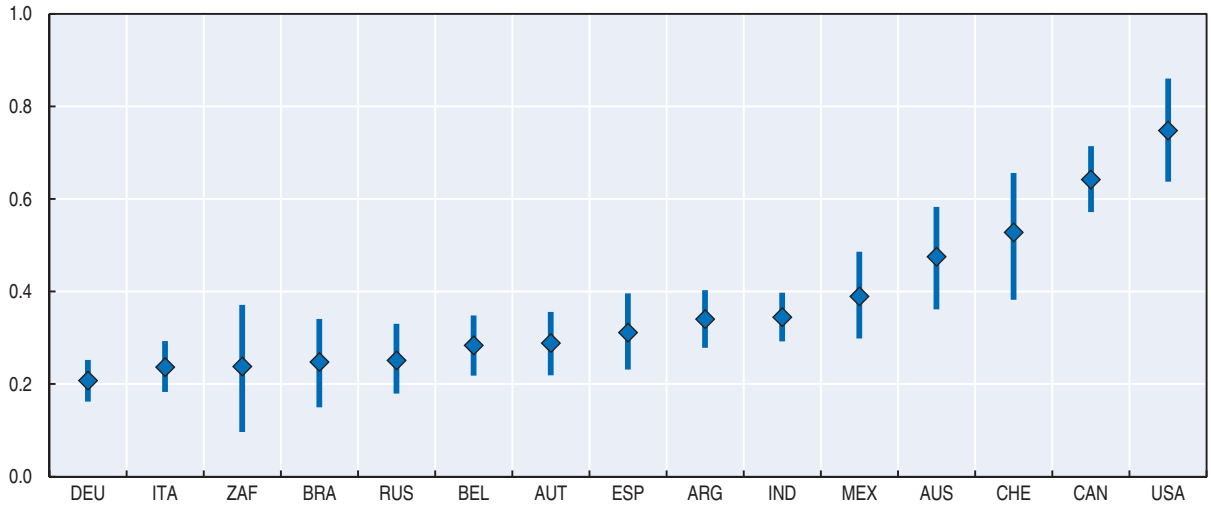
Sub-national fiscal responsibility, as measured by institutional indicators, again varies widely from country to country. While levels of fiscal responsibility are high in Australia, Canada, Switzerland and the United States, they are low in Germany, Italy, South Africa and Belgium (Figure 2.4). Germany, India and Italy have relatively *coherent* responsibility arrangements, while in South Africa, Australia, Switzerland and the United States they are less coherent. Coherence in Switzerland is low because, while there is little likelihood of a bailout, the system of federal support to sub-national state governments in distress is extensive.

States' power to co-determine federal policy

Co-determination is the extent to which SCGs can shape fiscal policy making at the federal level. While state autonomy refers to an SCG's power to legislate for its own jurisdiction, co-determination refers to the degree of influence that an SCG, or group of SCGs, can exert on the fiscal policy of the whole country (Hooghe, Marks and Schakel, 2008). States can influence overall fiscal policy through different channels, the most important of which is often the second chamber of the federal parliament, or Senate. The

Figure 2.4. **Fiscal responsibility of the state level**

Intermediate level indicator relating to building block 2



Note: The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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coherence of co-determination reflects the extent to which certain channels of influence are complements rather than alternatives to each other. In a balanced co-determination framework, sub-national governments use all channels. In a less balanced setting, they use some channels heavily, while others are barely available.

Bicameralism

The two-chamber, or bicameral, system is a core attribute of federalism. The second chamber acts as a forum where the interests of state governments are explicitly represented and where they can co-determine national policies. The extent to which they can co-exert influence at the federal level, however, depends on the institutional strength of the second chamber and how amply represented their interests are.

- *Institutional strength*. The Senate formally represents the states. It has full legislative and veto power in most federal countries, although some limit its power. In Canada and India, for instance, the second chamber can be excluded from initiating legislation. In Germany, the Senate can veto only legislation concerning the *Länder*. In Austria, the first chamber can overrule almost any Senate decision.
- *Representing states' interests*. States' interests are represented to a different extent in the second chamber. Senators elected or appointed with a mandate by a state legislature or executive – as in Germany – generally represent its interests faithfully. They are less likely to do so, however, if they are elected at the ballot box. In Canada, senators are appointed by the governor general on the advice of the prime minister, which thwarts effective state representation. If the distribution of seats is proportional to population size – as in Belgium and South Africa – the federal government is more likely to align policies with the preferences of the largest jurisdictions.

While strong sub-national participation in federal policy making may balance the interests of more stakeholders, it may also lead to a joint decision trap where no policy decisions are taken at all (Scharpf, 2006). Reducing the degree of joint decision-making was

the main aim of the 2006 federalism reform in Germany, where overlapping competencies, intertwined responsibilities and political bargaining led to frequent policy deadlocks. The German reform strengthened both the federal government's decision-making capacity and the autonomy of the *Länder* (Moore, Jacoby and Gunlicks, 2010).

Judicial review

The second channel through which sub-national jurisdictions can co-determine federal policy is judicial review by the supreme or constitutional court. Apart from Switzerland, all the countries considered here have some form of constitutional review of federal laws, which can even void unconstitutional laws. Sub-national governments can influence constitutional review in two ways.

1. *By challenging federal laws*. States can trigger judicial reviews of federal legislation either directly, as in Italy and Spain, or through the second chamber, as in Germany and South Africa. The law under scrutiny may be repealed or modified as a consequence. The sole right of states and the second chamber to challenge federal legislation in court can be perceived as a deterrent against legislation that is unfavourable to states (Stone Sweet, 2000).
2. *Through judicial appointment*. In countries like Argentina and Germany, the sub-federal level or second chambers are often involved in appointing and approving judges to courts. There is broad evidence of close alignment between appointers and judges.[10] Thus, when SCGs or second chambers play an important role in nominating or approving judges, they are likely to rule in their favour more often.

In Argentina, Australia, Germany, Mexico and the United States, judicial reviews play an important part in resolving conflicts between federal and sub-federal tiers of government. The United States Supreme Court is a particularly important crossroads of federal and state interests. A number of court rulings have reigned in the power of the federal government by insisting on a narrow interpretation of key clauses in the constitution.[11]

Other channels of co-determination

There are three other channels through which states co-determine policymaking at the federal level.

1. *Constitutional amendment*. All federal constitutions require that either sub-national jurisdictions – the provinces in Canada and the states in the United States – or the second chamber – as in Belgium and India – approve constitutional amendments. In some countries, e.g. Mexico and in Russia, both the second chamber *and* the states have to approve changes. In others, like Brazil and Mexico, the sub-national governments or, as in Italy and Switzerland, the second chamber may propose constitutional reform. That right is denied them, however, in countries such as Canada and Argentina.
2. *Intergovernmental executive meetings*. Intergovernmental meetings serve as a forum for negotiations between tiers of government and the co-ordination of national and state policies. Executive meetings are often institutionalised and take place as a matter of routine. Examples include the Consultation Committee in Belgium and the State Council in Russia. Some intergovernmental bodies wield considerable authority and their decisions formally bind the participants – e.g. the Council of Australian Governments (COAG) and Argentina's *Consejo Federal de Inversiones* (Federal Investment Council) and *Consejo Federal de Educación* (Federal Education Council).

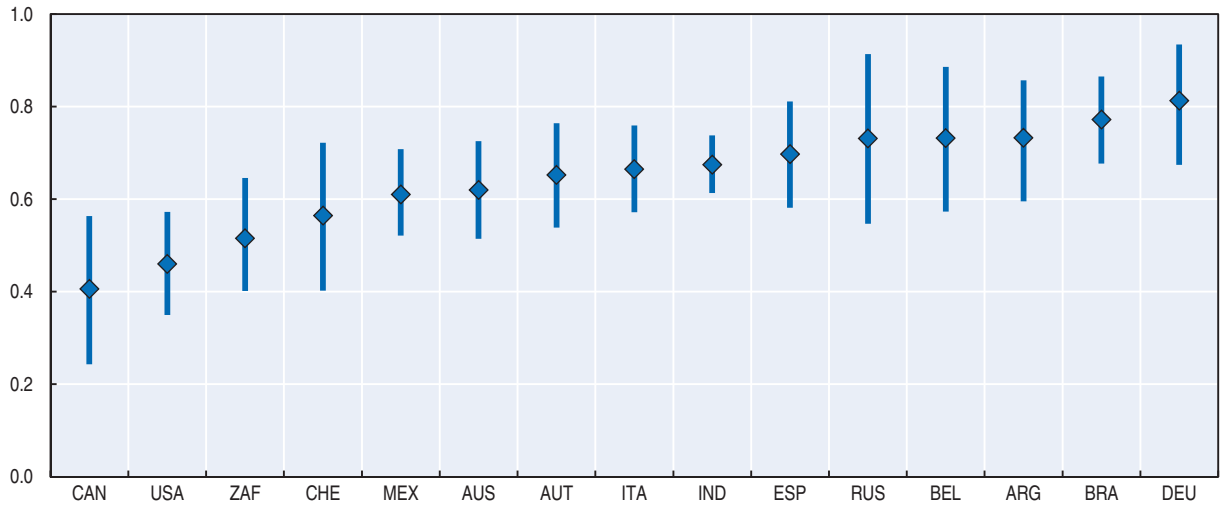
3. *Intergovernmental transfers*. Transfers are often determined through intergovernmental bargaining in which recipient governments have a say. Transfers are frequently the result of lobbying by sub-national politicians and interest groups. Indeed, SCGs can work to secure transfer through various channels, depending on how such channels are constitutionally anchored (OECD, 2014).

Co-determination indicators across countries

Most countries' constitutions have provisions for extensive co-determination, as in Argentina, Germany and Brazil, though not in Canada, the United States or South Africa (Figure 2.5). The most coherent institutional setting prevails in India, where the states influence national policy moderately through all channels. Co-determination in Belgium, Canada, Russia and Switzerland is less coherent, with Belgium, for example, boasting a strong executive branch but a relatively weak second chamber. The combination of a weak federal court – one which is not allowed to review federal laws – with a strong second chamber makes co-determination less coherent in Switzerland.

Figure 2.5. **Sub-national co-determination of federal policy**

Intermediate level indicator denotes building block 3



Note: The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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Strength of budget frameworks

Budget frameworks govern the budget process and seek to restrain discretionary fiscal policy. Frameworks are defined by three elements: numerical fiscal rules, procedural fiscal rules and fiscal councils. Tight fiscal frameworks impose a set of well-defined numerical fiscal rules, involve top-down, transparent procedural and budgeting rules, and include fiscal councils or other arms-length agencies. Coherent budget frameworks are those where the three elements have similar weight. Less coherent frameworks are those where instruments are not uniform – where tight numerical fiscal rules co-exist with weak procedural rules, for example.

Numerical fiscal rules

Numerical fiscal rules constrain policy makers' fiscal policy discretionary powers. The main rationale for fiscal rules is a perceived spending and deficit bias and the reluctance of states to commit to fiscal discipline. As such, numerical fiscal rules have gained popularity since the 1990s when they were put in place to curb irresponsible fiscal behaviour at all levels of government. There are four main types of numerical fiscal rules: those that focus on the budget balance (deficit), on debt, on expenditure and revenues, and those that focus on a combination of them all. Policy makers are most constrained when a country uses all four types.

There are four criteria for assessing the strength of numerical rules:

- *Legal basis*. While some rules are enshrined in federal constitutions – e.g. debt brakes in Germany and Switzerland – others, like rules in Argentina and Australia, are set forth in secondary legislation. Constitutional fiscal rules are more difficult to amend and may entail high reputation costs for the government if breached. The use of a constitutional fiscal rule signals that fiscal discipline is perceived as a fundamental policy objective (Drazen, 2002).
- *Status*. Sub-national rules are either federally imposed or self-imposed. Imposed rules are more likely to reflect a consistent, harmonised budget framework, whereas self-imposed rules may differ from one sub-federal jurisdiction to another. In Germany, for example, the federal government imposes a budget balance rule on the *Länder*. In Spain, too, central government imposes rules like the budget balance and debt and expenditure rules on the regions. In some countries, the different tiers of government negotiate rules. In Austria, for example, the various fiscal rules for the *Länder* are negotiated, while the regions and communities in Belgium discuss budget balance rules. In Switzerland and the United States, state fiscal rules are self-imposed and mostly enshrined in state constitutions.
- *Enforcement and sanctions*. The constitutional setting may underpin the enforcement of fiscal rules. Rules are self-enforced in Australia, Canada, Switzerland and the United States. They tend to be stronger when enforced by a higher tier of government or by external bodies. Sub-national fiscal rules are enforced by the federal government in Spain and Russia, for instance. Courts and audit institutions have a prominent role in Brazil and the United States.[12] In some countries, though, enforcement is not explicitly specified. The German constitution, for instance, does not mention sanctions and their enforcement.
- *Coverage*. Wide coverage limits policy makers' ability to bypass the rules and re-allocate fiscal resources between governments (Milesi-Ferretti, 2003). Some numerical fiscal rules cover the general government budget, as in Spain, whereas others apply only to federal or sub-federal finances. For example, the deficit rule in Mexico applies only to central government and a number of rules in South Africa govern only the provinces. In some countries, like Switzerland, separate federal and state fiscal rules complement each other.

Procedural fiscal rules

Procedural fiscal rules ensure that budget planning, approval and execution is subject to proper control and accountability, and that the annual budget law is consistent with medium- and long-term fiscal plans and objectives. Two elements help assess the bite of procedural fiscal rules: 1) the extent of top-down budgeting and 2) the transparency of the budgeting process.

- *Top-down approach*. Top-down procedural rules aim to empower a single actor in the budgeting process as a way of addressing the problem of common-pool resources in public decision making (Ljungman, 2009). The top-down approach gives strong prerogatives to the federal executive over the legislature in the approval stage of the budget and/or to the federal prime or finance minister over other spending ministers, as in Argentina or Brazil (Alesina et al., 1999). In some countries, such as Belgium or Germany, constitutional law restricts the federal legislature's power to amend a budget proposed by the federal government.
- *Transparency*. Constitutions strive for budget transparency in three ways: 1) Some, like the German and Spanish constitutions, require federal and sub-national budgets to be assessed by an independent audit institution. Brazil and India, too, require their states to be audited. 2) The Brazilian and Russian constitutions require that states draw up medium-term budget frameworks to ensure planning transparency over several years. Medium-term objectives are further co-ordinated between the federal government and Belgium's regions and South Africa's provinces, for instance. 3) Constitutions may require uniform accounting standards across all levels of government, as in Italy and India.

Fiscal councils and other arms-length agencies

Fiscal councils and other arms-length bodies can help strengthen the budget framework. Fiscal councils independently analyse and review governments' fiscal projections. To be more precise, they may assess compliance with fiscal rules and sustainability requirements or issue recommendations on specific items of budgetary policy. Councils thus raise awareness of the short- and long-term costs and benefits of budgetary measures both among policy makers and the general public (Calmfors and Wren-Lewis, 2011).

Three yardsticks help measure the strength of fiscal councils.

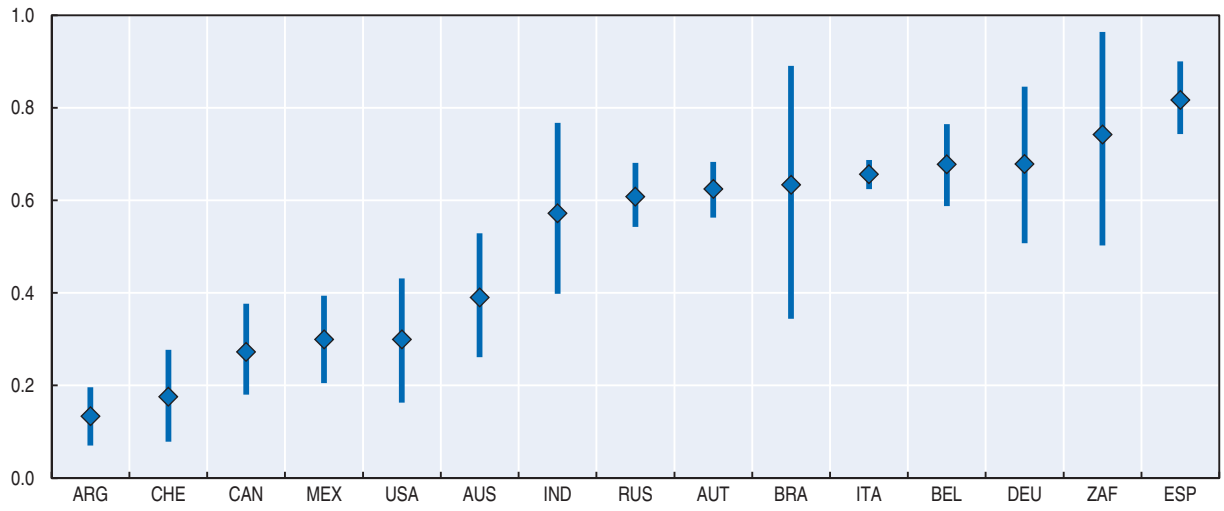
- *Institutional anchoring*. Fiscal councils are likely to enjoy more stability, legitimacy and recognition if enshrined in the constitution, as in Germany or Spain, rather than in ordinary law, as in Australia or Canada. In some countries, such as Argentina and Brazil, they have been enshrined in the constitution for many years, yet are still not in place.
- *Prerogatives*. In some countries, fiscal councils have such broad-reaching prerogatives as the right to assess the fiscal stance of both federal and state governments. Examples include the Parliamentary Budget Office in Italy and the High Council of Finance in Belgium. The Public Council in Russia and the Congressional Budget Office in the United States are allowed to evaluate the federal budget only.
- *Independence*. The degree of independence that a fiscal council enjoys depends on its make-up – members of parliament, representatives of states, ministers, independent experts, etc. – and the body (e.g. parliament) to which it reports. Fiscal councils are largely independent, for instance, in Germany and Spain, while the parliamentary budget offices in Italy and the United States are only partially so.

Budget framework indicators across countries

The strength of budget frameworks varies considerably from one country to another. It is substantial in Spain, South Africa and Germany, where frameworks are well integrated (Figure 2.6), but weak in Argentina, Switzerland and Canada. Budget frameworks are coherent in Austria and Italy, but less so in Brazil, South Africa and India. Brazil's budget

Figure 2.6. **Strength of budget frameworks**

Intermediate level indicator denotes building block 4



Note: The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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framework is less coherent because, although numerical and procedural fiscal rules are very robust, there is no fiscal council. Fiscal rules and councils work best if they are combined (Coletta et al., 2015).

Stability of constitutional arrangements

The stability of fiscal constitutions depends largely on the number and strength of actors and their powers of veto. Veto powers increase the transaction costs of reforms and bias the institutional framework towards the status quo (Tsebelis, 2002). And, while stable institutions may provide a basis for long-term fiscal planning at all government levels, they may also prevent reform and the ability to adapt to changing circumstances. Very stable constitutions may slow down the pace of structural reform and fiscal adjustment. Stability is thus a two-edged sword.

Bicameral veto

In most federal countries, the second chamber is involved in the legislative process and can veto reform of the fiscal constitution. The strength of a bicameral veto can be gauged by the extent of the second chamber's powers of veto and distribution of seats.

- *Extent of veto powers*. The Senate enjoys full power of veto when it can veto any law initiated by the first chamber, which is the case in most federal countries. In others, though, like Germany and Mexico, it has only partial veto power.
- *Distribution of seats*. A Senate with an even distribution of seats between states is usually more veto prone than a fragmented chamber, where it can be difficult to garner support for reform. Under a proportional, or partially proportional system (e.g. Germany and India), the federal government must secure support only from the larger jurisdictions.

Judicial veto

The strength of a judicial veto depends on the degree of constitutional review and the power to strike down unconstitutional legislation (Gutmann, Hayo and Voigt, 2014). It can be evaluated against four criteria.

- *Coverage*. Certain laws are off-limits for judicial review. The Swiss Federal Court may rule only on laws passed by the *cantons* and not by the federal government.
- *Right to petition*. The power of judicial review depends on the number of actors who may initiate a petition in court. In some countries, a broad range of political actors may do so, as in Austria and Brazil. By contrast, in Argentina and Australia, few have access to the constitutional court.
- *Timing*. Judicial influence is broadest where the court is competent to check the constitutionality of laws both *before* and *after* a law has been adopted and implemented, which is the case in India and South Africa. Judicial influence is weaker, however, if the court can review legislation only after adoption, e.g. Canada and Mexico.
- *Unconstitutionality*. Countries have different procedures for laws deemed unconstitutional. The offending piece of legislation is repealed automatically in Russia and Italy, while elsewhere it is returned to the legislature for revision. In countries like Canada and India, the constitution is silent on what happens with unconstitutional laws.

Powers of judicial veto are strongest when no laws are excluded from court adjudication, a wide range of actors can challenge federal legislation in the court, legislation can be challenged before and after a law is enacted, and when an unconstitutional law is automatically void.

Direct democracy

Direct democracy makes use of referendums and initiatives which might have opposite effects on the stability of the fiscal constitution. Referendums are an additional power of veto and make the status quo more difficult to change. Unlike referendums, citizens' initiatives introduce additional instability into fiscal frameworks since they translate changes in public opinion directly into policy. While the Swiss constitution enshrines the fundamental right to launch a popular initiative, the Argentinian constitution explicitly bans citizens' initiatives that address constitutional reform, international treaties, taxes, the budget and penal matters, for example.

Constitutional amendment

All constitutions contain sections that spell out the rules that govern amendment. They determine the frequency of actual amendments and, therefore, the stability of the constitution (Rasch and Congleton, 2006). There are five ways to change constitutions and which make it more or less easy to do so.

- *Qualified majorities*. In most countries a qualified majority is required to approve a constitutional reform. Issues pertaining to the federal level can be amended with the consent of a three-quarters majority in both chambers in Russia. Belgium and Germany require two-thirds majorities in both chambers, and India and Italy absolute majorities.
- *Referendums*. National referendums on constitutional reforms are required or allowed in Australia, Austria, Italy and Switzerland.

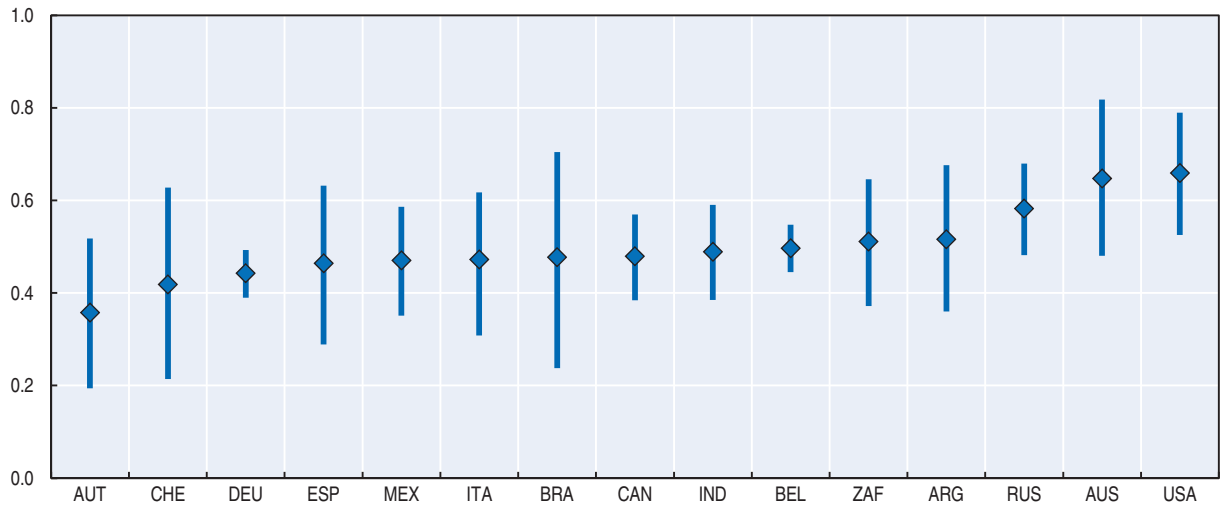
- *Consent from the states*. In some countries, such as Australia and Switzerland, constitutional change must be approved by a majority of voters nationally and by a majority of states.
- *The number of actors that can propose a reform*. In some countries a wide range of institutions and officials may propose constitutional reform. In Brazil the president, the first and second chambers (separately), and the states can do so. In Germany, only the federal parliament has that power.
- *Non-amendable parts*. The most radical constraint on constitutional amendment is non-amendability. The first 12 articles of the Italian constitution, for example, cannot be modified. One concerns the principle of local autonomy and how administrative decentralisation has to be implemented.

Indicators that measure the stability of countries' fiscal constitutions

Constitutional stability varies relatively little from one country to another compared to other building blocks. Generally speaking, though, the fiscal constitutions of Australia, Russia and the United States are more stable than those of Austria and Switzerland (Figure 2.7). Germany has the most coherent institutional environment. Brazil's is less so, as it has strong judicial and bicameral veto powers, while allowing multiple actors to propose constitutional change.

Figure 2.7. **The stability of fiscal constitutions**

Intermediate level indicator denoting building block 5



Note: The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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Overall constitutional patterns

The final step in the empirical assessment is to aggregate the five building blocks, compare fiscal constitutions with each other, then give some statistical underpinning to terms like "competitive", "co-operative", "executive", "dual" or "integrated" federalism. Two different methods help discern similarities as well as differences between the fiscal constitutions of the 15 countries under scrutiny. The first is *clustering*, which identifies countries whose fiscal constitutions are similar, but genuinely different from those of other groups. The second method is *factor analysis*, which makes it possible to calculate a

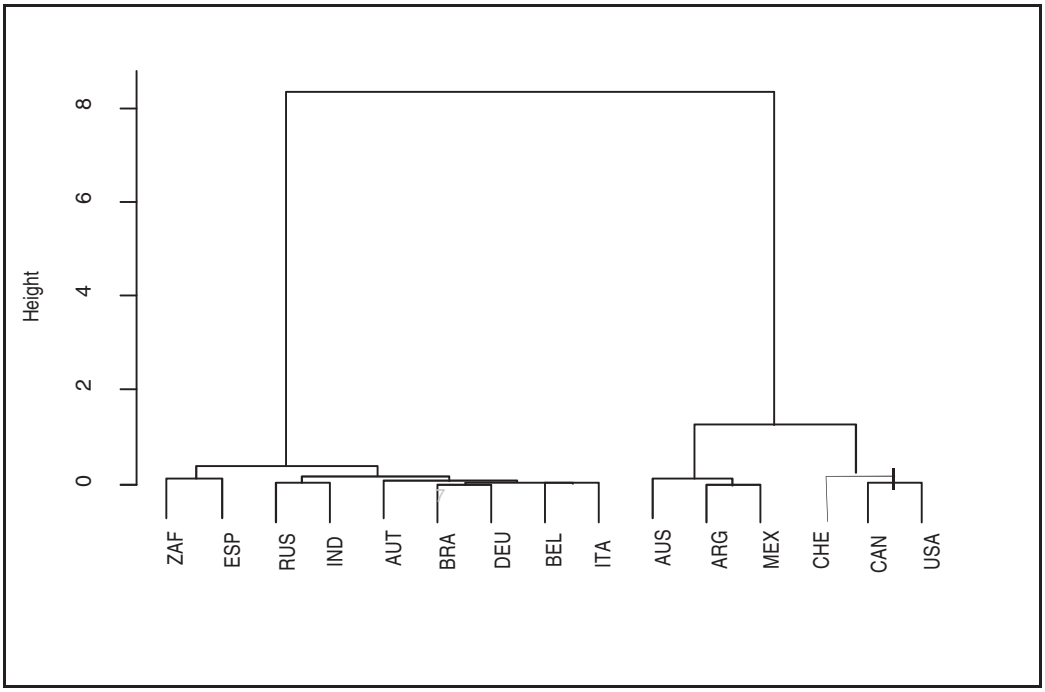
summary, or *composite, indicator* that measures the degree of decentralisation granted in the fiscal constitution. Statistical analysis provides some evidence that the 15 fiscal constitutions can all be said to deliver some "constitutionally guaranteed decentralisation", albeit to widely different degrees.

Clustering distinguishes between "decentralised" and "integrated" fiscal constitutions

This section describes the results of cluster analysis, which assesses whether some fiscal constitutions are similar to each other but different from others. It reveals two distinct groups – "decentralised" and "integrated" fiscal constitutions (Figure 2.8).

Figure 2.8. **Similarities and differences between fiscal constitutions**

Dendrogram based on cluster analysis



Note: The height on the vertical axis is a measure of dissimilarity. The higher its value the more heterogeneous are units grouped in a given cluster. The horizontal axis has no meaning, i.e. clusters lying close to each other are not more similar than clusters farther apart.

- The United States, Canada, Switzerland, Australia, Argentina and Mexico have *decentralised* fiscal constitutions. They combine institutions that give rise to states with considerable autonomy, relatively high levels of responsibility, low powers of co-determination, and weak budget rules and frameworks. Decentralised constitutions tend to be quite stable as well, although Switzerland is an exception. Despite forming a cluster, decentralised fiscal constitutions still differ significantly from each other when it comes to degrees of responsibility. In the United States, Canada and Switzerland states, provinces and *cantons* are highly accountable for their actions. However, levels of responsibility are lower in Argentina, Australia and Mexico, which form a separate cluster of quasi-decentralised federations.
- Austria, Belgium, Brazil, Germany, India, Italy, Russia, South Africa and Spain are characterised by *co-operative* or *integrated* fiscal constitutions. They are a mirror image of

the decentralised cluster, generally combining low levels of autonomy and responsibility with high powers of co-determination and strong fiscal rules and frameworks. Typically, integrated fiscal constitutions are less stable. Some outliers should be pointed out, nevertheless. South Africa's provinces have relatively weak powers of co-determination, while Belgium's regions and communities and Russia's *oblasts* boast quite stable fiscal constitutions.

A summary indicator of fiscal constitutions

The second method of gauging similarities and differences between fiscal constitutions is to develop a summary, or composite, indicator that reflects the degree of constitutionally enshrined decentralisation. The first step is to conduct a factor analysis to determine whether fiscal constitutions arrange their building blocks in the same combinations. Technically speaking, factor analysis tests to what extent variances in the building blocks' indicator values co-move. Results suggest that the different building blocks are indeed highly correlated, with two single factors accounting for around 85% of the total variation (Table 2.2).

- Factor 1 makes up around 66% of the variation in the original building blocks. It is strongly associated with autonomy, responsibility, co-determination and budget rules. These four building blocks are reduced to a single dimension, or factor, which may be termed "the extent of decentralisation".
- Factor 2 explains roughly 19% of the variation in the original variables. It is associated chiefly with the stability of the fiscal constitution. "Different degrees of stability" are thus the second characteristic, or factor, that helps differentiate fiscal constitutions.

Table 2.2. **Commonalities between the building blocks of fiscal constitutions**

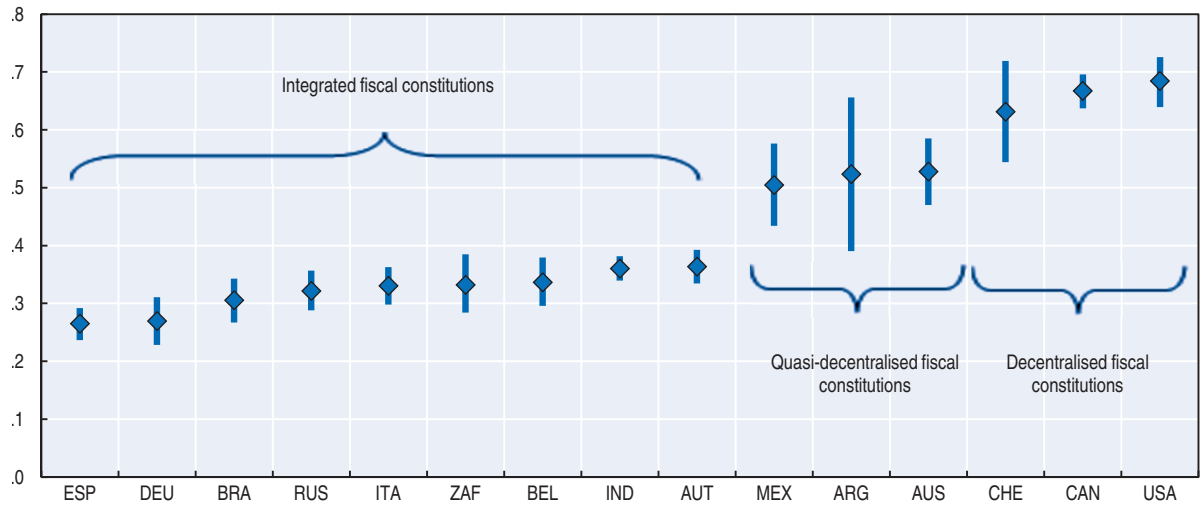
Results of factor analysis

Variable	Factor 1	Factor 2
Autonomy	**0.95**	0.17
Responsibility	**0.92**	0.20
Co-determination	**-0.81**	0.05
Budget frameworks	**-0.86**	-0.03
Stability	0.10	**0.99**
Proportion of total variance	**66%**	**19%**

The summary indicator method, which aggregates four building blocks (not including the stability building block) delivers results similar to those of the clustering method, except that it is more fine-grained and also incorporates coherence (Figure 2.9). The United States, Canada and Switzerland are federations with highly decentralised fiscal constitutions and sometimes referred to as "competitive federalism". Spain, Germany and Russia boast relatively well integrated, or co-operative, fiscal constitutions. Mexico, Argentina and Australia lie somewhere in between. Confidence intervals – the vertical bars around indicator values – indicate the level of coherence between building blocks. Spain and Canada have the most coherent fiscal constitutions, while Argentina has the least. Again, constitutional coherence is *independent* of whether a federation is decentralised or integrated. The fiscal constitution of the European Union, sometimes considered a proto-federation, leans towards decentralisation and is less coherent (Box 2.1). Decentralisation and stability are not correlated – i.e. they are *independent* of each other – as stable or unstable fiscal constitutions are to be found in both decentralised and integrated federations.

Figure 2.9. **Decentralised versus integrated fiscal constitutions**

Ranking and coherence of the summary indicator



Note: The composite indicator is generated by applying the random weights technique to the four intermediate-level indicators. The diamonds show indicator *levels*, while the vertical bars show indicator *coherence*. Longer bars depict less coherent constitutional arrangements.

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Box 2.1. **The EU's fiscal constitution: How decentralised, how coherent?**

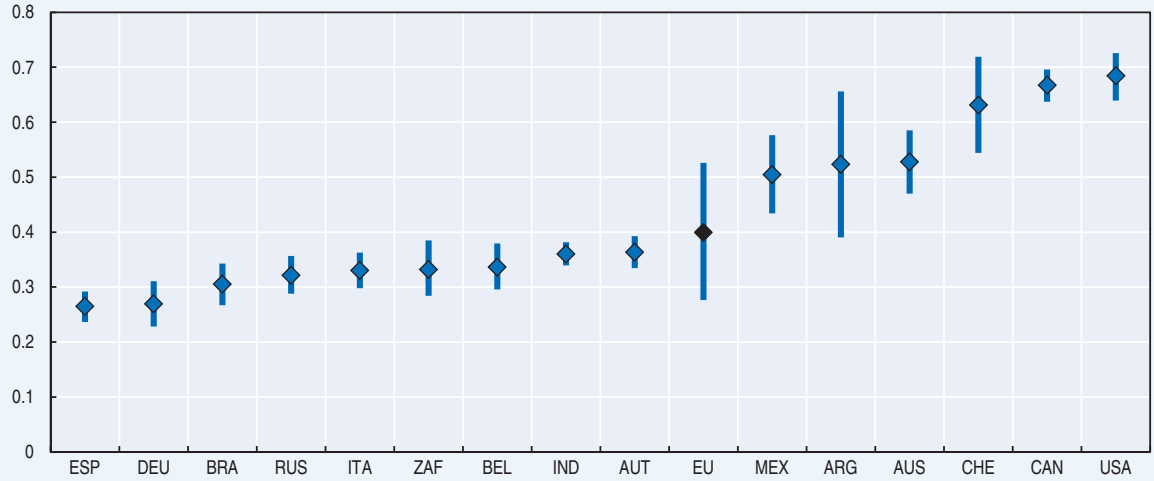
Although the European Union is not usually considered a true federation, some aspects of its institutional design and governance are akin to those observed in nation-state federations. As in all federations, many policy issues are related to institutional questions such as "Who does what?" and "How is co-ordination organised?" The single market, the (albeit small) EU budget and majority voting in selected policy areas also suggest that the European Union has some of the attributes of a federation. Against that background, it is possible to assess and rank the European Union's constitutional design and coherence by applying the same methodology used for the 15 nation-state federal countries.

The EU fiscal constitution is moderately decentralised and less coherent than those of most federal countries (Figure 2.10). It is less decentralised, though, than those of the United States, Canada and Switzerland, and also less than those of quasi-decentralised federations like Mexico, Argentina and Australia. It gives the member states relatively high levels of autonomy and responsibility, as well as extensive powers of co-determination and strong hierarchical budget rules and frameworks – building blocks of co-operative federalism. In other words, the EU fiscal constitution combines elements from both competitive and co-operative federal systems.

This assessment seems to reflect the EU's constitutional set-up well. Although the member states enjoy wide fiscal autonomy, a good number of EU policies help co-ordinate fiscal policy across countries and limit national discretionary powers. Since the EU budget is small, fiscal co-ordination is achieved through a set of stringent fiscal rules (OECD, 2014). They are applied under the terms of the Maastricht Treaty's Excessive Deficit Procedure, the Stability and Growth Pact, the Fiscal Compact, and Six Pack and Two Pack regulations. Policies are also co-ordinated and kept under surveillance by the European Commission and the European Council as part of the annual cycle of the European Semester. Recent changes to the EU's fiscal constitution further reinforced fiscal and economic governance by amending surveillance procedures, sharpening sanction mechanisms and setting intermediate fiscal and economic targets and adjustment procedures. This binding framework has been put in place over the last 20 years, particularly in the wake of the economic and fiscal crisis. It stands in contrast to the extensive autonomy of the member states in tax and spending matters.

Box 2.1. **The EU's fiscal constitution: How decentralised, how coherent?** *(cont.)*

Figure 2.10. **How decentralised and coherent is the EU's fiscal constitution?**



Note: The diamonds show indicator *levels*, while the vertical bars show *coherence* of an arrangement. Longer bars depict less coherent arrangements.

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How fiscal constitutions have evolved

Fiscal constitutions evolve over time, which raises three questions: "What changes?", "How does it change?", and "Why does it change?" (Benz and Broschek, 2013). The first and second questions relate to the five building blocks and the third to the mechanisms that produce constitutional reform. Fiscal constitutions may change because the fiscal or economic environment changes (at times of boom and bust), because the political setting changes (with sharp swings in the political climate or the advent of military or authoritarian regimes), or because there is a rise in separatist movements or a country's break-up looms large. Fiscal constitutions thus reflect not only fiscal policy considerations, but the wider environment within which countries thrive.

A short history of fiscal constitutions

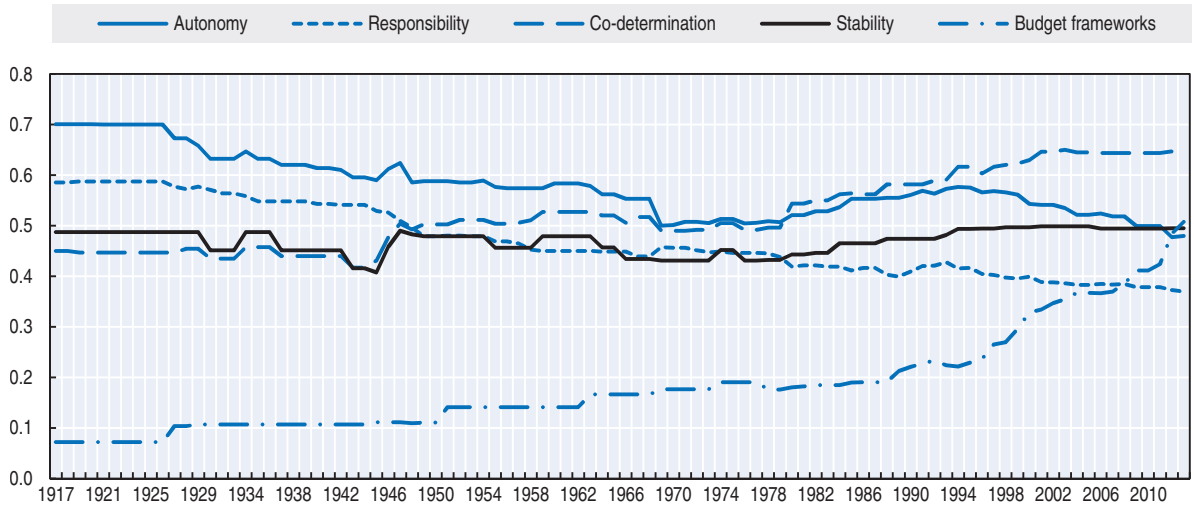
Over time, most fiscal constitutions have become less decentralised and more integrated since their inception, although there were a few countervailing episodes (Figure 2.11). To assess how fiscal constitutions have evolved, Blöchliger and Kantorowicz (2015) calculate the average of the summary indicator values of all 15 countries for the years 1917 to 2013.[13] While the autonomy and responsibility of sub-federal entities trend downward – despite some increases in autonomy in the 1980s and 1990s – co-determination and budget frameworks have strengthened over time. The degree of stability has remained – well – stable.

What drives constitutional reform?

This section affords further insight into the changes in the individual building blocks of fiscal constitutions. As the federal country club has grown over the last 100 years, the changes reflect both trends within old federations and the birth and subsequent evolution of new ones.

Figure 2.11. **How fiscal constitutions have evolved over time, 1917-2013**

Changes in the five building blocks, average for the 15 countries



Note: The lines represent the annual average of indicator values for 15 countries. The country panel is unbalanced, i.e. countries enter the sample at different points in time (Argentina, Australia, Brazil, Canada, Mexico, Switzerland and the United States in 1917, Austria in 1945, Italy in 1948, Germany and India in 1949, Belgium in 1969, Spain in 1978, Russia in 1993 and South Africa in 1996).

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Trends in autonomy

Changes in the autonomy of sub-federal jurisdictions can be divided into three periods:

- **1917-80**

During this period, losses of autonomy occurred chiefly in times of crisis. Autonomy declined during the Great Depression in the early 1930s, World War II and, less clearly, during the oil crises at the beginning of 1970s. Economic shocks and crises often prompted federal interference in sub-national autonomy. In Switzerland, the federal government expanded its powers of taxation at the expense of those of the *cantons*. After World War II, however, trends varied from country to country. Australia's states never regained the power to tax income, which is today largely a federal prerogative. In Canada, by contrast, provinces like Quebec and Ontario ended the tax rental agreement with the federal level and established their own tax base again in the post-war period.

- **1980 to mid-1990s**

During this period, sub-national autonomy grew. States started regaining power in the 1980s. In Australia, the credit limitations imposed by the Loan Council were phased out and the monitoring of states' debt was left to financial markets. Mexico experienced a considerable surge in state autonomy, with several policy functions delegated to the states as part of the education reform in the early 1990s. In the 1990s, the states in the United States gained more power in the wake of a series of Supreme Court rulings and welfare reforms. The rulings devolved substantial responsibility to the states in the implementation of welfare policies.

- **Mid-1990s onwards**

Since 1990, there has been a renewed decline in state autonomy, stemming chiefly from the financial crisis in emerging economies in 1998 and the global crisis of 2008. In the

early 2000s, following a debt crisis and the bailouts of sub-national governments, the federal government in Brazil passed the Fiscal Responsibility Law in 2000, curbed sub-federal fiscal autonomy and re-centralised fiscal policy. In the European Union, the financial crisis of 2008 and the debt crisis of 2010 led many countries to introduce or refine numerical fiscal rules. In 2009, Germany adopted a constitutional debt brake that encompassed all levels of government. Spain and Italy soon followed suit.

Authoritarian regimes tend to restrict state autonomy, with governors (heads of sub-national executives) no longer being directly elected but appointed by central government. The military regimes of Argentina and Brazil began appointing governors in the 1930s, interspersed with democratic episodes when they were elected. The restoration of democracy in the 1980s in both countries resulted in a surge of sub-national autonomy. In Mexico, state autonomy was curbed by *de facto* single-party rule in all tiers of government between 1929 and 1989. Single-party rule was also the norm at both levels of government in India until the early 1990s.

Trends in responsibility

The responsibility indicator has trended downward since 1917, much in line with autonomy. The small upward movement in the late 1980s can be related to institutional changes in Australia, Canada and the United States. During the 1980s, the federal government in the United States abolished its revenue-sharing and equalisation mechanism and reined in the intergovernmental grant system. In Australia and Canada, states and provinces self-imposed a set of fiscal rules, although such rules actually play only a minor role in Canadian fiscal policy.

There are two main reasons for sub-national fiscal responsibility shrinking throughout the 20th century. The first is bailouts. The second is the rise of intergovernmental transfers in all forms in response to crises, regional disparities between sub-national jurisdictions, and the growth of inequality as a policy issue:

- *Tax sharing*. Tax sharing is a popular means of sharing risk across all tiers of government levels in federal countries. It often dates back many decades. Argentina introduced its *coparticipación* system in the mid-1930s through ordinary legislative channels. Finally, in 1994, after pooling more and more taxes under federal supervision, it anchored *coparticipación* in the constitution. Germany's tax-sharing mechanism has been constitutional since 1955 and was further broadened by an amendment to the constitution in 1969. The United States introduced a tax-sharing-*cum*-equalisation mechanism in the mid-1970s, before abolishing it in 1986.
- *Equalisation*. Redistribution across sub-national jurisdictions has become wider-reaching and more institutionalised over time, as the policy objective of cutting inequality has gained importance. Switzerland made equalisation constitutional in 1958 and Canada in 1982, although it had fully established it in 1962. Australia has operated full horizontal fiscal equalisation since the 1980s, though not on a constitutional footing, while Russia introduced an equalisation formula in its Budget Code in 2004. Indeed, apart from the United States, all federations have explicit equalisation systems nowadays.
- *Stabilisation*. Stabilisation policy and counter-cyclical transfers were introduced in the second half of the 20th century in the wake of the Great Depression. In 1947, the Swiss were the first to adopt a constitutional provision for coping with a slowdown, before further strengthening measures in 1978. In Germany, the power to pass counter-cyclical

policy measures became constitutional in 1967, while Spain's new constitution of 1978 empowered federal government to co-ordinate general economic planning. In Canada, the Federal-Provincial Fiscal Arrangements Act of 1985 enables the federal level to stabilise provincial revenues, with earlier legislation dating back to 1967.

- *Other transfers*. Federal countries gradually established grant systems, either co-financing policy areas under state jurisdiction or, more recently, compensating for decentralised spending responsibilities. The German and Swiss constitutions contain multiple provisions which state that the federal level "should" or "must" support state activities. In 1999, Russia increased transfers to *oblasts* in support of spending mandates, while Belgium has funded spending decentralisation over the last two decades chiefly through more grants. In 1998, Mexico's fiscal co-ordination law added transfers for education, health and infrastructure. In general, institutional anchoring of grants has increased with time.
- *Bailouts*. Bailouts are a specific form of *ad hoc* intergovernmental transfer. Apart from Switzerland, all federations have bailed out a sub-national jurisdiction at some time. In Australia, New South Wales and in Canada Alberta, respectively, were bailed out during or after the Great Depression of the 1930s. In the United States, New York was bailed out in 1975, shortly after the first oil crisis, while in Latin America a first round of bailouts occurred after the fiscal crisis and sudden-stop episodes of the late 1980s. Although patterns were similar in Argentina and Brazil throughout the 1990s, they seemed to diverge in the 2000s. While Argentina bailed out two more states in 2003 and 2011, Brazil managed to stick to its constitutional no-bailout strategy.

Trends in co-determination

There are two episodes in the dynamics of co-determination that are worth discussing. The first was a surge in powers of co-determination in the 1950s and 1960s, the second a slower upward trend that commenced in the early 1980s.

- Stronger powers of co-determination in the late 1940s and early 1950s followed the end of authoritarian rule in some countries. The evolution of co-determination during the 1960s was largely driven by Germany and Brazil. In the late 1960s, the power of the second chamber in Germany (Bundesrat) increased further, making the country one of the federations with the strongest joint decision-making powers. However, in 2006, the second chamber saw some of its powers reduced. As for Brazil, strong co-determination was established after the authoritarian rule during the 1960s and 1970s.
- From the 1980s onwards, a number of countries strengthened sub-federal jurisdictions' power to co-determine federal policy. In the 1980s, Belgium introduced the Consultation Committee, made up of the prime ministers of both tiers of government. Among its other tasks, the committee approves each government's contribution to the effort to reduce the overall deficit in compliance with the Stability and Growth Pact. The establishment of a Constitutional Court in 1980 also strengthened Belgium's regions and communities. In 1994, the Supreme Court in Mexico was given the power to review federal legislation to ensure compliance with the constitution. Similarly, in 1982, the Canadian provinces secured the right to approve constitutional amendments. As for Australia, it established the Council of Australian Governments (COAG) in 1992. Finally, since 1997, the Standing Conference for the Relationship between the State and the Regions has been the forum for political negotiations between the two tiers of government in Italy.

Changing patterns in budget rules and frameworks

Budget rules and frameworks have been beefed up at an unprecedented scale over the last decade, after long having changed very little. Numerical and procedural rules and other fiscal institutions have undergone sweeping reform, driven chiefly by the recent financial and debt crises.

The introduction of second-generation numerical fiscal rules was probably the most salient element of budgetary reform. Switzerland introduced a constitutional debt brake (in effect, a balanced budget rule) in 2001. Germany, Italy and Spain followed suit in 2009, 2011 and 2012, respectively, although the rules they introduced were more encompassing because they covered general government and not only, as in Switzerland, the federal level. A Spanish organic law also sets debt and expenditure rules for general government, while Italy's Internal Stability Pact introduced expenditure and deficit rules in 1999. As a post-crisis and preventive measure, Russia amended its Budget Code in 2012 and introduced a fiscal rule that set a cap on federal government expenditure. As early as 1982, Germany ushered in expenditure rules that operated on the basis of political commitment to control spending.

Budget institutions and frameworks were also strengthened. The 2012 fiscal reform in Spain introduced medium-term budgetary frameworks for the top-two tiers of government and enabled the Supreme Audit Institution to scrutinise the budgets of the autonomous regions. In the same year, Italy harmonised budgetary frameworks across all tiers of government and unified accounting methods. Both countries also established fiscal councils. Canada's Parliamentary Budget Office started operating in 2008 and Russia's Public Council in 2011, although both bodies still boast only limited powers. In Germany, the 2009 constitutional amendment established the Stability Council, which has had the duty of monitoring compliance with the debt brake since 2013. In the United States, the Congressional Budget Office was established in 1974, while in Belgium the Public Sector Borrowing Requirement Section of the High Council of Finance came into being in 1989.

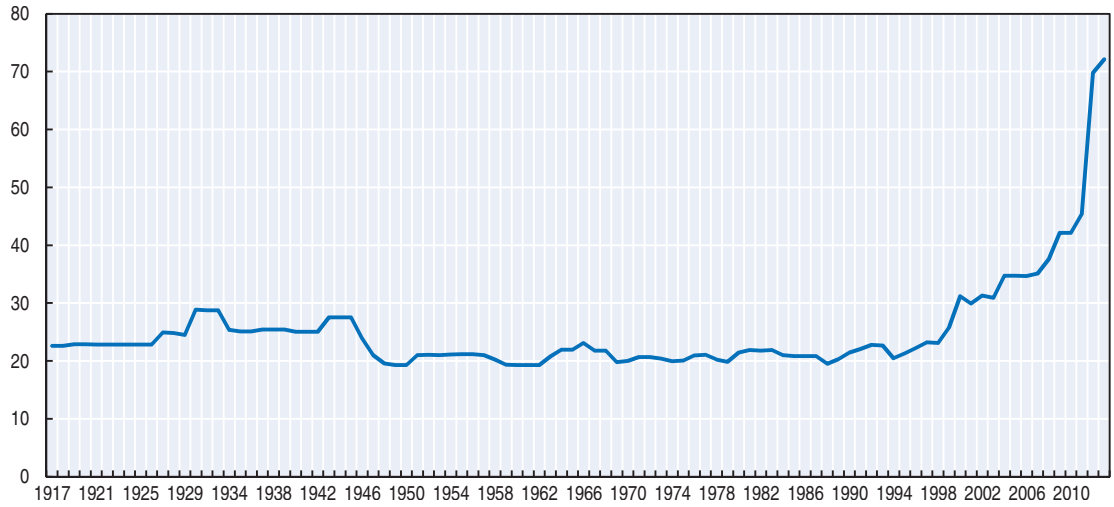
Coherence of fiscal constitutions increased over time

Overall, the coherence or alignment of fiscal institutions remained flat over long periods, but has considerably increased since the 1980s (Figure 2.12). The increase in the last 30 years can be traced back to the strengthening of the budget framework in many federations, often in reaction to low state responsibility and, to a lesser extent, to closer alignments of autonomy and responsibility. Decentralised federations have evolved less than integrated ones. Incoherence is most acute in times of war and under authoritarian regimes. Some constitutions, such as those of Argentina or the United States, have seen practically no change in their levels of coherence.

The clear-cut distinction between decentralised and integrated fiscal constitutions that can be observed today is actually quite recent. A cluster analysis of fiscal constitutions in 1980 and 1996 found that federations could not be neatly divided into the two groups (Blöchliger and Kantorowicz, 2015). In 1980 and 1996, at least four clusters of federations were distinguished, with no characteristic dividing line between them. Over the last 20 years or so fiscal constitutions have moved towards either the decentralised or the integrated model. In other words, distinction has become more pronounced.

Figure 2.12. **Coherence in fiscal constitutions from 1917 to 2013**

Average of 15 countries



Note: Coherence is measured as the average of the variance around intermediate level indicators for all 15 federations in each year. An upward sloping curve means rising coherence.

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Fiscal constitutions and fiscal outcomes

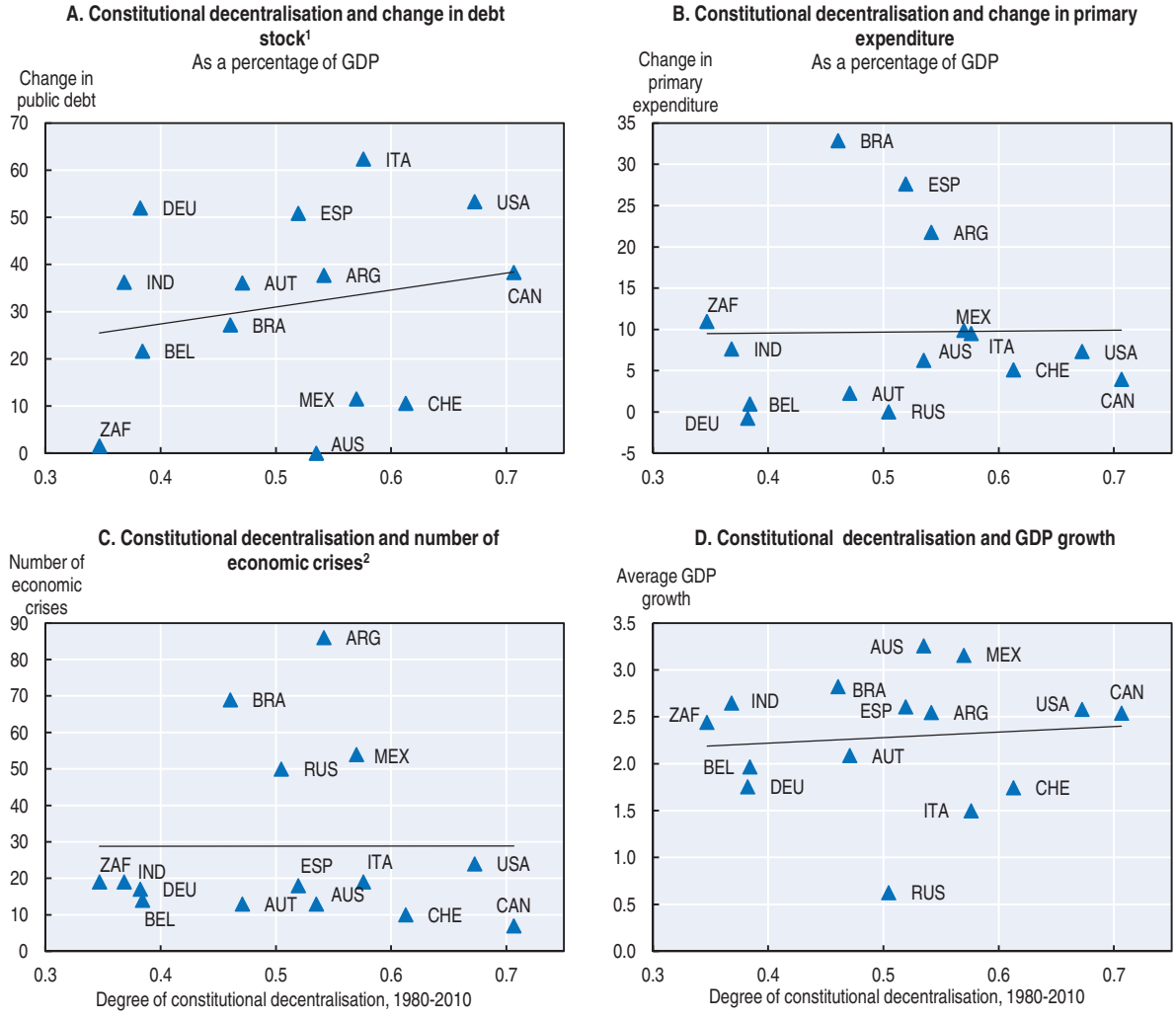
This section considers a few simple bivariate correlations between selected features of a fiscal constitution and fiscal outcomes between 1980 and 2013. The correlations link fiscal outcomes to both the *level* and *coherence* of constitutional decentralisation or, in other words, to both indicator values and variances. Correlation does not mean causation, but rather interaction. Fiscal institutions may affect fiscal outcomes at certain times, while outcomes might trigger changes to basic fiscal frameworks at others – as Section 2.5 shows. Average indicator values for 1980-2013 help capture long-term effects.

The correlations suggest that fiscal outcomes are hardly related to the *level* of constitutional decentralisation (Figure 2.13), while they are more closely related to *coherence* of constitutional decentralisation (Figure 2.14). In other words, the extent to which fiscal constitutions are decentralised has less impact on outcomes than the extent to which the various arrangements within a fiscal constitution fit together. As a result, the results of the simple bivariate correlations linking coherence to outcomes can be summarised as follows:

- *Coherence and spending*. Primary spending growth seems to be positively correlated with less coherence. An unbalanced setting might allow jurisdictions to shift the consequences of excessive spending to other government levels or general government.
- *Coherence and debt*. The growth of debt seems to be positively correlated with less balanced fiscal constitutions. In less coherent settings – when autonomy and responsibility are not aligned, for example – sub-national governments may be able to shift the consequences of fiscal profligacy to the federal level or other jurisdictions.
- *Coherence and crises*. There is a correlation between the incoherence of fiscal constitutions and the frequency of crises a country underwent. Less balanced settings may be more prone to the build-up of deficit and debt, leading to a greater likelihood of crisis.
- *Coherence and economic growth*. Coherence is positively correlated with growth rates. Conversely, unbalanced fiscal constitutions can harm the economic fabric.

Figure 2.13. **Correlations between the degree of decentralisation and fiscal and economic outcomes**

1980-2010



1. Russia has been dropped from the sample because Russian public debt fell by more than 100 percentage points from 116% to 13% of GDP in the period 1993-2010, for which the fiscal constitution is coded.
2. An "economic crisis" is defined as the sum of crisis events such as currency, inflation, stock market, sovereign debt and banking crisis, as defined by Reinhardt and Rogoff (2010) (*www.carmenreinhart.com/data/browse-by-topic*).

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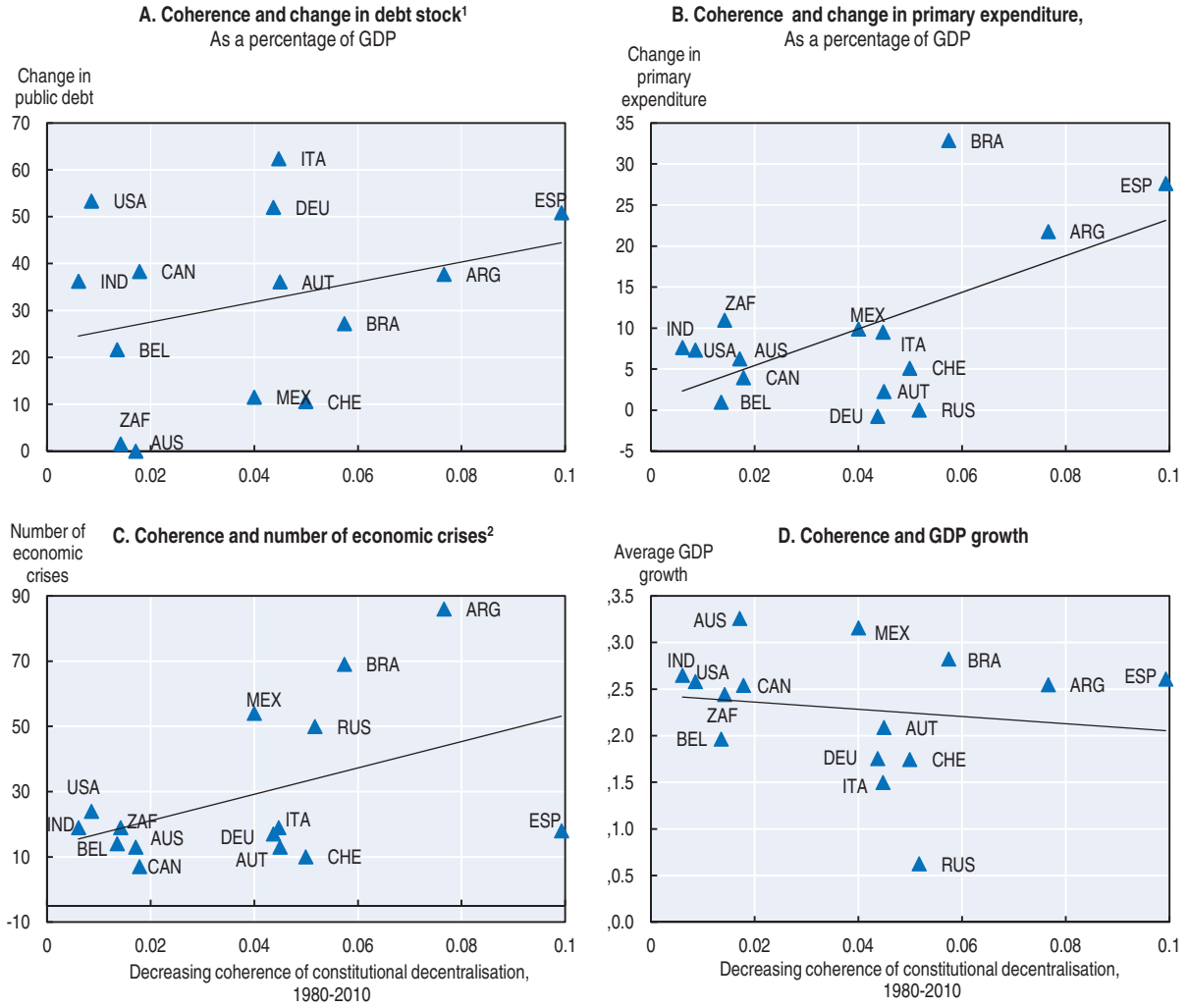
As for *levels* of constitutional decentralisation, linking them to the same fiscal outcome variables as coherence (growth of debt, growth of primary spending, economic crises and GDP growth) delivers almost no relationship. The one possible exception is the relationship between the level of decentralisation and debt growth, which is positive, albeit only slightly.

Summary and conclusions

This chapter has sought to analyse the fiscal constitutions of federal countries and how they define intergovernmental relations and sub-central governments' power and authority over fiscal resources. The results suggest that constitutional set-ups vary widely from one country to another. Yet their differences boil down to a single underlying

Figure 2.14. **Correlations between the coherence of fiscal constitutions and fiscal and economic outcomes**

1980-2010



1. Russia has been dropped from the sample because Russian public debt fell by more than 100 percentage points from 116% to 13% of GDP in the period 1993-2010, for which the fiscal constitution is coded.
2. An "economic crisis" is defined as the sum of crisis events such as currency, inflation, stock market, sovereign debt and banking crisis, as defined by Reinhardt and Rogoff (2010) (*www.carmenreinhart.com/data/browse-by-topic*).

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dimension – the degree of constitutionally guaranteed decentralisation – within which three groups of federations can be distinguished: decentralised, integrated and (somewhere in-between) quasi-decentralised. All three comprise the same components (or building blocks) – sub-national fiscal autonomy, fiscal responsibility, influence on federal fiscal policy, and the strength of intergovernmental fiscal frameworks. Yet they are combined in distinctive arrangements in each group. Very tentative empirical evidence suggests that the constitutional set-up of a federation – the extent to which it delegates fiscal power to its sub-federal jurisdictions – has hardly any impact on such core policy outcomes as its budget balance, debt levels, economic growth or the number of economic crises it has undergone. At first glance, no federal model is better than another.

However, further empirical evidence suggests that *coherence* of constitutional arrangements does indeed have an impact on fiscal and economic outcomes. Coherence is the extent to which constitutional arrangements fit together – to what extent spending autonomy matches tax autonomy, for example, or whether fiscal rules are aligned with the fiscal responsibility of state and local governments. Less coherent constitutional arrangements tend to be associated with greater budget deficits, higher debt growth, lower economic growth, and more economic crises. Like a jigsaw whose pieces can fit only a certain way, the elements and building blocks of a fiscal constitution must form a coherent whole if they are to yield sound fiscal and economic outcomes. It is important to note that coherence is *independent* of whether a federation is decentralised or integrated: in both cases building blocks can be well or poorly aligned.

Some mismatches in fiscal constitutions are recurrent. Policy makers might wish to re-align certain building blocks and elements through constitutional or other policy reforms. The most frequent reforms would probably include:

- Aligning sub-national taxing and spending autonomy – especially by increasing sub-federal and local governments' share of total tax revenue and their power to tax.
- Aligning the autonomy of sub-national governments with their responsibility – particularly by strengthening budget constraints; adjusting deficit, debt and spending rules; and enforcing no-bailout clauses through an insolvency framework.
- Aligning sub-national co-determination prerogatives with autonomy – either by strengthening co-determination if fiscal autonomy is to be reduced, or restricting it if fiscal autonomy is being extended and the over-fishing of common-pool resources has to be prevented.
- Establishing a well anchored budget framework and a set of good budget practices – especially by introducing medium-term budgeting and aligning substantive (numerical) and procedural fiscal rules.

Other coherence and alignment issues may be more specific to individual federations. For each country has its own way towards a coherent fiscal constitution.

Notes

1. The term "state" is used interchangeably with the country-specific terms for the intermediate level. In Austria and Germany, a state is a *Land*. In Canada and South Africa states are called *provinces*. In Belgium, Italy and Spain, the intermediate level is a *region* or *community*, in Switzerland a *canton*, and in Russia an *oblast*. Finally, in Australia, Brazil, India, Mexico and the United States, the intermediate level of government is a state or *estado*.
2. The questionnaire asked about assignment rules for personal and corporate income tax, indirect taxes, natural resource taxes and social security contributions.
3. Although states could in principle exit the revenue sharing system and start levying their own taxes, there is a provision in the law that makes exit prohibitively expensive (*Convenio de Adhesion*). If a state exits the system, federal taxes continue to be levied at the sub-national level, and revenue shares are calculated as though the state were still in the system. So the federal government keeps residual revenue fully.
4. For the purpose of this study, 16 spending categories (policy areas) were selected from the OECD's Classification of the Functions of Government, second-level (COFOG-2). These are 1) national defence, 2) police services, 3) law courts, 4) prisons, 5) public transportation, 6) environmental protection, 7) housing development, 8) out-patient services, 9) hospital services, 10) primary education, 11) secondary education, 12) tertiary education, 13) sickness and disability, 14) old age, 15) family and children and 16) unemployment.

5. The Commerce Clause says that states may not adopt regulations or taxes that place an "undue burden" on interstate commerce. Similar provisions are enshrined in Austrian and Swiss constitutional law.
6. The principle of subsidiarity holds that decentralising economic functions to lower levels of government should be favoured unless convincing arguments can be advanced for centralising them. Residual legislative power means that, unless some policy area is assigned to one level, it is automatically within the authority of the other level.
7. The court ruled that the canton of Valais was not liable for the debt of Leukerbad municipality, which went bankrupt in 1998. With the court's ruling the no-bailout clause was confirmed. The court's decision cut the relation between cantonal risk premiums and the financial situation of the municipalities, and reduced cantonal risk premiums by around 25 base points. The ruling showed that weak no-bailout commitments impose high costs on potential guarantors (Feld et al., 2013).
8. Since the beginning of 19th century the states had accumulated a large amount of debt chiefly to finance infrastructure projects. After fiscal panic due to shrinking revenues, several states were unable to service their debt. A bailout was discussed in the federal legislature but ultimately rejected. This decision sent a clear message that state debt was a state responsibility. In order to tap into the credit markets again, states made substantial reforms including the introduction of various balanced budget requirements. In the 1870s, after a banking panic and ensuing depression, states tightened their fiscal rules further (Dove, 2014).
9. In Australia, the Commonwealth Grants Commission, a non-partisan body, is responsible for equalisation. Unlike South Africa, the Commission's role is not defined in the constitution but only by ordinary law.
10. For Australia, see Smyth and Narayan (2004); for Canada, see Songer et al. (1989); for Germany, see Vanberg (2005); for Italy, see Della Pellegrina and Garoupa, 2012; for Spain, see Garoupa, Gómez-Pomar and Grembi (2013).
11. See for instance, the 1995 court case United States v. Lopez. Also in 2012, in the case National Federation of Independent Business v. Sebelius the justices decided in favour of the states, ruling that the significant expansion of Medicaid was not a valid exercise of Congress' spending power, since it forced states to accept the expansion at the risk of losing existing Medicaid funding.
12. In Brazil, state and local public officials are subject to criminal prosecution for non-compliance with the Fiscal Responsibility Law of 2000. The law limits new funding for sub-national governments and denies credit guarantees in case of systematic violation (Goldfajn and Guardia, 2004). A special Fiscal Crime Law (Lei dos Crimes Fiscais) sets out a range of penalties for budget mismanagement such as fines, removal from office, ineligibility for public office up to five years and even imprisonment.
13. The indicators for the following countries and periods are coded: Argentina (1853-2013), Australia (1901-2013), Austria (1945-2013), Brazil (1891-2013), Belgium (1969-2013), Canada (1867-2013), Germany (1949-2013), India (1949-2013), Italy (1948-2013), Mexico (1917-2013), Russia (1993-2013), South Africa (1996-2013), Spain (1978-2013), Switzerland (1848-2013) and the United States (1791-2013).

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Chapter 3

Reforming the tax on immovable property

Ancient civilisations taxed land and property for thousands of years – long before they discovered income, business or consumption taxes. More recently, policy makers have again become enthusiastic about this oldest of taxes and immovable property taxation has returned to the fore. This chapter surveys and evaluates immovable property tax policy in the OECD. The first section shows main property tax trends and developments. Section 2 surveys and evaluates property tax regimes currently in place in OECD countries. Section 3 analyses the economic impact of property taxation on, for example, investment and growth, income distribution, macroeconomic stability and revenue buoyancy and, finally, on land use. Section 4 reviews the relationship between property taxation and intergovernmental relations. Section 5 presents an alternative to property taxation, namely the taxation of imputed rent as part of income taxation. The sixth and final section deals with the political economy of property taxation and how to make property tax reforms happen.

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.

Main trends and developments

The property tax: capital, income and consumption tax

Taxes on immovable property – often simply called "property" or "real estate" tax – comprise levies on land and buildings and other physical capital like machinery. They defy classification in any one of the broad tax categories. They can be considered a capital tax since they tax an asset or an input to production. They can be considered a consumption tax since they tax the services that derive from living in an apartment or a house. They can be considered an income tax since they tax the imputed rent from owning a house. The tax on immovable property is not neutral since it taxes certain forms of property only (e.g. physical assets), while leaving other types of property untaxed (e.g. financial assets). The taxation of property shows up not only in the "recurrent immovable property taxes" category of the OECD Revenue Statistics, but also in income taxes (e.g. tax on rent or imputed rent) or consumption taxes (e.g. value-added-taxes arising from the refurbishment of a house).

The special nature of immovable property taxation is policy-relevant. It points to different policy approaches for land and buildings, for residential and business property, and for owner-occupied and rented houses. And policy makers must carefully evaluate the way it may interact with other taxes. How efficient it is depends much on its design. While pure land tax is seen as one of the most efficient, equitable taxes – since it taxes rent only – taxes on physical capital is much less well-regarded because capital taxes can deter business investment, economic development and efficient land use.[1] The distributive effect of property taxation also depends on policy design, e.g. on whether poorer or liquidity-constrained households benefit from tax exemptions. The immovable property tax can be paid by either the owner or the occupant of a property, and in several countries both types of recurrent immovable property tax co-exist.[2]

The significance of the property tax varies strongly across countries

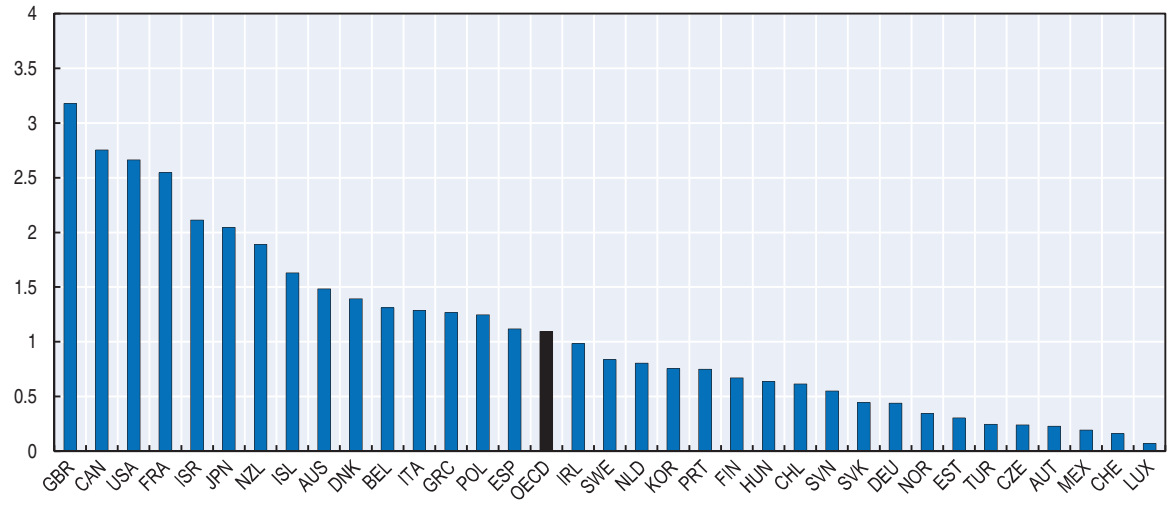
The size of the property tax take varies widely from country to country as a percentage of both total tax revenue and GDP (Figure 3.1). Overall, though, its significance is modest. Across the OECD, immovable property taxation made up around 3% of the total tax take and a little over 1% of GDP in 2013. Countries with a high property tax-to-GDP ratio include the United Kingdom, Canada and the United States, while it is almost nil in countries such as Luxemburg, Switzerland and Mexico. The property tax is more prevalent in English-speaking countries, but constitutional set-ups are irrelevant: there are both federal and unitary countries with both high and low property taxation.

The share of the property tax is low but has started to rise

Despite the advantages ascribed to the property tax, its share of GDP has remained largely stable over the last few decades, hovering at around 1%. It declined as a share of total sub-central revenue until 2008 when it started to rise again, partly because it withstood

Figure 3.1. **The significance of the recurrent immovable property tax varies across countries**

Share of recurrent immovable property tax revenue in GDP, 2013



Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

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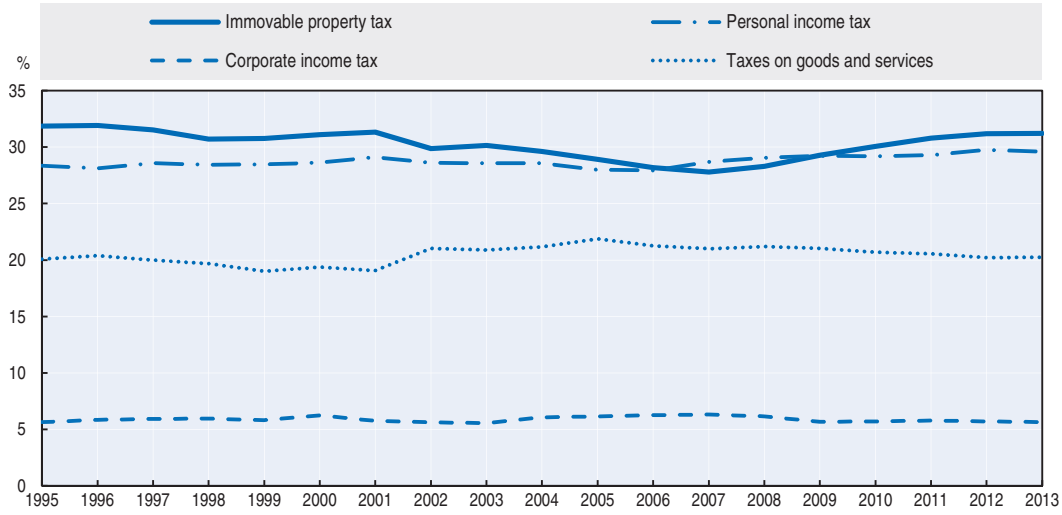
the crisis better than other taxes and partly as a result of property tax reforms. Property tax revenue currently accounts for around 31% of sub-central tax revenue; personal income tax makes up 30%, consumption taxes 20%, and other taxes the remaining 19% (Figure 3.2).

Figure 3.2. **Property tax as a share of sub-central tax takes is rising again, 1995-2013**

Share of major taxes in the total sub-central tax take



Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

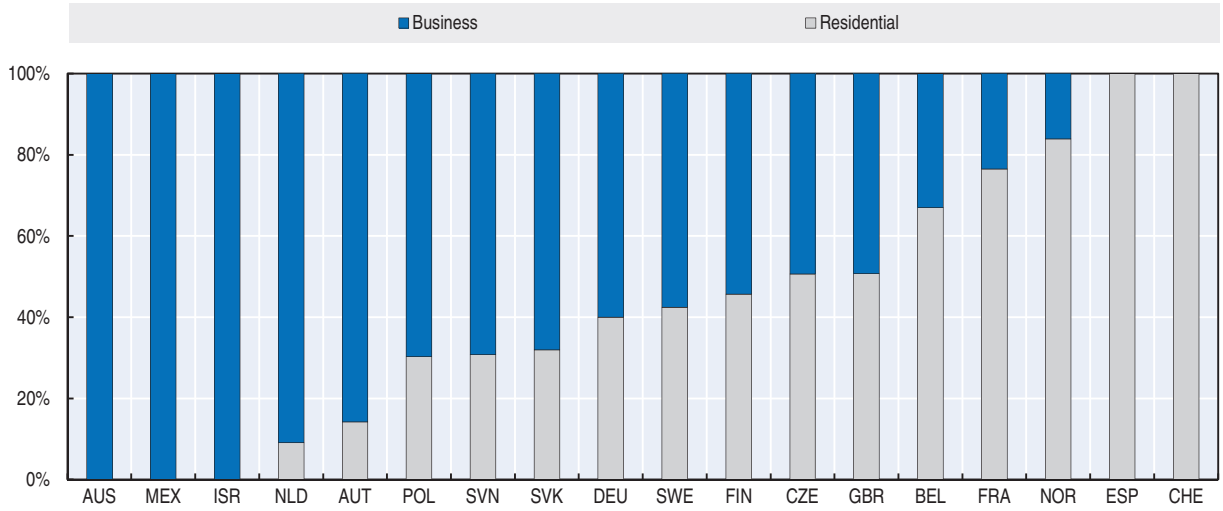
StatLink http://dx.doi.org/10.1787/888933342016

Various factors, mostly related to political economy, could explain the relatively modest role the property tax plays. Voters contest it because it is not linked to the ability to pay, thereby hitting social groups that are income poor, but housing wealthy. The rise of property prices prior to the recent crisis created sustained political pressure on sub-central

governments (SCGs) to limit property tax increases, as exemplified by the tax revolts in many US states. As a result, a variety of measures – often social-policy-induced such as caps, abatements and exemptions – are gnawing away local property tax revenue. In many OECD countries, the tax base – i.e. property/cadastral values – has not been updated for years or even decades, creating distortions and unfairness between different types of property and property owners. As for business property taxation, the dwindling significance of manufacturing with large physical plants – for long the backbone of property tax revenues in many jurisdictions – may also explain the declining share of property tax revenue in the total local tax take. Business taxation still makes up a significant share of total immovable property taxation in some countries (Figure 3.3).

Figure 3.3. **Business property taxation is still important in some countries**

Shares of business and residential property tax revenue, in % of total immovable property tax revenue, 2013



Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

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A survey of property tax systems in OECD countries

The OECD area is home to a variety of property tax regimes. Some yield considerable revenues, others very little. Some countries boast several distinct taxes on immovable property that have different tax bases and rates. This section surveys, assesses and compares property taxation across the OECD. The survey draws chiefly on a questionnaire sent to OECD member countries in early 2014 that considers property tax systems from four main angles: 1) coverage and scope; 2) assessment and evaluation; 3) tax abatements; and 4) tax rates. (For further detail, see Tables A1 and A2 in the Annex.) Most property tax regimes are administered by sub-central governments, which constrains full assessment of property tax regimes.

Scope of recurrent immovable property taxation

The scope of the property tax can be assessed along two lines: 1) the purpose of use i.e. residential (main and secondary) and business property; 2) the taxed items, i.e. land and improvements. Some countries also tax agricultural land, forests and undeveloped land. Most exempt property owned by the state and non-profit-organisations.

- *Residential and business taxation*. Most countries tax residential and business property. A few countries levy separate taxes on both (such as Belgium) and some, like Italy, exempt the main residence. Secondary homes are always taxed, while undeveloped land is quite often exempt. Agricultural land is often not taxed or subject to special regimes.
- *Taxation of land and taxation of improvements/buildings*. Most countries tax both land and buildings, sometimes with lower rates on the buildings and other investment than on the land itself. Only three OECD countries levy a pure land tax. They are Australia (the state of New South Wales), Denmark and Estonia. Conversely, property taxes in Ireland and Italy apply to improvements only.

The variety of taxable items translates into a variety of property tax regimes. Accordingly many countries have a single integrated property tax; some have separate land and property taxes (e.g. Denmark), some have separate property and building taxes (e.g. Italy), and finally some have separate land, property and building taxes. A number of countries (e.g. Czech Republic) use physical indicators such as the size of a plot of land or a building to assess property values. The variety of tax bases is sometimes related to intergovernmental frameworks, with different property taxes accruing to different tiers of government. In Australia, for example, land tax accrues to the states and property taxes to the local/municipal level.

Valuation and assessment of immovable property

Adequate valuation and assessment of immovable property are key to a fair, efficient property tax system (Table A1). Unlike most other taxes, property values are generally presumptive – they must, in other words, be *estimated*. Appropriate valuation and assessment of land and improvements is therefore crucial to both tax policy and administration. A property's potential market value is usually considered the most appropriate yardstick for determining the property tax base. Indexation can help update property values between market updates, but the less frequent such market assessment is, the more indexed property values will deviate from actual market values. For further details, see Almy (2014).

Property assessment practices across the OECD can be summarised as follows:

- *Valuation methods*. Comparing sales prices is the most common method of assessing property values. A practice that has become widespread is mass appraisal, whereby a property's value is determined by comparing the sales price of similar properties. Several countries (e.g. Finland and Italy) combine the sales price and cost methods, estimating land at sales prices and approximating the value of improvements by the cost of constructing or replacing a building. A few countries, such as Belgium, use the income method – i.e. actual or imputed annual rent – to calculate property values, while a few apply all three forms of property valuation, depending on the type of property and the purpose of its use (e.g. United States). There are also a number of countries, such as Poland, that apply simplified versions of "fiscal zoning", using some indicators (size of plot, location close to public infrastructure) to help assess property values.
- *Value updates*. Updating property values and, thereby, the tax base is arguably the most difficult issue, both administratively and politically. OECD countries address it in various ways. Some – such as Denmark or Korea – update property values annually, while others – like Portugal and Turkey – update every three to four years. Legislation requires several countries to update property values periodically, although they actually fail to do so (e.g. Belgium and Germany). There are also many instances in the OECD areas of price

indexation – e.g. construction, house, and consumer price indices or combinations thereof – as a way to update property values. Indexation is an alternative to regular reassessment and can help maintain buoyancy in tax revenues. However, property values may evolve differently across different areas, distorting property assessments.[3] A few countries use a simplified assessment method, allotting value bands to properties – the United Kingdom, for example, has eight value bands.

- *Tier of government responsible for assessment rules*. In general, property tax revenues accrue to local governments. Yet the responsibility for determining assessment rules – and thus for setting the tax base – is usually incumbent on higher tiers of government, i.e. the state level in federal countries and the central government in unitary countries. Research in the United States suggests that standard setting by a higher government level improves the quality of assessment (Strauss and Sullivan, 1998). In many countries valuation is assigned to special valuation agencies that cover wide areas, which prompts calls for some centralisation, at least of tax administration. In a few countries, taxpayers are required to self-assess their properties. Owners who occupy their property must therefore impute rent, so running the risk of sanctions if their returns are wrong, as in Ireland, Italy and Mexico.

Tax abatements and reductions

Tax abatements reduce the property tax base and drive a wedge between assessed and taxable immovable property values. Tax abatements can partially explain the decline of property tax revenues as a share of total tax revenue (Kenyon, Langley and Paquin, 2012). Most countries provide a wide range of abatements, e.g. relief, credit, and exemptions for both residential and business property (Table A2). Some of these reductions can be justified on the grounds of equity and may make a system less regressive, even progressive. Others, though, are difficult to defend on economic grounds.

When it comes to tax abatements and reductions, policies in the OECD can be summarised as follows:

- *Taxable values are often set below assessed values*. In some countries taxable values are set as a fraction of assessed property values. The practice is one of the main reasons for the persistently wide disparities in ratios of property tax revenue to GDP across the OECD area. Germany sets taxable values at 33% of assessed values only, while elsewhere percentages are higher. Korea initiated a wide-reaching property tax reform in 2005 to bring taxable values into line with assessed values, but political obstacles have kept the percentage at 60% to 70%. In 2013, as part of a sweeping property tax reform, the city of Philadelphia in the United States lifted the percentage from around 30% to 100%, while lowering tax rates to one-third of their previous level.
- *Tax exemptions for residential property*. There is a broad range of breaks and exemptions in property tax in most of the OECD area:
  - for owner-occupied housing (e.g. in Italy);
  - for low-income households (most countries);
  - lump-sum allowances granted to both residential and business property owners – usually in the form of one allowance per owner and, though more rarely, per property;
  - deductions in certain spending categories, e.g. for green housing technologies and energy-saving investment (e.g. Norway),
  - tax holidays for owners who build their new homes (e.g. Austria and Slovenia).

- The taxation of under-used property is particularly interesting. While some countries (e.g. the United Kingdom) *reduce* the taxable amount if a property is under-used, others *increase* due tax (e.g. Slovenia). While lighter taxation of under-used property can be defended on social grounds, especially for elderly single-person households unable to pay high property taxes, occupation is a rather imprecise indicator of poverty.
- *Tax exemptions for business*. The corporate sector benefits from a variety of tax breaks and abatements – e.g. tax holidays for start-ups and allowances for certain types of activity. With increased corporate cross-border mobility, local governments have come to use property taxation as an economic development policy tool. However, it seems that the effect of property tax relief on corporate behaviour is generally negligible. Experience from the United States suggests that business property tax incentives have a poor record in promoting long-term economic development (Kenyon et al., 2012). In some cases, though, they may help revive distressed areas – if properly designed.

Property tax exemptions are like any other tax exemption: although sometimes well intentioned, they narrow the tax base and often have unintended side-effects. A short assessment of some property tax exemptions may shed a little light on their effects (Box 3.1).

Box 3.1. **A short assessment of a long exemptions list**

There is a long tradition of granting property tax exemptions to ease the burden on people viewed as vulnerable and to promote desirable activities. Educational, religious and charitable institutions are exempt from property taxes in most countries. Upper-tier governments usually pay no tax on property they own in local jurisdictions. Policy measures to reduce property tax liabilities include reductions of assessed or taxable property values, reductions and exemptions for low-income earners, exemptions for selected property uses or property owners, special tax abatement programmes for enterprises, certain types of spending on property, and many others. Other policy measures, including caps on annual property value or tax liability increases (sometimes called "circuit breakers"), also narrow the tax base but are not considered exemptions.

There is wide-ranging analysis of the effects of property tax exemptions on both residential and business property taxation, especially in the United States. Its overall view of the effectiveness of exemptions is rather sceptical, since exemptions reduce the tax base and revenues and may have unintended consequences. Sometimes they even fail to achieve the desired objective.

A few common (and less common) tax exemptions emerged from countries' responses to the OECD's 2014 questionnaire on property tax regimes:

- *Lump-sum and proportional exemptions*. They are fixed-amount deductions from assessed or taxable property values. They tend to make property taxation more progressive with respect to property values – though not necessarily to income – since the resulting effective tax rates are lower on small than on large properties. Granting a lump-sum exemption for *every* property – rather than just one per owner – gives owners incentives to split up properties for tax purposes. Granting *proportional* exemption – i.e. taxing property at below 100% of its assessed value – may severely reduce tax revenues with no discernible effect on equality.
- *Tax holidays*. Tax holidays are tax abatements over a limited time period. They are often granted for new buildings and for periods up to ten years. Tax holidays for new construction drive a wedge between different types of property. They are an incentive to

Box 3.1. **A short assessment of a long exemptions list** *(cont.)*

invest in new property development rather than to re-use infrastructure on developed land. They thereby foster rather than limit urban sprawl and are unlikely to curb equality.

- *Tax exemptions for under-use*. Some countries offer tax relief for under-used properties, e.g. houses that are inhabited by fewer people than what could be considered "normal". Tax relief for under-use is generally designed to help elderly people live on their family home even after their offspring have left for good. Although many people own large houses but have small incomes after retirement, there is no automatic relationship between age and poverty. Tax exemption for under-use is therefore not well targeted from a social policy point of view. Moreover, providing an incentive to stay on in a dwelling deprives others of opportunities or, in more general terms, reduces spatial and intergenerational mobility.
- *Tax deductions for certain types of spending*. Property tax exemptions to promote energy-saving technologies and other forms of green investment have become more widespread in recent years. The overall experience is mixed, however (Brandt, 2014). While some studies claim that exemptions do indeed "green" housing investment, others are more sceptical, concluding that property owners are largely free-riding – i.e. they would have invested in green technologies anyway.
- *Business property tax exemptions*. Most countries provide a myriad of tax incentives for businesses, mostly in the form of tax holidays for new or expanding firms and other property tax abatement programmes. These incentives are usually designed to attract and retain businesses and promote local economic development. Again there is a vast body of analysis which is largely sceptical as to the effectiveness of targeted incentives – as opposed to lower tax rates. Indeed, some analysts see them as a pure zero-sum game since the upshot is lower tax revenues with no truly discernible effect on development (Kenyon, Langley and Paquin, 2012). Experience from the United States, however, suggests that when targeted at distressed urban areas, business property tax exemptions might benefit local development.

Some tax exemptions may be more justifiable than others. For low-income households they are defendable on social grounds, although means-tested income support still targets beneficiaries more accurately. Generally speaking, transparent information as to the costs and benefits of tax exemptions and the revenues foregone could help policy makers make informed decisions about when and where to provide property tax exemptions. A property tax expenditure database showing foregone tax revenue for each tax exemption could be a useful start.

Tax rates

Differences in average property tax rates explain, to a large extent, the differences between countries in property tax as a share of GDP (Table A2). Average tax rates range from 0.1 or 0.2% to more than 2% of the tax base. Property tax rates are usually the only tax policy lever for local governments, since the tax base tends to be determined by upper-tier governments. In many countries tax rates vary by two or threefold across jurisdictions. In a few others local governments do not have tax rate setting power or do not make use of it. Some apply a progressive scale, with tax rates rising with property values. In general, though, statutory property tax rates might be a misleading guide when it comes to assessing effective tax rates, since the tax base – i.e. property values – is not assessed uniformly across countries or even jurisdictions within them.

Economic effects of property taxation

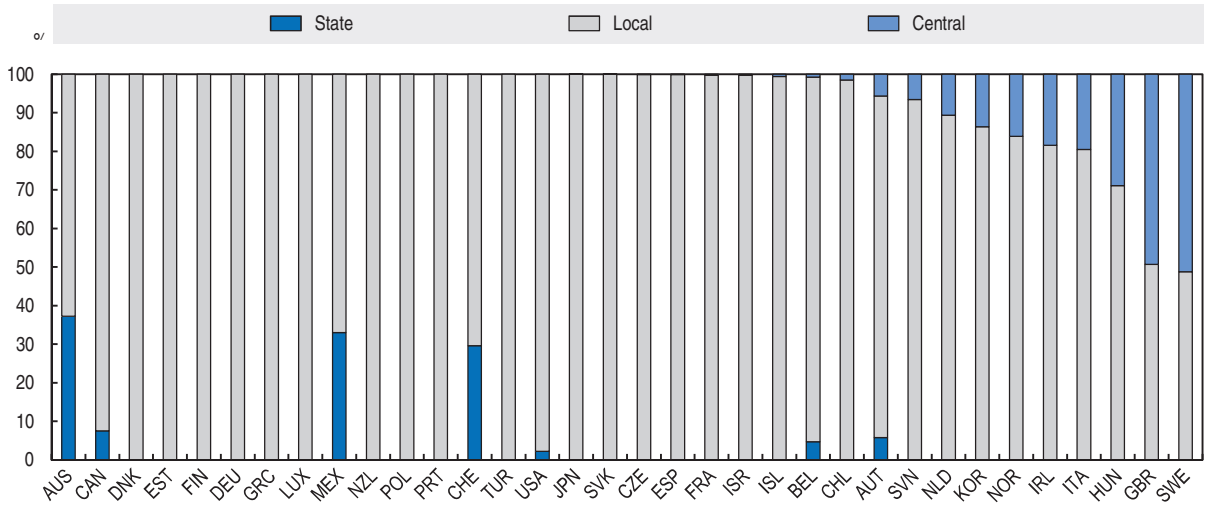
Property taxation is efficient – but that still depends on design

The tax on immovable property is usually seen as one of the most efficient and among the least detrimental to economic growth.[4] The tax base is immovable and inelastic – in other words, households generally react little to changes in tax policy. The property tax differs from income or business taxes which tend, more markedly, to shape behaviour. Since property taxation largely maintains firms' and households' decisions to save and invest, it should be less of a drag on economic growth. OECD analysis suggests that immovable property taxes are the least harmful to economic growth (Arnold et al., 2011).

Property taxation also shows a close link between taxes paid and public services received, which make it more like a user fee for local services (Figure 3.4) and explains why it is generally kept at levels commensurate with the preferences of residents. Differences in property taxation and service levels across jurisdictions are capitalised in house prices, thereby reducing tax competition (Blöchliger and Pinero Campos, 2011).

Figure 3.4. **The property tax is a typical sub-central tax**

Share of each government level in the recurrent immovable property tax take, 2013



Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

StatLink http://dx.doi.org/10.1787/888933342039

There is an important caveat to this rosy view of property taxation, however. Property taxation is not neutral because it discriminates between physical and non-physical capital. Taxing property might affect the capital spending of both businesses and homeowners. Businesses may be discouraged to invest in physical capital, especially if machinery is included in the property tax base (Zodrow, 2001), and homeowners will be discouraged to improve their dwellings if the result is higher taxes. More specifically, business property taxes are difficult to defend on the grounds of the benefits principle, since the business sector receives fewer services from local communities than residents, and taxes may be exported to non-residents – consumers, workers and capital-owners. Business property taxes seem to be more harmful for growth than residential property taxes (OECD, 2010). Finally, taxing improvements may prompt the under-utilisation of land and lead to urban sprawl if the land-to-capital ratio declines (Brandt, 2014). Still, business property taxes can

be a backstop against the avoidance of residential property taxation through excessive incorporation – much as the corporate income tax acts as a backstop against avoiding personal income tax (OECD, 2007).

If different property tax regimes were to be ranked, a *pure land tax* with a uniform tax rate across all types of property and property owners would come out first.[5] Land is immobile, and land taxation has hardly any impact on investment decisions.[6] What is more, a pure land tax is more effective against urban sprawl than the two-tier property tax. Still, a move towards stronger land taxation requires careful policy design. Land values are only a fraction of property values, so land tax rates would have to be higher than current property tax rates to keep tax revenues constant (Brandt, 2014). Property taxes with a higher tax rate on land than on improvements could be an intermediate solution. Finally, since land values have to be separated from the value of improvements, methods of assessing land values have to be well designed to be effective.

Property taxation is not very progressive

The progressivity of property taxation depends on *tax incidence*, e.g. which individuals and households ultimately have to pay a tax (Zodrow, 2001). Views on incidence are, in turn, often overshadowed by debates about the true nature of the property tax. Those who consider the property tax a tax on housing services deem it regressive since, they argue, the share of housing-related spending declines as income increases. Those who see property tax as a capital tax contend that it is progressive since capital is concentrated more heavily in the hands of high-income earners. Those who view it as a fee for local public services (benefit taxation) argue that it is neutral since any redistributive effect it might have is offset by the redistributive gains from consuming public services. Moreover, property tax can be designed to be more or less progressive, e.g. by allowing for lump-sum tax allowances or for tax exemptions for low-income earners.

The empirical evidence on tax incidence suggests that the property tax can indeed be anything from progressive to regressive. From a life-cycle perspective, it appears proportional since spending on housing is supposed to increase in line with income over the life span (Fullerton and Metcalf, 2002). In highly urbanised areas, where capital tends to be more heavily concentrated among high-income groups and it is difficult to shift the property tax onto rent-paying tenants, it is considered progressive (Chang, 2006). An OECD analysis that relates income deciles to property tax payments suggests that the property tax is regressive, probably because homeownership is more equally distributed than income (Joumard, Pisu and Bloch, 2012). Tax incidence also depends on the wider central or sub-central policy setting in areas like land use, rent control and the labour market. The more property owners are able to forward-shift the property tax to tenant, consumers or workers, the more it tends to become regressive. The tax might therefore be perceived differently depending on which end of the income distribution is being considered: it might be regressive in the low- to medium-income range and progressive in the highest income brackets.

In sum, the redistributive effect of property taxation hinges on various factors. Overall, though, property tax is probably less progressive than personal income tax, which is sometimes seen as an alternative in sub-central government finance.

Property taxation can help stabilise housing markets

The tax on immovable property can be used as a policy instrument for asset price stabilisation. Property taxes can dampen house price volatility and excessive house price

increases. Rising property tax revenues that evolve in line with rising property prices – assessed by regular updates of property values which broaden the tax base – can temper the intricate boom-and-bust-cycle of property markets. Property taxation may thus help ease fluctuations in the overall economy and act as an automatic (counter-cyclical) stabiliser over the business cycle.

The stabilising effect of property taxation on house prices can be attributed to capitalisation, i.e. the inverse link between house prices, imputed rent and the property tax. Property taxes are capitalised in house prices – the net present value of a house can be obtained from the discounted stream of cash-flow (rents) or services (imputed rent) minus maintenance costs and property taxes. As house prices rise, property taxes account for a growing share of rents, thereby reducing the net present value and counteracting further house price appreciation (Muellbauer, 2005). Higher property taxation may also curb the *amplitude* of house price fluctuations around the long-term trend and thereby help avoid property boom-and-bust cycles. The reason is that in a high-tax environment the demand for housing with respect to house prices is more elastic, whereby an (exogenous) housing demand shock has a weaker impact on house prices (van den Noord, 2005). Lower house price fluctuations would, in turn, ease fluctuations in GDP, given the various channels through which house price developments affect GDP.

New empirical analysis from the OECD provides some evidence for the volatility-dampening impact of property taxes, although the effect is relatively weak (Table 3.1a). Doubling the tax-to-GDP ratio – e.g. by lifting it from 0.5% to the current OECD average of 1% – would curb house price volatility by between 1% and 4%.The dampening effect has remained largely stable over the last 50 years, as well as during and after the 2008 crisis. Similarly, a higher property tax-to-GDP ratio seems to slow the growth of house prices, particularly as house prices tend to follow the business cycle (Table 3.1b). Countries with low property taxation and less frequent property value updates tend to show steeper house price fluctuations, although the relationship is again weak (for details see Blöchliger et al. [2015]).

Table 3.1. **Property taxation dampens house price volatility**

a) Changes in house price *volatility* and changes in the property tax-to-GDP ratio

Period: 1965-2012	Reaction of house price volatility to …			
Property-tax-to-GDP ratio	**-0.033****	**-0.040****	**-0.009***	**-0.010***
Volatility of output gap	0.008**			
Volatility of changes in output gap		0.005**		
Volatility of real growth			0.867**	
Volatility of changes in real growth				0.353**

b) Changes in house prices and changes in the property tax-to-GDP ratio

Period: 1965-2012	Reaction of house price volatility to …			
Property-tax-to-GDP ratio	**-0.036****	**-0.002**	**-0.009**	**-0.024****
Output gap	0.003**			
Changes in output gap		0.013**		
Real growth			1.209**	
Changes in real growth				0.790**

Note: Coefficients are derived from multi-variate regressions linking house price volatility to the property tax-to-GDP variable and from a number of variables reflecting the business cycle. Coefficients represent percentage changes, e.g. -0.04 means that a 10% *increase* in the property tax-to-GDP share *reduces* house price fluctuations or growth by 0.4%. An asterisk (*) denotes significance at the 10% level and a double asterisk (**) denotes significance at the 5% level. Details of the estimation strategy may be found in Blöchliger et al. (2015).

Empirical results also suggest that property taxes do not respond much to the business cycle and, therefore, provide a relatively stable revenue source (Table 3.2). Property taxes are a-cyclical or pro-cyclical, depending on how the cycle is measured, and do little to stabilise the economy. The a-cyclical behaviour may be the result of two countervailing forces: on the one hand, property taxes may have a stabilising effect on the economy by lowering house price volatility; on the other hand, they may have a destabilising effect due to their inertia over the business cycle. Rapid tax increases during a slowdown – or tax reductions during a boom – cause property taxation to exert a strongly destabilising effect on the economy, which suggests that property taxes should be raised only when both the housing market and the economy are in good shape. A more regular update of the tax base in line with property market developments could help ensure that property tax revenues evolve more in line with the cycle – although it would then provide a less stable revenue source for SCGs.

Table 3.2. **Property taxation is counter-cyclical or a-cyclical, 1965-2012**

Correlations between property taxes and the cycle, various tax and cycle variables

Period 1965-2012	Reaction of the tax-to-GDP ratio to…	Reaction of real tax revenue growth to…
Output gap	-0.004	-0.001
Changes in output gap	-0.013**	-0.003
Real growth	-1.227**	-0.457
Changes in real growth	-0.206	0.159

Note: Coefficients are derived from multi-variate regressions linking the tax variable (real tax revenue growth or growth of the tax-to-GDP ratio) to a number of variables reflecting the business cycle. Coefficients represent percentage changes, e.g. -1.227 means that a 1% increase in real growth reduces tax revenue growth by -1.227%. Double asterisks (**) mean significance at the 5% level. Details of the estimation strategy may be found in Blöchliger et al. (2015).

Property taxation can promote sustainable land use

Land use has become a prominent environmental policy issue. The growth and sprawl of urban areas eats up and fragments open space, threatening biodiversity, landscapes, and the use of land for recreation. Dispersed land-use patterns generally lead to increased energy use and transport needs like commuting, and exert an adverse effect on the environment. Since property tax is – at least partially – a tax on land and its use, it has potential as an instrument for shaping land use. It could reduce pressure on land development or re-direct it towards areas which are already infrastructure-connected. Properly designed property taxes could also support land use planning and help reduce the environmental impact of transport and energy use. However, if property tax is to help drive the effective use of land, policy makers must address a number of issues (Brandt, 2014).

- Policy makers must view property taxes in the context of other policy instruments, such as land use planning and transport policy, which can also help internalise externalities related to urban sprawl. Such instruments generally have a much stronger impact on land use than the property tax, whose effect is weak. Furthermore, while property taxes can have an overall impact on land use patterns, they are too rough an instrument to ensure the protection of specific plots of land or to foster patterns of land use such as the protection of natural amenities from any development whatsoever. The property tax can, however, underpin such land use policies such as urban spatial planning or transport policy.
- The impact of property taxation on land use hinges on its design and, again, different property taxes should be distinguished. A pure land tax increases the cost of hoarding land

and offers incentive to put it to its most valuable use. Development becomes a more attractive prospect, particularly in areas where land values are high, such as those close to existing infrastructure. In this way, a pure land tax fosters denser cities. The effect of the traditional property tax (or two-tier tax), which covers both land and improvements is less clear-cut, however. On one hand, if the tax is shifted onto consumers, house prices increase and drive the demand for smaller housing units, so increasing population density. On the other hand, property tax may promote urban sprawl in that it reduces the capital-to-land ratio and, by the same token, the number of housing units per unit of land area.

- Property transaction taxes are bad for sustainable land use. They increase incentive to buy cheap land, which generally lies far from city centres and transport infrastructure, while deterring transactions that might help put land to a more efficient use. They also encourage the purchase of undeveloped land for new development rather than upgrading developed areas.
- A number of specific land-use taxes to contain urban sprawl and curb excessive land use have been considered in OECD countries. A tax on land *area* is a stronger incentive for making efficient use of land than tax on land *value,* especially when the latter is low. Germany, for example, is addressing the possibility of levying taxes on new property development and soil sealing, while the Netherlands and the United States have discussed the feasibility of taxing property developments to reduce the loss of open space and associated loss of well-being. The social value of open space, however, has proven difficult to estimate. Another proposal is to tax value added to land after it has been re-zoned. Since changes in land value are often caused by re-zoning and yield, in essence, windfall gains for land owners, it is often argued that such gains should be taxed. Some Swiss *cantons* are discussing provisions for taxing the value added – and compensating the value lost – that stems from re-zoning land. Finally, development impact fees to cover the costs of new infrastructure are fairly common in North America. Such fees could ensure that developers internalise infrastructure cost and slow down urban sprawl.
- Spatial planning is the best and most widely used instrument for controlling the use of land. In some countries it serves explicitly to contain sprawl – through urban growth boundaries and greenbelt policies, for example. Spatial planning and the taxation of land and property taxation are complements, however, not alternatives. Property taxes could be designed to discourage sprawl, while land-use planning, which is much more arms-length, can achieve such specific targets as the protection of individual land plots from development.
- Property taxes generate revenues which can create perverse incentives for SCGs whose tills they fill. They may eye land development or re-zoning for purely fiscal reasons and might even be tempted to increase revenues from such environmental levies such as soil-sealing or greenfield taxes, thereby undermining their original purpose.[7] Governments should handle such perverse incentives through proper land-use planning instruments, with local authorities addressing local land-use externalities and upper-level governments those with a wider geographical reach.
- Property taxes can be redesigned to foster green investment. Local governments in the United States have numerous property tax incentives for boosting energy efficiency and renewable energy use, while the Czech Republic, Italy, Norway and Spain are further examples of countries that offer property-tax relief for renewable energy installations. The environmental effectiveness of such rebates needs to be weighed against losses

arising from a narrower property-tax base and less tax revenue. However, no studies have yet assessed the efficiency of property tax relief as a way to promote investment in energy efficiency and renewable sources of energy.

Although property taxes seek primarily to raise revenue, they can also be a useful instrument for increasing the density of land use and curbing urban sprawl. Yet their overall effect on land use much depends on other instruments such as land use planning.

Property taxation and intergovernmental fiscal relations

Property tax is levied primarily by sub-federal and local jurisdictions (Figure 3.4). Any reform of property tax regimes must therefore be tied to reforms of intergovernmental fiscal frameworks. This section endeavours to answer two questions that arise from the link between property taxation and fiscal relations:

- Do property tax reforms require the reform of intergovernmental grants and sub-central taxation and spending?
- Do reforms to fiscal relations give sub-central governments an incentive to increase property tax revenues?

Property tax reforms may entail reforms of intergovernmental relations

Property tax reform to increase the share of property taxation in the total tax take may require changes to the wider intergovernmental fiscal framework. Without flanking policies, a rise in property taxation increases sub-central taxation as a share of both general government taxation and GDP, which may not be warranted. A hike in property tax that is revenue neutral with regard to revenue and the level of government therefore requires amendments to both spending and taxation across all tiers of government. There are, however, different options when it comes to reforming property tax in a revenue-neutral way:

- The easiest option is to adapt the sub-central tax system without changing the intergovernmental framework. One way forward would be to abolish sub-central property *transaction* taxes (i.e. stamp duties and similar taxes on the transfer of ownership), considered bad for labour mobility and unfair since they depend not on the value of the property but on how often it is traded (Norregaard, 2013). Another option would be to reduce sub-central business or labour (payroll) taxes. In order to avoid disruptive changes involving hefty tax raises for some property owners, reforms could be phased in through relatively small changes to the annual tax base or rate.
- The second option would be to cut intergovernmental grants by the same amount that local tax revenues are raised. Since grants exceed property tax revenue by a multiple in all countries, central government funding may be reduced without damaging sub-central finances, particularly as around half of all grants are non-equalising and raise little redistributive concern (Blöchliger and Petzold, 2007). Moreover, since property tax revenues are less pro-cyclical than revenues from intergovernmental grants in many countries, overall SCG revenues would become more stable over the cycle (Blöchliger and Égert, 2013). Still, since tax-raising capacities vary across jurisdictions, and would do so even more widely after a property tax hike, remaining grants will have to focus more clearly on equalisation.
- The third reform option would be to introduce a dual central and sub-central property tax. The additional revenue would be allocated to central government which would have

to cut some other taxes to compensate for the higher property tax. The grant system would remain untouched. The downside to this option is that it would complicate the property tax system and could lead to vertical tax competition between central and sub-central jurisdictions with a tendency towards excessive tax rate increases (Devereux, Lockwood and Redoano, 2007). A dual property tax also goes against standard policy recommendations that property tax should be assigned to sub-central governments.

- The fourth, and most complex reform option, is to devolve additional spending responsibilities commensurately with increases in property tax revenues. This option could well work in countries where decentralised spending is clearly below the OECD average. The flipside, though, is that it would require reform not only on the tax side but also on the spending and responsibility side within the intergovernmental fiscal framework, which might be difficult to achieve. Moreover, inter-jurisdictional disparities might become an issue if new spending responsibilities have a redistributive effect.

Property tax reform could cause tax revenues to evolve unevenly from one SCG to another because house prices assessed at market value evolve differently. A study in Germany finds that – depending on the model chosen – property tax reform intended to value property at market value would considerably change relative tax capacity across the *Länder* (Färber, Salm and Hengstwert, 2013). To offset the redistributive effects, fiscal equalisation would have to kick in, even though many OECD countries do not equalise property tax bases across jurisdictions. The need to combine tax reform with changes to intergovernmental relations would make reform more complex. However, it would also yield opportunities from a political economy perspective since it would allow the bundling of different reforms (Blöchliger and Vammalle, 2012).

Intergovernmental relations may help underpin property tax reform

Reforms to intergovernmental fiscal frameworks may, in turn, trigger property tax reform. In many countries, equalisation penalises tax collection because, when SCGs raise tax revenue, central government often cuts equalisation grants, which defeats the point of property tax collection. Breaking the link between equalisation and property tax collection, or at least reducing the marginal equalisation rate at which additional tax revenue is skimmed off, could give SCGs greater incentive to collect more property tax revenue. Central government might even foster the tax effort by disbursing higher intergovernmental grants to SCGs if they collect more property tax. No such scheme is currently in place, however.

Some countries have instituted property tax regimes that, at least partially, reward SCGs for collecting more property tax revenue. Fiscal equalisation in Norway does not factor in municipalities' property tax revenues, while in Germany only 64% are taken into account. In Norway, therefore, all property tax revenues stay in the jurisdiction where they were generated and in Germany over one-third do. In 2012, Finland also removed the property tax from the municipal equalisation system. The extent to which a property tax can be excluded from equalisation probably depends on how important it is as a source of revenue. In countries where it is a minor source, it is easier to exclude fully.

Personal income tax on imputed rent as an alternative to the property tax?

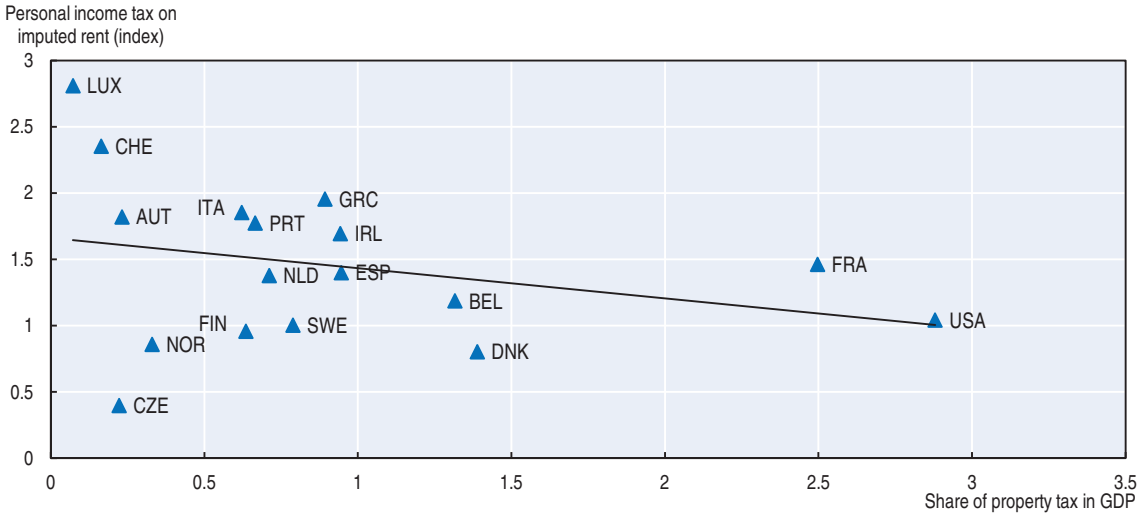
As an alternative to the property tax, immovable property may be subject to the *personal income tax*. In this case, imputed rent of owner-occupied real estate is considered personal income, as already the case for rental income. If so, then the benefit derived from

owning real estate is added to a household's other income streams – e.g. from labour – and taxed at the personal income tax rate. The taxation of immovable property as income has been examined at length in a considerable body of OECD work (Van den Noord, 2005; André, 2010; Brys, 2010; OECD, 2010; Andrews et al., 2011; Caldera Sánchez and Johansson, 2011; and Harding, 2013). This section therefore touches on the subject only summarily.

Taxing income derived from imputed rent indeed seems an alternative to immovable property tax as a way of ensuring that real estate is properly taxed. A stronger property tax tends to go together with te lighter income taxation of imputed rent and vice versa, which suggests that the two forms of taxation of immovable property are viewed as alternatives. Countries that levy a wealth tax, which includes the net value of immovable property, usually have also relatively low immovable property taxes. Nevertheless, the correlation is weak and in some countries real estate is hardly taxed at all (Figure 3.5). Making immovable property liable to income or wealth tax rather than immovable property tax produces a generally more progressive tax system because income tax rates, which are usually progressive, apply to imputed rent. The European Union also sees the income taxation of immovable property as an alternative to the immovable property tax (Gayer and Mourre, 2012).

Figure 3.5. **The personal income tax and the property tax tend to be alternatives to each other**

Immovable property tax-to-GDP ratios set against income taxation of imputed rent, 2012



Note: The vertical axis shows the sum of two indices: the extent to which mortgage interest payments are income-deductible and the extent to which imputed rent is subject to personal income tax. The mortgage deductibility index is taken from Andrews, Caldera Sánchez and Johansson (2011). The index of taxability of imputed rent is based on individual country information and takes on the value of 1 if imputed rent is taxable, 0 otherwise.

Source: Calculations based on OECD *Revenue Statistics (2014)*, *http://dx.doi.org/10.1787/rev_stats-2014-en-fr* and Andrews, D., A. Caldera Sánchez and Å. Johansson (2011), "Housing Markets and Structural Policies in OECD Countries", *OECD Economics Department Working Papers*, No. 836, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933342046

Essentially, imputed rent should be taxed jointly with personal income from other sources. If tax system provisions allow capital and labour income to be taxed at different rates, real estate may be taxed at capital tax rates, although this might distort households' incentives to shift between labour and capital income. Although mortgages should be deductible, ceilings could be applied to loan-to-value ratios to avoid excessive leverage. In order to ease the tax burden on the poor and/or liquidity-constrained households, a basic allowance which exempts part of the owner-occupied immovable property from personal

income tax could be considered. Immovable property taxes already contain such provisions. Property values and imputed rent need to be assessed in a way that puts all property and property owners on an equal footing – possibly through the use of fair market value. In sum, taxing imputed rent as personal income, but offsetting it with some limited deductibility of mortgage interest, could make immovable property taxation more politically palatable.

Taxing real estate as personal income would fundamentally change intergovernmental fiscal relations, however. While revenue from the immovable property tax overwhelmingly accrues to local government, personal income tax widely belongs to central government. A shift from property to income tax would shift revenue to national governments and strip local jurisdictions of their most important tax source of income. A partial solution could be a tax-sharing system where national government would cede part of personal income taxation to local governments. The share of income allocated to lower-tier jurisdictions could reflect different criteria, which could include the income generated from the taxation of imputed rent. Still, such a tax-sharing system would curtail the tax autonomy of sub-central governments and change their tax mix. A move from real estate to income taxation might also have redistributive consequences for all sub-national governments.

Making property tax reform happen

The political economy of reform is about the interaction between policy proposals and the procedures for adopting them. Political economy deals with the economic and political factors that influence the design, decision-making process, adoption and implementation of institutional reform – the property tax regime in the present instance – and the resulting options and constraints.

Political economy issues in property tax reform

Property tax reforms are relatively rare and piecemeal, and there are many reasons why the property tax, despite its assumed benefits, is so deeply unloved. The following political economy issues may help explain why reforms are difficult to bring to fruition:

- The property tax is capitalised in property prices and any tax hike is reflected in lower property values and higher tax payments. Since property cannot be moved, unlike income or consumption, for example, property owners resist any tax rises in their jurisdiction. And they "voice" their unhappiness at tax increases particularly strongly because there is no "exit" (Hirschmann, 1970).
- The property tax is a presumptive tax, i.e. one based on an estimated value. The need to value and assess properties sets property taxation apart from other taxes that are levied on more easily measured flows – income, sales or consumption. Unless property is sold or bought in a transaction that adequately reflects its true value, valuation and assessment remain contentious. Many countries do not update values on a regular basis. Updates of property values spark political reactions from taxpayers who demand caps and brakes on higher tax payments. Tax revolts in the United States and other countries were, and are the political reaction to rising house prices, property reassessments and unhappiness with ever-rising tax liabilities.
- The property tax is highly salient, or visible. Property taxes are usually paid once a year in retrospect and are difficult to avoid – unlike consumption taxes, which are paid continuously in small amounts, and personal income tax, withheld at source in most

OECD countries. Salience is often seen as one of the main reasons for the unpopularity of property tax and seems to drive tax revolts (Cabral and Hoxby, 2012). Yet salience improves the efficiency and accountability of the sub-central tax system since it raises taxpayers' awareness of the cost of public services. But if some taxes are more salient than others, and if voters dislike them, it is difficult to sell a reform that increases the burden of the most salient tax.

- The property tax is often seen as regressive. Although the redistributive impact of a property tax hike is unclear – it can be anything from regressive to progressive – perceived regressivity makes it difficult for politicians to sell reforms to property tax. Moreover, even if its precise redistributive characteristics are unknown, property tax is probably less progressive than personal income tax, even as an alternative to a flat sub-central surcharge on a (progressive) national income tax. An SCG tax reform package that sought to balance higher property taxation against lower personal income taxation would therefore be difficult to sell or would require even more complex changes to the intergovernmental fiscal framework.
- Property tax can be a burden on liquidity-constrained households. It is based not on cash flow, but on an illiquid asset and, moreover, on gross rather than net property values, so indebtedness (mortgages, etc.) is not accounted for. The imperfect association between household income and property tax liabilities may put an excessive burden on income-poor but housing-wealthy households, such as the elderly. One way to address liquidity issues is to offer the elderly tax relief through deferral schemes, where tax becomes payable only when the property is sold. Although tax deferral is an efficient solution to the liquidity problem, it is not yet very popular or widely used. Once again there is divergence between the economics and the political economy of the property tax.

Making property tax reform happen

The costs and benefits of any tax reform are likely to be unevenly distributed across social groups, and there will always be winners and losers. Losers tend to defend their acquired rights vigorously, while winners often have lower stakes in a reform and are often not even aware of its potential benefits. Such asymmetries might be especially important when it comes to the property tax, which is particularly salient, and immediately felt in the pocket of every home owner or tenant whenever it is increased. Property tax reform is deeply country-specific and must be carefully calibrated to fit particular circumstances.

However, a few general pointers may help increase the chances of a property tax reform being both economically efficient and politically palatable (Table 3.3.). The most distinguishing feature of the property tax is that it has a presumptive tax base. Any reform must therefore try to establish a property appraisal system that is considered fair and equitable. Country experience shows that regular market value updates can successfully brought through the political process. Additional measures for the crucial purpose of making property tax more acceptable could be means-tested exemptions for low-income households and deferrals for those that are liquidity-constrained. Salience – in itself a laudable feature because it helps taxpayers realise the cost of public services – may be addressed by allowing home owners to pay their tax in instalments. Some transitional and phasing-in mechanisms – like smoothing tax liabilities during the transition period – may be necessary to assuage opposition to reform (Blöchliger and Vammalle, 2012).

Table 3.3. **Strategies for property tax reform**

Promising and less promising approaches

Issues and problems	Promising approaches	Problematic approaches
Salience: The property tax is more visible than other taxes	Tie tax reform to improvements in local services Tax paid in instalments, tax withheld at source, and other payment options	Assessment limits Property tax capping
Liquidity constraints: The tax is a burden on the housing-rich but income-poor, especially seniors	Tax deferrals for seniors More payment options	Assessment limits Property tax capping
Perceived regressivity: Taxes can be higher as a percentage of income for low-income taxpayers	Property tax credits Tax deferrals Bundle with other tax reforms Package with expenditure changes Low-income housing exemptions	Banding Classified tax rates Progressive tax rates Assessment limits Property tax capping
Volatility: Potentially large swings in taxes for some taxpayers	Annual reassessment Indexing between reassessments Taxpayer education Information in understandable form	Assessment limits Property tax capping
Presumptive tax: The tax base is inherently arbitrary	Taxpayer education Consultation Accessible appeal process	Self-assessment Classified property tax rates Assessment limits Property tax capping

Source: Based on Bird, R. and E. Slack (2013), "The Political Economy of Property Tax Reform", *OECD Working Papers on Fiscal Federalism*, No. 18, OECD Publishing, Paris.

Property tax is a local tax. It should be in local governments' own interest to increase the revenues they derive from it and to see it reformed. Nevertheless, upper-tier governments also play a crucial role in fostering property tax reform. They largely shape the tax base and enjoy a certain scope for encouraging local governments to increase the property tax take. They may, for instance, remove the property tax base from equalisation, thereby leaving all additional tax revenue to the collecting jurisdiction. Or they may link certain intergovernmental grants to the tax effort and local property tax collection. Governments should make use of such incentives as part of their property tax reform strategies.

Notes

1. The property tax is sometimes said to be the combination of the "best and the worst of all taxes" (Vickrey, 1999). See also the Mirrlees Review (2011).
2. For example, France levies a recurrent tax both on the owner of an immovable property (taxe foncière) and on its occupant (taxe d'habitation).
3. In 2011, the German Federal Court of Justice considered the German property tax system unfair because it applied different tax values on otherwise identical properties (Schulemann, 2011).
4. Some environmental taxes such as a carbon tax might even have less harmful effects on growth, while improving welfare.
5. Henry George, 19th century political philosopher and economist, was the most influential proponent of the land value tax and the capture of land rents (George, 1881).
6. Land use may react to a land tax at the margin, however. The taxation of "polder" in the Netherlands may affect human-led transformation of sea into land and hence total land surface.
7. This is a more general problem of ecological tax reform, which has to do with the fact that ecological taxes should change behaviour but, as a side effect, generate revenue. Tensions often came into play between the ecological and fiscal objectives of environmentally related taxation, with governments interested in green taxes for fiscal rather than environmental reasons.

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ANNEX

Table 3.A.1. **The valuation of immovable property**

Assessment and valuation of immovable property, OECD countries, 2014

Country	Property tax name	Coverage			Assessment and valuation				
		Scope	Main purpose	Other types of property taxed	Valuation method	Frequency of market value updates	Last market value update	Other updating methods	Responsibility for tax base setting
AUS	NSW Land tax	Land only	Residential and business, except owner-occupied	Undeveloped land		Every three years	2014		State government
AUS	NSW Council rates	Land only	Residential and business	Undeveloped land, agricultural land	Sales prices	Every three years	2014		State government
AUT	LTA+LTB	Land and buildings	Residential and business	Undeveloped land, agricultural land			1973	Irregular updates	National government
BEL	Households	Land and buildings	Residential only	Undeveloped land, agricultural land	Income method	Every ten years	1975	Consumer price index	National and regional government
BEL	Businesses	Land and buildings	Business only	Undeveloped land, agricultural land	Income method	Every ten years	1975	Consumer price index	National and regional government
CAN	-	-	-	-	-	-	-	-	-
CHE	Canton of Berne	Land and buildings	Residential and business	Undeveloped land, agricultural land	Mix of sales prices and income		1998	Irregular	State government
CHL		Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices, cost method and income method		2009/2014		National government
CZE		Land and buildings	Residential and business	Undeveloped land, agricultural land	Area-based assessment				National government
DEU		Land and buildings	Residential and business				1935/1964	Index	National government
DNK		Land only	Residential and business	Undeveloped land, agricultural land	Sales prices	Bi-annually	2011		National government
ESP		Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices			Various indices	National government
EST		Land only, all types of land	Residential and business	Undeveloped land, agricultural land	Sales prices		2001		National government
FIN		Land and buildings	Residential and business	Undeveloped	Sales prices for land, cost method for buildings	Every five years		Construction price index	National government
FRA	-	-	-	-	-	-	-	-	-
GBR	CT	Land and buildings	Residential and business	None	Sales prices		1991		National government
GBR	NDR		Business only, including machinery	None	Sales prices, cost method and income method	Every five years	2010		
GRC	-	-	-	-	-	-	-	-	-
HUN		Land and buildings	Residential and business	Undeveloped	Sales prices	Annually			National government
IRL	LPT	Buildings only	Residential and business	None	Sales prices				National government
IRL	NPPR	Buildings only	Business only	None	Fixed lump sum		Varies		
ISL	-	-	-	-	-	-	-	-	-

Table 3.A.1. **The valuation of immovable property** *(cont.)*

Assessment and valuation of immovable property, OECD countries, 2014

Country	Property tax name	Coverage			Assessment and valuation				
		Scope	Main purpose	Other types of property taxed	Valuation method	Frequency of market value updates	Last market value update	Other updating methods	Responsibility for tax base setting
ISR	Local authorities rates	Land and buildings	Residential and business	agriculture				Consumer price index	
ITA	IMU	Land and buildings	Residential and business, except owner-occupied	Undeveloped land, agricultural land	Sales prices and cost method				National government
ITA	TASI	buildings only	Residential and business	none	Sales prices and cost method				National government
JPN	CPT	Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices and cost method	Every three years	2012		National government
JPN	MPT	Land and buildings	Residential and business, including machinery	Undeveloped land, agricultural land	Sales prices and cost method	Every three years	2012		National government
KOR		Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices	Annually			National government
LUX		Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices	no update			National government
MEX	Impuesto predial	Land and buildings	Residential and business	Undeveloped land	Sales prices	Annually	2014		
NLD		Buildings only	Residential and business	Undeveloped land	Sales prices (and other methods for business property)	Annually	2014		National government
NOR		Land and buildings	Residential and business	Undeveloped	Sales prices	Every ten years		House price index	National government
NZL		Land and buildings			Sales prices		varies		Local government
POL		Land and buildings	Residential and business	Undeveloped land, agricultural land	Area-based (residential), income method (business)				
PRT		Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices	Every three years			National government
SVK		Land and buildings	Residential and business	Undeveloped land, agricultural land					National government
SVN	DPQ		Residential and business	none					Local government
SVN	NUSZ	Land and buildings	Residential and business	Undeveloped					Local government
SWE		Land and buildings	Residential and business	None	Sales prices			Income base accounts	National government
TUR		Land and buildings	Residential and business, except owner-occupied	Undeveloped land, agricultural land	Sales prices for land, cost method for buildings	Every four years		GDP inflator	
USA	Philadelphia local property tax	Land and buildings	Residential and business	Undeveloped land, agricultural land	Sales prices, cost method and income method, depending on type of property	Annually	2013		State and local government

Source: OECD Immovable Property Tax questionnaire.

Table 3.A.2. **Property tax abatements and property tax rates**

OECD countries, 2014

Country	Property tax name	Tax abatements		Tax rates	
		Tax value set below assessed value	Exemptions	Level and variation across local governments	Progressive tax rates
AUS	NSW Land tax		Low income households		0% to 2.6% depending on property value
AUS	NSW Council rates				
AUT	LTA+LTB		Tax holidays for new buildings	No local variation	0.25% to 0.75% depending on type and size of properties
BEL	Ménages	Tax value is 140% of assessed value	Lump-sum exemption for one property; exemptions for under-use		
BEL	Sociétés	Yes	Certain businesses		
CAN	-	-	-	-	-
CHE	Canton of Berne		Low-income households	0%-1.5%	
CHL		Yes, 63% (residential), 79% (business)	Lump-sum exemption for each property; exemptions for disabled	0.98%-1.14% (residential)	Only for agricultural land
CZE					No, rate depends on type of property (CZK 1 to 6 per square metre)
DEU		Yes, 33%			
DNK				1.6%-3.4%	No
ESP		Yes	Low-income households; spending types; certain businesses	0.3%-1.3%	
EST			Lump-sum exemption for each property; low income pensioners		
FIN		Yes, 70% (buildings), 74% (land)		0.32%-0.7% (owner-occupied), 0.6%-1.35% (other)	No
FRA	-	-	-	-	-
GBR	CT	8 value bands	Various reliefs granted individually by local governments		
GBR	NDR		Lump-sum exemption for each property; low income pensioners		
GRC	-	-	-	-	-
HUN		18 value bands		No local variation	
IRL	LPT			No local variation	0.18% below, 0.25% above EUR 1 million property value
IRL	NPPR				
ISL	-	-	-	-	-
ISR	Local authorities rates		Low income households		
ITA	IMU	Yes, 50%	Low income households	0.2% (land)/0.46% (buildings) -1.06%	

Table 3.A.2. **Property tax abatements and property tax rates** *(cont.)*

OECD countries, 2014

Country	Property tax name	Tax abatements		Tax rates	
		Tax value set below assessed value	Exemptions	Level and variation across local governments	Progressive tax rates
ITA	TASI		Low income households	0.10%	
JPN	CPT	Yes	Low income households; certain spending; certain businesses		
JPN	MPT	Yes	Low income households; certain spending; certain businesses		
KOR		Yes, 60-70%	Certain spending; certain businesses	No local variation	0.1%-4%
LUX		No abatements		3.3%-100%	No
MEX	Impuesto predial	Yes			Between 0.13% and 0.33% depending on property value
NLD		No, 100%	None, except some local exemptions	0.04%-0.5%	
NOR		Tax holiday for new buildings	Each local government to decide	0.2%-0.7%	
NZL					No
POL			Low income households		
PRT			Lump-sum exemption for each property	0.80%	
SVK					
SVN	DPQ		Lump-sum exemption for one property; higher tax for under-use		
SVN	NUSZ		Low-income households; tax holiday for new buildings		
SWE		Yes, 75%			Yes
TUR		No	Low-income buildings	0.1%-0.3%, double in metro areas	
USA	Philadelphia local property tax	No, 100%	Lump-sum exemption for one property; tax holiday on new buildings, certain spending; certain businesses		

Source: OECD Immovable Property Tax questionnaire.

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Chapter 4

Taxes or grants: What revenue source for sub-central governments?

Sub-central governments (SCGs) have two main revenue sources: own taxes and grants from other tiers of government. Both revenue sources help finance sub-central public expenditure, but differ in the way they are generated and distributed. As a result, the sub-central revenue mix is likely to shape decisions at all levels of government about how, when and on what to spend money. This chapter presents the policy issues and trade-offs for both central and sub-central governments as they seek to strike a balance between own taxes and grants. The first section shows how the make-up of sub-central revenues has evolved from country to country. The second section explores the advantages of own sub-central taxation, while the third section makes the case for intergovernmental transfers. As for the fourth section, it puts forward policy options for improving the balance between taxes and grants.

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.

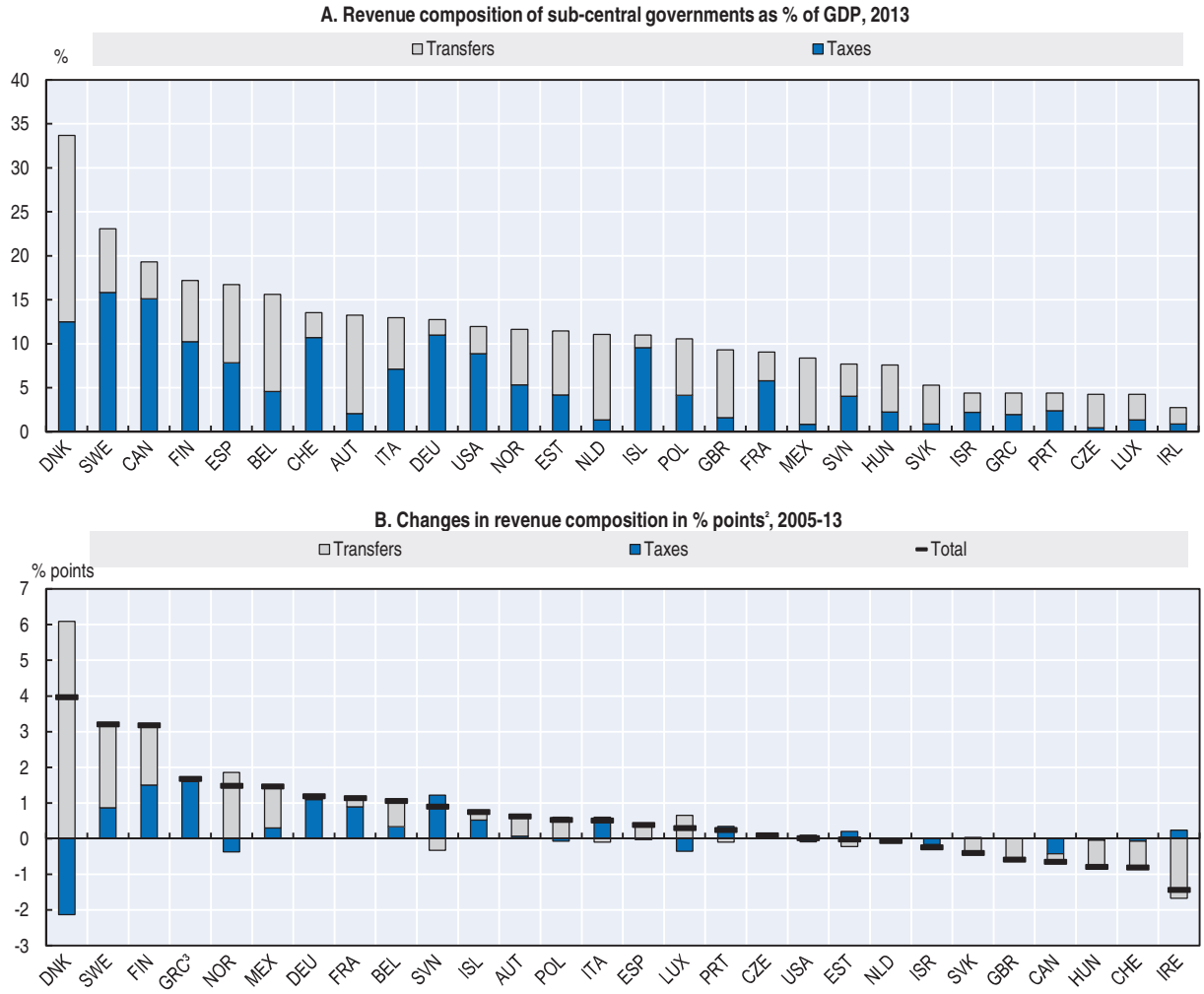
Trends in revenue composition

The composition of sub-central revenue OECD-wide has changed little over time – around half is supplied by own and shared taxes and half by intergovernmental grants.[1] The picture is very different when countries are considered individually, though. While in Iceland almost all sub-central government (SCG) revenue consists of own taxation, it comes near-exclusively from grants in the Netherlands, although those proportions should be set against the total share of sub-central revenue in general government revenue (Figure 4.1A). In federal countries, SCGs boast a slightly higher share of taxes than in unitary countries. Since 2005 the share of grants in sub-central revenue rose in most countries (Figure 4.1B). A case in point is Denmark, where own taxation shrank by more than 2 percentage points whereas transfers grew by more than 6 percentage points.

The growth of transfers was prompted by a widespread policy of decentralising expenditure. In the late 1990s and the first half of the 2000s, many countries decentralised spending responsibilities, especially in the areas of education, infrastructure and neighbourhood services, while SCG tax revenues remained largely stable. The resulting rise in the vertical fiscal imbalance – the difference between SCGs' own revenues and spending obligations – was met by ever-growing grant systems. Transfers were thus mechanisms used in response to higher SCG spending. With the onset of the economic and fiscal crisis in 2008, which affected all tiers of government, the share of SCG spending started to decline again – partly because central government brought selected functions back into its fold, and partly because its consolidation endeavours led to reduced transfers. Over the entire period, year-on-year increases in transfers as a share of SCG revenue were much more frequent and smaller than falls which, though they happened more seldom, were larger (Blöchliger and Petzold, 2009). The inference may be that transfer *growth* is systemic and creeping, while transfer *reductions* are the consequence of structural reform. After the up- and downswings of the last 20 years or so, the composition of SCG revenue is today close to where it stood in 1995.

The composition of sub-central revenue will depend on 1) how relative spending needs evolve across all tiers of government and 2) how rising sub-central needs will be met. Pressure will be felt most keenly by the tier of government which is assigned the task of meeting fast-growing needs – e.g. those related to ageing or to combating climate change. Such pressure is thus country-specific. A German study on demographic change and multilevel public finance concludes that spending pressure will be higher at central than sub-central level. The chief reason is that spending on social security, usually a central responsibility, tends to grow faster than overall expenditure. Conversely, primary and secondary education – in most countries a sub-central responsibility – will grow more slowly (Seitz, 2008). By contrast, an Austrian study claims that sub-central needs will be greater since their responsibilities in areas such as education, childcare, elderly care and transport infrastructure are growing faster than general government expenditure (Aiginger et al., 2006). A Canadian study, for its part, sees little change ahead in relative spending needs (Slack and Kitchen, 2006).

Figure 4.1. **The revenue composition of sub-central governments**[1]



Note: 1. Australia, Chile, Japan, Korea, New Zealand and Turkey are not included because one or more of the relevant data points are not available. 2. A positive value means an increase in the tax or grant share, a negative value means a decrease in the tax or grant share. 3. Denotes a comparison of revenue data for 2006 and 2013.

Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en and *OECD National Accounts Database, http://dx.doi.org/10.1787/na_glance-2015-en.*

StatLink http://dx.doi.org/10.1787/888933342057

As for the second factor affecting revenue composition, tax reforms may increase SCGs' share of total tax revenue and consequently reduce the need for intergovernmental transfers. This is the topic of the next section.

The balance between taxes and grants

The benefit of having own tax revenues

Relying on own taxes brings a number of benefits. While it could be argued that the amount rather than the composition of sub-central fiscal resources is what matters, overwhelming evidence suggests that the impact of the two fiscal arrangements on public finance and economic outcomes tends to be different. As a general rule, spending and revenues should be aligned along the Wicksellian Connection, suggesting that spending is to be largely covered by own revenue – at least for jurisdictions with GDP above the national average (Bird and Slack, 2013; Ter-Minassian, 2015). The reasons are as follows:

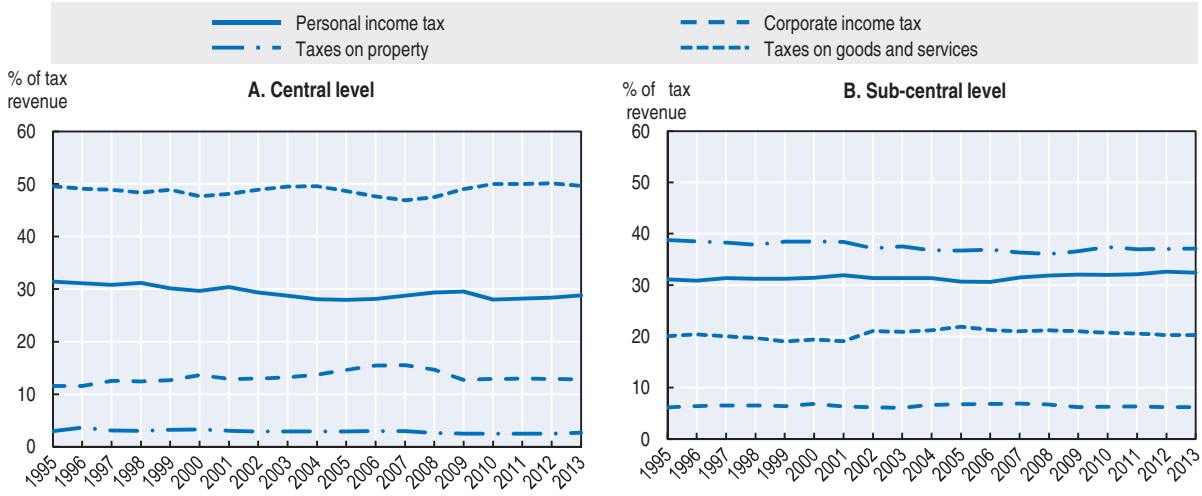
- *Autonomy*. Own tax revenue brings greater autonomy in determining public service levels. With own taxes, voters in a jurisdiction are able to define freely where and how much to spend on their public services. Tax autonomy makes particular sense in countries where tastes, preferences and attitudes towards the public sector vary according to jurisdictions – in other words, where autonomy is likely to make a difference to tax and service levels. Grants do not give SGCs much freedom to decide spending levels – and even less when earmarked for specific purposes.
- *Accountability*. Own taxes make governments accountable to their citizens, particularly through electoral democracy. SCGs which tax their own citizens are under pressure to justify their revenue sources and how and for what purposes they plan to spend. If voters feel that they are not getting what they pay for, they will say so at the ballot box. Civic engagement and political participation tend to be stronger if SCGs are financed through own taxes rather than grants.
- *Resource mobilisation*: Reliance on own tax resources may underpin overall resource mobilisation in a country. SCGs might, for example, seek to tap resources that are otherwise underutilised or overlooked by central government. Property taxes or user fees are a case in point. Income taxes, too, could – at least partially – be mobilised efficiently at the sub-central level. Assigning tax revenues to SCGs can be a means of improving tax effort and generating incentives for greater tax collection.
- *Sustainability*. Own taxes are a hard budget constraint on SCGs, making them accountable for their fiscal policy. Grants, by contrast, tend to ease the budget constraint and leave SGCs prone to overspending. There is considerable evidence to that effect in the link between transfer and spending growth. Central government caving in to sub-central demands for more grants and the so-called "flypaper effect" – a tendency for governments to spend grant money more easily than own-tax money – seems to lie at the core of the link between transfers and spending.
- *Political economy*. Most grant systems contain provisions that are not based on objective criteria. They are, in fact, the consequence of political factors such as the pressure of special interest groups, the sub-central election system, or the alignment of political parties across central and the sub-central tiers of government. Many grant systems favour certain groups or jurisdictions for no objective reason. Although sub-central tax systems are also prone to distortions that stem from special interest group pressure, they tend to be less so than grants.

In sum, SGCs could be assigned more own tax revenue. The challenge is to find the fitting taxes. While optimal tax decentralisation is quite country-specific, a few general rules govern tax assignment. They are discussed in the next section.

The current sub-central tax mix

Income and consumption taxes are central government's main sources of revenue, while property and income taxes are SCGs' (Figure 4.2A and B). That summary statement obscures the fact that within a country the sub-central tax mix is less balanced than the central tax mix. In some countries, particularly English-speaking ones, property taxes account for the overwhelming share of local taxes. Elsewhere, though, such as in the Nordic countries or Switzerland, income taxes are almost the sole sub-central tax source. As for own or shared consumption taxes, they are a significant sub-central source of revenue in a few federal countries like Canada, Germany and the United States. The tax

Figure 4.2. **Tax structure of the central and sub-central government level**



Source: OECD Revenue Statistics Database, http://dx.doi.org/10.1787/data-00262-en.

StatLink http://dx.doi.org/10.1787/888933342066

mix has changed and fluctuated little since 1995, but a salient feature up to 2007 was the gradual decline of revenue from property tax in some two-thirds of all countries. Of late, it has started growing again for cyclical and policy reasons – the principal ones being that property taxation withstood the crisis better than other taxes and that several countries implemented reforms to bolster property tax revenues. Corporate income taxes yield little revenue, as few countries boast a sub-central corporate income tax. Where there is one, it seems to have weathered cyclical downturns and inter-jurisdictional tax competition well.

Which taxes for sub-central governments?

Taxes can be ranked according to whether they are efficient, fair or redistributive, whether they produce high and stable yields, and whether administrative and compliance costs are low. The OECD studied the relationship between taxation and economic growth to rank taxes from an economic development perspective (OECD, 2010). The results suggest that, measured against per capita GDP growth, taxes on immovable property are the least distortive, followed by consumption taxes, personal income taxes and corporate income taxes. If the tax mix were to be truly revenue neutral, therefore, it would have to shift from personal and corporate income taxation towards immovable property and consumption taxes. The opposition to such reforms would, however, be considerable. Lower income tax would be contested on redistributive grounds and higher property taxes – a resolutely unloved tax – would likely be met with strong resistance from various groups.

There are a number of additional limitations on achieving a "good" sub-central tax mix. Although there is no equivalent to the empirically tested economic growth ranking described above, there is quite a broad consensus on what makes an effective sub-central tax mix. As a basic principle, SCGs should rely on *benefit taxation*, i.e. taxes where there is a link between the taxes that households and businesses pay and the public services (i.e. benefits) that they receive (Oates and Schwab, 1988). The criteria underlying the benefit principle comprise:

- SCG taxes should be non-mobile and non-redistributive (to prevent tax erosion);
- they should be non-cyclical (to stop SCGs running pro-cyclical fiscal policy);

- they should not be exported to other jurisdictions (to ensure the benefit principle is maintained);
- the tax base should be evenly distributed across jurisdictions (to avoid wide disparities and/or the need for large fiscal equalisation systems).

On the strength of these criteria, the property tax would enjoy even greater pride of place in sub-central than central taxation. Other taxes might lose out, particularly sub-central corporate income taxes, as they are mobile, highly cyclical, geographically concentrated and tend to shift the tax burden to non-residents.

The way ahead for countries seeking to increase their sub-central tax shares while reducing intergovernmental grants is rocky, but feasible:

- *Property taxes'* share of SCG tax revenue is at around 36% and was declining until recently. Hikes are much contested by taxpayers and, if the sub-central tax share were to rise, it is unlikely that property taxes could play a substantial part as a source of SCG tax revenue. And yet recent property tax reforms in Greece or Ireland demonstrate that revenues from land-related taxes can supply a greater share of sub-central revenues.
- *Consumption taxes* will continue to play a limited role as a source of revenue for SCGs. Although there are a number of proposals for sub-central consumption taxes – like destination-based dual central/sub-central VAT or a mix of central VAT/sub-central sales taxes – they are confined to large countries with large regional jurisdictions (Marè, 2007). Most countries would need to incorporate sub-central consumption taxes into tax-sharing systems, leaving SCGs no tax autonomy.
- *Personal income taxation* could supply a larger share of sub-central tax revenues. If central government were to cede some income taxes to SCGs, they, in turn, could introduce a proportional surcharge on the national income tax. Such "piggyback" taxation – practised in several countries, introduced in Belgium and Portugal over the last decade, and under discussion in Germany and the United Kingdom – would maintain benefit taxation at the sub-central level.

With a mix of taxes on immovable property, proportional income taxes and – in selected cases – consumption taxes, a revenue-neutral increase in the sub-central tax share could go hand in hand with a more efficient overall tax system and a reduction in intergovernmental grants.

Central government's role in shaping the sub-central tax mix

While a higher sub-central tax share might be desirable, central government must set a number of rules on sub-central tax policy and restrict the power of SCGs to raise certain taxes. These would chiefly relate to non-benefit taxes and taxes with externalities, i.e. those that export the tax burden to non-residents. SCGs may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for sub-central taxation. National government should therefore restrict sub-central access to taxes that fall mainly on non-residents – corporate income taxes, certain consumption taxes, natural resource taxes, etc. If the benefit principle were applied strictly, property taxes on non-residents would also become an issue, although such taxes – plus user fees and charges – may help fund services that extend across jurisdictional borders. In short, central government might wish to establish a uniform set of tax bases for sub-central governments. Another, more lenient, approach is to establish a

set of rules under which SCGs are allowed to tax certain items. A number of countries use constitutional provisions to limit SCG taxation if they feel that it harms inter-jurisdictional trade or distorts internal markets.

Intergovernmental transfers have a role to play

While a stronger link between SCGs' own spending and their own-source revenue is desirable on various grounds, there are both efficiency and distributional arguments in favour of intergovernmental grants. A certain vertical fiscal imbalance – the gap between spending needs and own revenue sources – is probably inevitable. Transfers are thus a core ingredient of most intergovernmental fiscal frameworks and likely to complement most jurisdictions' own-tax revenues.

Grants help reduce differences in tax raising capacity

A higher sub-central tax share might well be preferable on the grounds of efficiency and accountability. It is, however, likely to raise distributional concerns. Tax-raising capacity is unevenly distributed across jurisdictions and may leave some unable to provide an appropriate level of public services. Consequently, narrowing disparities in tax-raising capacity and public service provision needs between jurisdictions are considered the most important objective of intergovernmental grants (Boadway, 2007).

Most countries have explicit or implicit equalisation systems that use either vertical transfers to financially weak SCGs or horizontal transfers from the financially strong to the financially weak. For a set of 15 countries, equalisation amounts to around 2.3% of GDP, 4.8% of total government expenditure and around half of all intergovernmental grants (Table 4.1).[2] Tax revenue equalisation and cost equalisation systems are roughly the same size, despite tax revenue disparities being four to five times greater than disparities in the cost of providing public services (not shown in Table 4.1). On average, fiscal equalisation diminishes disparities in revenue-raising capacity – as measured by the Gini coefficient or variation coefficient – by almost two thirds, from 29% to 10% and virtually zero in some countries. After equalisation, fiscal disparities are clearly narrower than economic disparities, as measured by regional GDP. In other words, the ability to provide public services is more evenly distributed than economic output.

Empirical evidence suggests that a larger sub-central tax share or more sub-central tax autonomy are associated with larger fiscal equalisation systems, although the relationship is not always significant (OECD, 2007). For reasons of political economy, countries wishing to increase SCGs' share of taxes or their tax autonomy might have to think about strengthening fiscal equalisation. Be it vertical (from central government to poorer jurisdictions) or horizontal (from rich to poor jurisdictions), a well-functioning transfer and equalisation system plays a crucial role in decentralised systems. Given that around half of all transfers are currently equalising, there is ample room for improving equalisation (Blöchliger and Petzold, 2009).

Grants could help reduce inter-jurisdictional externalities

Horizontal and vertical fiscal externalities, or "spillovers", may justify intergovernmental grants on the grounds of the effectiveness of overall fiscal policy. They arise if the fiscal policy of one jurisdiction or government level affects fiscal outcomes elsewhere. Intergovernmental grants can compensate jurisdictions that are affected by such externalities, which may originate on both the spending and revenue sides of decentralised budgets.

Table 4.1. **A snapshot of fiscal equalisation**

Equalising grants and their fiscal disparity-reducing effect, 2012

Country	Gini coefficient of differences in tax raising-capacity				Ratio of highest to lowest tax-raising capacity			
	Before equalisation		After equalisation		Before equalisation		After equalisation	
	2005	2012	2005	2012	2005	2012	2005	2012
Federal/regional countries								
Australia	0.05	0.07	0.00	0.00	4.8	7.5	1.0	1
Austria			0.02	0.05			1.1	1.5
Canada	0.10	0.11	0.07	0.08	2.4	2.4	1.7	1.8
China	0.33	0.31	0.25	0.18	14.4	10.3	9.5	5.3
Germany	0.06	0.06	0.02	0.02	1.7	1.7	1.2	1.1
Italy	0.21	0.19	0.10	0.04	6.1	4.5	1.3	1.3
Spain	0.15	0.13	0.04	0.05	2.1	3.0	1.4	1.4
Switzerland	0.15	0.17	0.11	0.11	3.8	4.3	2.5	2.6
Unitary countries								
Chile (2010)		0.49		0.14		20.6		2.3
Denmark	0.08	0.06	0.04	0.03	2.2	1.4	2.0	1.2
Finland	0.11	0.12	0.03	0.05	1.8	1.8	1.1	1.4
Japan	0.20				3.2			
Norway	0.13	0.13	0.05	0.04	2.2	2.1	1.3	1.2
Portugal	0.34		0.14		12.7		2.1	
Sweden	0.06	0.07	0.01	0.01	1.4	1.5	1.1	1.1
Turkey	0.22		0.06		65.0		1.7	
Average	0.16	0.16	0.07	0.06	8.8	5.1	2.1	1.8

Source: OECD (2014), *Fiscal Federalism 2014: Making Decentralisation Work*, OECD Publishing, Paris. *http://dx.doi.org/10.1787/9789264204577-en.*

- *Spending externalities*. Spending externalities arise when an SCG's spending policy affects the residents of other jurisdictions. Examples include public services funded by one jurisdiction– e.g. infrastructure – which benefit the residents of neighbouring jurisdictions. Externalities may also arise if the spending decisions of an upper tier of government on, for example, tertiary education depends on the expenditure of a lower-level government on primary and secondary education. Jurisdictions may undersupply externality-prone services.
- *Tax externalities*. Tax externalities arise when an SCG's tax policy affects the residents of other jurisdictions. Examples include tax exporting – local and regional taxes borne by non-residents – or strategic tax rate setting (or tax competition) that affect revenues in other jurisdictions, although rate setting is not always considered an "externality". Tax externalities may also arise if different government levels tax the same tax base. Persistent tax externalities may distort the tax mix and the spatial allocation decisions of firms and residents, or they may lead to excessively high or low tax rates.

Intergovernmental grants – particularly matching grants which are determined as a percentage of sub-central spending – can offset such externalities and encourage SCGs to provide adequate levels of public services. Or they compensate them for the tax policies of other jurisdictions. However, the rationale for grants as an anti-externality device is not always clear-cut and seems to be relevant only in a limited number of countries with a specific institutional and fiscal background.

- Horizontal tax externalities can play a role if SCGs enjoy strong powers of taxation *and* rely significantly on sales taxes – which is very much the case in the United States, where autonomous sales taxes account for 50% of state and 20% of local tax revenue.

Studies estimate those externalities at between 0.5 and 5% of total tax revenue (OECD, 2005). However, rather than use grants to correct such externalities, policy should reform the tax system by replacing SCG sales taxes with a sub-central value added tax or by incorporating SCG indirect taxes in a tax-sharing system. Australia, in 2000, and Mexico, in the 1980s, reformed their consumption tax systems accordingly, although they also reduced sub-central fiscal autonomy at the same time.

- Horizontal spending externalities are relevant in countries where SCGs boast considerable spending power. In tertiary education, for instance, the geographical mobility of students could deter SCGs from investing in universities. Another example is transport infrastructure where inter-jurisdictional externalities (or spillovers) could lead to underinvestment by sub-central governments (Sutherland et al., 2009). A number of Swiss studies estimate spillovers for various municipal services at between 8% and 5% of total municipal expenditure (OECD, 2002). Since Switzerland is a benchmark for both jurisdictional smallness and spending decentralisation, those percentages could hold as an upper limit for OECD countries. In Canada, spending externalities appear to be negligible (Smart, 2005). Moreover, some spillovers tend to cancel each other out, which gives affected jurisdictions an incentive to negotiate horizontal compensation agreements.[3]
- Vertical spending externalities arise when the policy outcomes of one government level relies on those of another. Tertiary education – often a higher-tier government provision – relies on the performance of primary and secondary education, mostly provided by lower-level governments. Central government may subsidise SGCs' spending on primary and secondary education when it assumes that they do not invest sufficiently in preparing students for higher education. Other services where vertical spending externalities might occur include healthcare and infrastructure. However, the few existing empirical studies suggest that SCGs do supply adequate levels of core services and, in some cases, even tend to overspend (OECD, 2005).[4]
- Vertical tax externalities arise if central and sub-central governments tap the same tax base. Concurrent taxation is pervasive in many OECD countries, resulting in externalities where one government level fails to factor in the impact of its tax policy on another government level. Tax externalities are particularly relevant if all tiers of government tax mobile bases like those of personal or corporate income (Keen and Kotsogiannis, 2002). However, since it is not clear which government level is actually responsible for vertical externalities, the question of who has to compensate whom remains moot, and grants could just as easily flow from the sub-central to the central level. If governments feel that concurrent taxation creates externalities, intergovernmental consultation and changes to the tax framework rather than compensating grants are the appropriate solution.

Actually, the extent of fiscal externalities is much smaller than the transfers supposed to address them. Earmarked matching grants plus discretionary earmarked grants (often of a matching nature, too) account for around 54% of intergovernmental grants and around 18% of total sub-central spending for both SCG levels taken together (see Figure 1.10 in Chapter 1). These percentages are well above almost any externality identified in an OECD country. Moreover, matching rates – the percentage at which a specific sub-central spending item is subsidised – are typically much higher than can be justified by plausible externality levels in most countries. If intergovernmental grants are going to be implemented or reformed on the basis of intergovernmental fiscal externalities, the size and nature of the externalities should be thoroughly assessed.

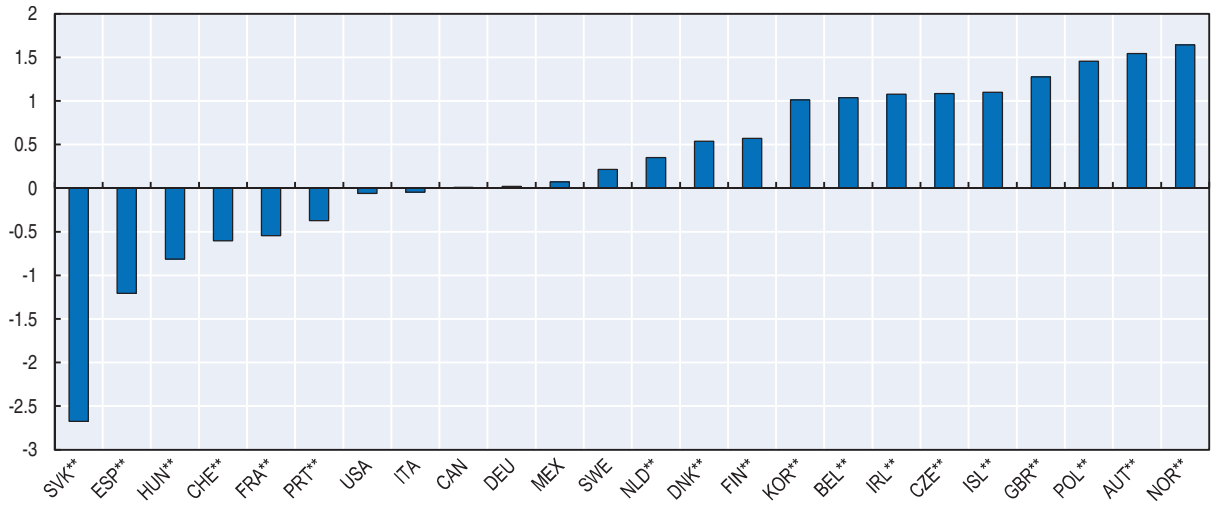
Grants could stabilise sub-central revenue, but often do not

Intergovernmental grants could ensure that SCGs' total revenues remain stable over the business cycle, thereby compensating for own-resource revenue fluctuations. And they would absorb tax revenue volatility and act as insurance against asymmetric shocks. Seen from the perspective of central government, transfers could, in fact, act as automatic stabilisers. Indeed, properly designed, sub-central tax revenues and grants would be inversely related: abundant tax revenues would combine with lower grant allocations and vice versa, and aggregate sub-central revenues would be less volatile than sub-central tax revenue alone.

In practice, however, many intergovernmental transfer systems do not have those stabilisation properties. In 2013, the Fiscal Network conducted an empirical study whose findings suggested that, in many OECD countries, grants tended to exacerbate fluctuations in SCG revenue or GDP rather than damping them (Figure 4.3). Overall, a 1 percentage point *increase* in the output gap – a measure of economic slack – *reduces* transfer growth by between 0.6 and 0.8 percentage points (Blöchliger and Égert, 2013). Although the destabilising effect seems a little stronger in countries with large transfer systems and a relatively stable tax base (like the property tax), no clear pattern has yet emerged. Since consolidation started in 2010, transfers have begun to exert a slightly stabilising effect – in other words, central government has partially compensated SCGs for their falling own-source revenues, especially in unitary countries (Foremny and von Hagen, 2013).

Figure 4.3. **How transfers have responded to the size of the output gap**

1970-2009



Note: The columns show the percentage point changes in transfer growth in each country when the output gap increases by 1 percentage point. A negative value means an anti-cyclical transfer system, while a positive value means it is pro-cyclical. Values for countries denoted by a double asterisk (**) or a single one (*) are significant at the 5% and 10% levels.

Source: Blöchliger, H. and B. Égert (2013), "Fiscal Consolidation across Government Levels – Part 3. Intergovernmental Grants, Pro- or Counter-cyclical?" *OECD Economics Department Working Papers*, No. 1072, OECD Publishing, *http://dx.doi.org/10.1787/5k43nxqrlmtf-en.*

StatLink *http://dx.doi.org/10.1787/888933342070*

What are the underlying forces that cause many intergovernmental grant systems to exert a destabilising effect?

- Some grant formulae contain an element of tax sharing – in other words, total grant spending is partially a function of central or sub-central tax revenue. And since tax

revenue tends to move with the cycle, spending on transfers also becomes pro-cyclical. The fact that the nature of some transfers is akin to tax sharing – in Austria, Japan, Korea and Mexico, for example – could explain their destabilising impact on sub-central revenue.

- Matching grants, which account for 40% of all grants, make grant allocation a function of sub-central spending. The more a SCG spends, the more transfer revenue it gets. So, if SCG spending varies positively with the cycle, then matching grants become pro-cyclical. The matching character of transfers might go some way towards explaining pro-cyclicality in Ireland and the United Kingdom.
- Equalising transfers usually rely on a fiscal capacity indicator, where grant allocation is determined by the difference between an individual SCG's fiscal capacity and the national average. This average tends to move with the cycle. If recipient SCGs have, on average, weaker cycles than the country, the difference between the national average and an individual SCG's fiscal capacity tends to become destabilising – which could explain pro-cyclical equalisation in Canada and Germany even though pro-cyclicality is weak.
- Finally, pro-cyclical transfers can be politically driven. Revenue buoyancy tends to be associated with higher spending, including spending on intergovernmental transfers (Joumard and André, 2008). Since roughly 20% of all transfers are not formula-based but can be increased or cut at the discretion of central government, grants can be adapted to changing budget conditions and become pro-cyclical.

If central government transfers exacerbate fluctuations in the revenue of SCGs, their budgets become more difficult to manage over the cycle. And sub-central fiscal policy becomes even more pro-cyclical if fiscal rules cap SCG spending or borrowing – a common practice in most countries, at least for current spending. SCGs could also react asymmetrically to excessive revenue fluctuations by raising expenditure when times are good and increasing tax rates or borrowing when they are bad, thereby inflating the size of government and the public sector in the long run (Rattso and Tovmo, 1998).

There are a number of ways to reduce pro-cyclical fluctuations in intergovernmental grants and strengthen their automatic stabiliser properties.

- *Grants should be needs-based*. To avoid excessive sub-central revenue volatility, transfers should, as a general rule, be linked to SCGs' effective needs, measured by tax raising capacity or the standard cost of providing services.
- *Grants should be decoupled from central government tax revenue collection*. Decoupling grants from central government tax revenue collection prevents the tax system's pro-cyclicality from being transmitted to grants.
- *Matching grants should be limited*. Limiting the percentage of matching grants would be an effective way of breaking the link between central and sub-central spending, which could help ease pro-cyclical pressures on central government transfer spending.
- *Horizontal equalisation*. Horizontal equalisation schemes tend to be less prone to cyclical fluctuations than vertical ones, so switching to them could improve the stabilisation properties of transfers.
- *Grant entitlements could be lagged*. The use of lagged variables in determining SCGs' grant entitlements may reduce excessive revenue volatility, although the resulting grant systems might not be flexible enough to respond to rapidly changing sub-central needs.

Grants can have unintended consequences

Intergovernmental grants constitute a "common pool" resource for an individual jurisdiction. A SCG that receives a grant or increased grant allocation enjoys its full benefits, yet bears only a fraction of the cost of the additional tax revenue or borrowing required by central government to finance the grants or grant increase. Moral hazard can work through several channels, affecting not only fiscal outcomes such as SCGs' own-tax revenue, expenditure, deficits and debt, but the size of the transfer system itself.

- *Grants may reduce the sub-central tax effort*. In most countries, grants provide a minimal fiscal endowment for low-income jurisdictions in inverse relation to their fiscal capacity. While such equalising grants are justified on the grounds of equity, they might discourage SCGs from raising their own tax revenue since, if they do, their grants are reduced. This "equalisation tax", "compensation rate" or "tax on tax revenue" accounts for as much 80% or 90% of additional sub-central tax revenue in some countries. Because the more a jurisdiction lags behind the national average, the higher the equalisation tax usually is, the reluctance to raise own-tax revenue can be particularly pronounced in the poorest jurisdictions.
- *Grants may put pressure on spending*. In most countries, the cost of a jurisdiction's services provision explains a share of the grant it receives. Grant formulas usually factor in specific unit cost and the number of service units produced or consumed in a jurisdiction. SCGs therefore have an incentive to manipulate those figures to obtain more grants. Moreover, many grants are matching, so an allocation increases if a SCG spends more on the matched service. Since cost-based grant systems often rely on a multitude of indicators, and so tend to be complex, they are prone to rent seeking and pressure from special interests. Country studies suggest that political economy forces exert considerable influence on the size and structure of grant allocation (Blöchliger and Charbit, 2008).
- *Grants may increase deficits and debt*. The grant system may negatively affect sub-central fiscal balance and trigger the self-perpetuating growth of deficit and debt. Empirical evidence suggests that central government's commitment to a certain level of transfers is not always credible, prompting SCGs to overspend or under-tax in the hope that they will receive additional transfers (Aldasoro and Seiferling, 2014). In that event, the growth of transfers becomes endogenous – higher deficits bring about more grants, and more grants bring about higher deficits (de Mello, 2007). What's more, the grant-debt relationship might be asymmetric: cuts in grants might be associated with higher debt issuance, but grant increases are not necessarily associated with debt repayment (see Martell and Smith [2004] on the United States).

A skilfully designed transfer system (Box 4.1) can reduce fiscal slippage across levels of government. However, with grants still a common-pool resource for the individual SCG, disincentives cannot be avoided, even if they can be limited.

Box 4.1. **Well-designed grants at a glance**

Countries have developed several approaches to containing the negative side-effects of their intergovernmental transfer systems (Bergvall et al., 2006; Blöchliger and Charbit, 2008). They can be divided into three groups of measures that sometimes overlap.

Box 4.1. **Well-designed grants at a glance** *(cont.)*

1. *Measures on the tax revenue side*. It is possible to step up the tax effort if the potential tax base, rather than actual tax revenue, is used to assess SCG tax capacity. Many countries use a representative tax system (RTS), where potential revenue from each sub-central tax is determined by multiplying a standard tax base by a standard tax rate. Some may also use revenue from a central tax to assess sub-central tax capacity. A RTS should cover the major sub-central taxes. Alternative indicators for assessing potential tax capacity include sub-central GDP or household income (a macroeconomic approach). RTS can help curb strategic behaviour and prevent SCGs from manipulating tax capacity indicators in order to obtain more grants.
2. *Measures on the grant side*. Spending pressure can be reduced if grant allocation is based on a few broad-based indicators that measure geographic, demographic or socio-economic needs. The use of fewer indicators to determine principal sub-central needs tends to be more transparent and to make the allocation of entitlements less of a statistical headache. Indicators should be outside sub-central control to prevent any manipulation. Most countries today use standard or norm cost approaches whereby grant allocation is independent of a SGC's incurred expenditure. And it is possible to improve spending performance by disentangling grants that serve several purposes at once – e.g. subsidising SCG services and equalising SCG disparities – and developing separate ones.
3. *Institutional measures*. Finally, institutional reform can help contain grant-related budget drift. Some countries set transfer caps irrespective of sub-central financial needs. Having independent agencies and other arms' length bodies manage grant distribution can help channel transfer increases and ease pressure from special interests. An adequate set of budget management rules can also improve fiscal discipline. A number of countries show intergovernmental grants as a single, separate budget item, thereby increasing transparency. A two-stage budget procedure, in which negotiation of the overall grant budget is separate from the distribution formula, can also offset pressure from special interests.

Summary and conclusions

Across the OECD, own-tax revenue covers some 50% of sub-central government spending and intergovernmental grants the other half. Transfers have slightly increased their share over the last two decades with a peak in 2005. In several countries, own-tax revenue's contribution to sub-central spending is small, which binds the fiscal policy of central and sub-central governments closely together. A higher own-tax share would make SCGs more efficient and accountable and help mobilise resources at the state/region and local level.

Intergovernmental grants still have a role to play. They help reduce disparities between jurisdictions in tax revenue per capita and costs of service provision and they address fiscal externalities, particularly the under-provision of certain collective goods. Yet, for that dual purpose, they would have to be only around half their current size. And not only are they larger than they have to be, they are often pro-cyclical, too, exacerbating rather than easing SCG revenue fluctuations. Hence the need to reform both taxes *and* grants if intergovernmental fiscal frameworks are to be more effective.

To make sub-central funding more effective, countries can go in three main policy directions:

- *Increase the share of own taxes in the overall funding of sub-central governments*. Countries, particularly those where the share of own-tax revenue (or else user fees) in overall sub-central revenue is low, should seek to increase it. A few countries could increase the sub-central own-tax share by as much as 15 percentage points. In order to address distributional concerns arising from stronger sub-central taxation, more effective fiscal equalisation might have to be put in place.
- *Assigning the right taxes to the right sub-central jurisdiction*. Not all taxes are equally suitable for SCGs. While tax reform would help increase the share of immovable property taxes in the total tax take, they would probably not cover all sub-central spending needs. Personal income tax would likely have to complement them. The most common form of sub-central income taxation is a flat rate added to a reduced central government income tax (so-called "piggyback" taxation). Countries with large SCGs might be able to assign some indirect taxes to them.
- *Reforming the grant system*. Regardless of the issue of increased own-source revenue, the grant system itself might warrant reform. As a rule, grants should be linked to SCG needs, measured against the yardsticks of tax-raising capacity or objective spending obligations, and can be disbursed subject to performance (conditionality). Grant allocation indicators should be immune to sub-central manipulation and non-equalising grants reduced. And institutional measures should ensure that the overall size of the grant system reflects voters' preferences.

Notes

1. Other revenue sources – user fees, property income – are not taken into account.
2. Since some equalisation systems work via tax sharing not reported as intergovernmental grants, the share of equalising transfers in total transfers is likely to be lower than 55%. Moreover, many grants reported in Table 4.1 as "equalising" consist of both an equalising and a neutral part, with the neutral part often larger than the equalising part.
3. Around 3% of SCG spending is covered by grants from other jurisdictions of the same government level. This type of grants usually reflects horizontal compensation agreements.
4. Swiss cantons seem to provide excessive hospital care compared to what the federal level would do if it was responsible for this service (Steinmann et al., 2003). Some regions in Spain appear to overspend on transport infrastructure to lure economic activity (e.g. Delgado and Alvarez, 2007).

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Chapter 5

Monitoring sub-central government debt: Trends, challenges and practices

OECD-wide, sub-central government debt accounted for 13% of GDP and 17% of total public debt in 2013. This chapter begins by examining the main drivers of sub-central government debt, explains why it is important to monitor debt, and surveys monitoring practices in OECD countries. The chapter then goes on to explore the main challenges that governments face when they design monitoring mechanisms and identifies policy options. The chapter explores in detail how mechanisms to monitor sub-central government borrowing – e.g. fiscal rules or direct control – work in OECD countries. It also provides an overview of data requirements and accounting procedures at all levels of government. Finally, it considers insolvency procedures and other mechanisms for dealing with sub-central governments in financial distress. The chapter draws on an OECD Fiscal Network survey of sub-central fiscal rules and macroeconomic management conducted in 2013.

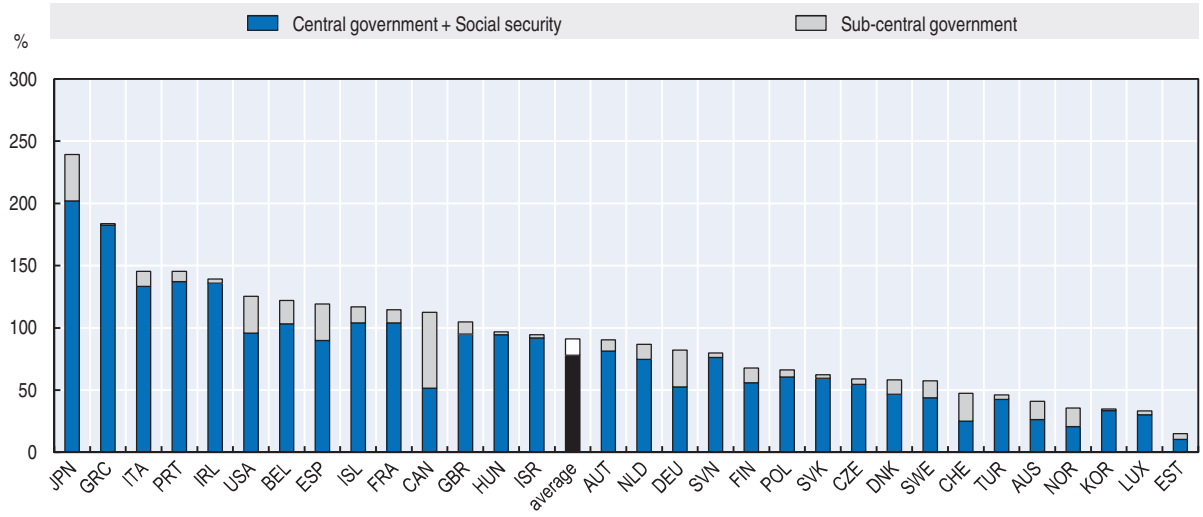
The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

The drivers of sub-central government debt

Why should central governments monitor sub-central government debt?

Sub-central government (SCG) debt – the debt of state or regional and local jurisdictions – accounted for some 13% of GDP and 17% of total public debt on average in OECD countries in 2013 (Figure 5.1). It also rose at a much slower pace than central government debt in the wake of the 2008 crisis. However, although sub-central debt is lower than general government's, it must also be seen in relation to its revenues.

Figure 5.1. **The composition of public debt as a share of GDP, 2013**



Note: 2012 data for Korea and Switzerland. All countries use consolidated data in compliance with the SNA08 standard apart from Switzerland, the United Kingdom, the United States (non-consolidated, SNA08), Canada, Turkey (consolidated, SNA93), Japan, Korea (non-consolidated, SNA93).

Source: OECD National Accounts, http://dx.doi.org/10.1787/na_glance-2015-en.

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There are a number of reasons why sub-central debt policy is an issue that concerns all governments and why it is important to monitor and manage debt well.

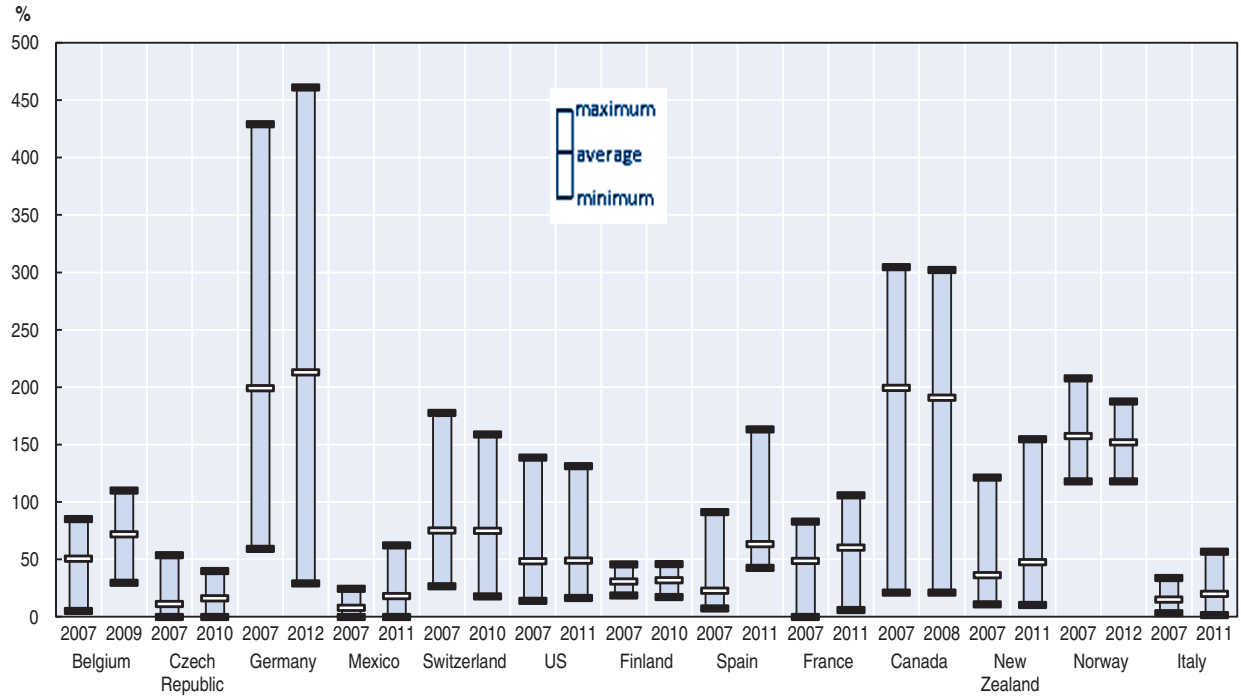
- *Externalities*. Debt creates externalities in all tiers of government. In other words, sustainability is determined by the joint action of all governments, and financial difficulties at one level of government can affect the others. The dynamics of this common pool problem are even more pertinent if discontinuities or threshold effects are present, i.e. if interest rates suddenly rise or growth starts falling once general government exceeds a certain level of debt, or if fiscal fatigue sets in (Fall et al., 2015). The risk of contagion can disrupt financial markets as even the problems of small SCGs can have a big impact on financial markets. Moreover, SCGs often own public enterprises whose debt is not accounted for in the national accounts, thereby creating contingent liabilities. Finally, in

most countries, central government is held politically responsible for SCG debt, with a bailout implicitly or explicitly guaranteed.[1] Safe in the knowledge of a bailout, SCGs may engage in unsustainable fiscal policy, so increasing general government debt.

- *Limited sub-central capacity*. SCGs enjoy less autonomy than central government. One reason is that their revenue bases are smaller and their power to increase revenues is usually limited, as they have little or no power over tax rates or tax bases. Another factor is that an important share of SCG expenditure is mandatory and/or difficult to cut, and cuts entail high social and political costs. A large share of sub-central spending is on critical sectors such as education, health and social protection. Moreover, spending is expected to rise due to demographic factors. Finally, the rules and standards of SCG expenditure are often set by higher tiers of government, which affords SCGs little leeway for cutting spending.
- *Wide variations across SCGs*. Average levels of sub-central debt can be misleading, as there are wide disparities between SCGs within countries (Figure 5.2). In most countries, the debt levels of some SCGs are far above the national average, which suggests that the issue of debt sustainability is more important for some SCGs than for others.

Figure 5.2. **How sub-central debt-to-revenue in regions/states is dispersed**

Debt as a percentage of revenues, various years



Note: Accounting standards used for calculating debt differ between countries, limiting comparability to some extent.
Source: OECD Network on Fiscal Relations across Levels of Government and Territorial Development Policy Committee Questionnaire on Regional Finances, 2013.

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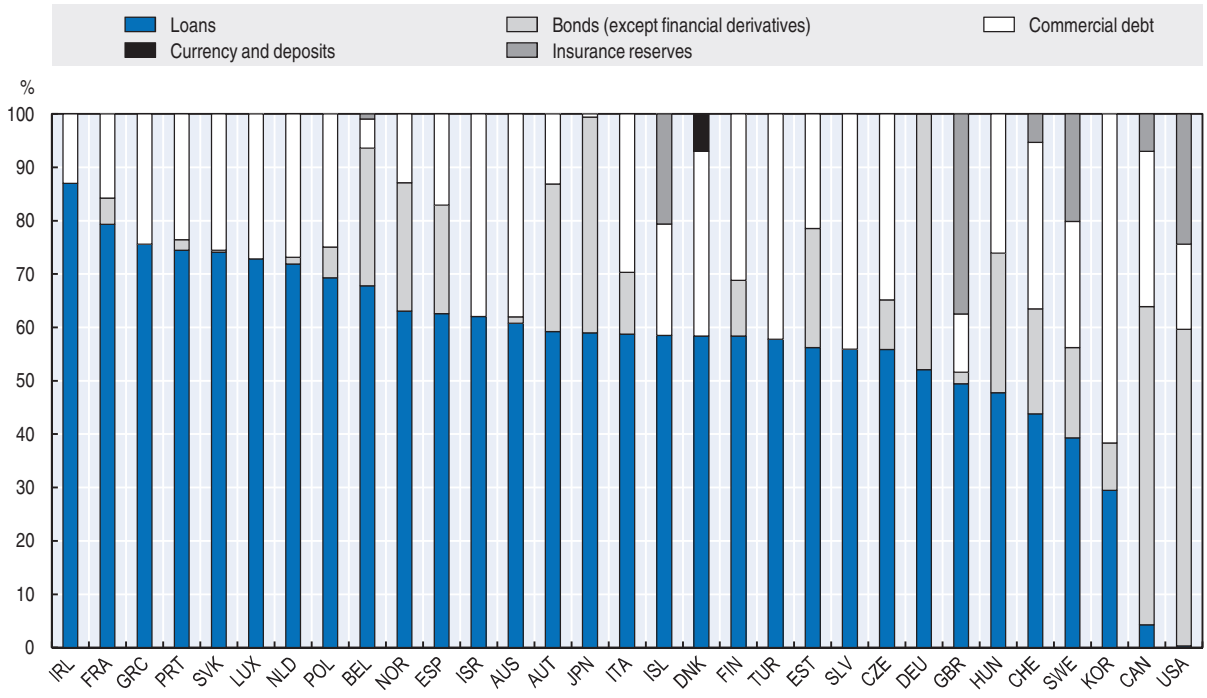
Who lends to sub-central governments?

The OECD National Accounts distinguishes five categories of debt, classified according to the different types of creditors. SCG debt varies widely in all the categories from one country to another, affecting the volatility and cost of sub-national debt (Figure 5.3).

Figure 5.3. **Composition of sub-central debt, 2013**

Percentage of total debt



Note: Data for Korea and Switzerland relate to 2012. All countries use consolidated data in compliance with the SNA08 standard except Switzerland, the United Kingdom, the United States (non-consolidated, SNA08), Canada, Turkey (consolidated, SNA93), Japan, Korea (non-consolidated, SNA93).

Source: OECD National Accounts, http://dx.doi.org/10.1787/na_glance-2015-en.

StatLink http://dx.doi.org/10.1787/888933342107

Overall, though, loans, bonds and commercial debt are the three most widely used by SCGs. *Loans* by the central government, commercial banks or SCG-related banks account for the largest share of SCG borrowing. In many countries, *commercial debt* is also large although it seldom exceeds 50% of total debt, apart from the case of Korea. *Bonds* make up a large share of SCG debt in federal and quasi-federal countries, but a low or no share in most other OECD countries. The share of debt for which bonds and loans account began rising in the mid-1990s, while commercial debt increased only during the 2007 global financial crisis as a result of deteriorating SCG finances.

Commercial banks are the main loan providers and often the only source of loans (Table 5.1). In the wake of the crisis the Spanish central government replaced banks as the main lender for the regions with the Regional Liquidity Mechanism, which represented nearly 40% of regional debt in late 2014. In Ireland and the United Kingdom, central government is also a large lender, which facilitates monitoring. Lastly, SCGs in the Nordic and many federal countries are funded in large part through specific financial institutions which are either directly owned by sub-central governments or enjoy close relationships with state/regional or local authorities (Box 5.1).

Table 5.1. **The institutions that lend to sub-central jurisdictions**

Percentage of lenders, 2011

	Loans from central government	Commercial bank loans	Loans from banks related to SCGs
Czech Republic	0.4	99.6	0
Denmark	0	0	100
Estonia	0	100	0
Finland	0	100	
France	0	100	0
Germany (local)	0.7	41.7	57.6
Greece	0	100	0
Hungary	0	100	0
Ireland	85.4	14.6	0
Poland	10.9	89.1	0
Slovak Republic	37.4	62.6	0
Slovenia	0	100	0
Spain (state)	0	100	0
Spain (local)	0	100	0
Switzerland (state)		100	
Switzerland (local)		100	
UK (English Local Authorities)	81.3	18.7	0
UK (Devolved Authorities)	100	0	0

Source: OECD Network on Fiscal Relations across Levels of Government – Survey on Sub-national Fiscal Rules and Macroeconomic Management, 2015.

Box 5.1. **Municipal funding in the Nordic countries**

Sub-central governments in Denmark, Finland, Norway and Sweden have long established municipal funding agencies that provide low-cost funding. As a result, SCGs in those countries are less dependent on capital markets than those elsewhere. The four main municipal funding vehicles are: KommuneKredit (Denmark), KBN Kommunalbanken (Norway), KommuninvestiSverige AB (Sweden), and Municipality Finance PLC (Finland). These institutions were created at different times (in 1898, 1926, 1986 and 1989, respectively) and have different organisational structures. However, they share many similarities:

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

Nordic municipal funding vehicles were particularly helpful during the recent financial turmoil, as they prevented disruption in the financing of sub-national governments. At the end of 2008, loans granted by Finnish, Swedish, Norwegian and Danish agencies accounted for 5.1%, 2.8%, 3.8% and 3.9% of GDP, respectively. Similar agencies were created in France, New Zealand and the Netherlands, and are planned in England.

Source: Vammalle, C., D. Allain-Dupré and N. Gaillard (2012), "A Sub-national Government Perspective on Fiscal Policy in a Tight Fiscal Environment", in OECD and KIPF, *Institutional and Financial Relations across Levels of Government*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/9789264167001-3-en*.

The main drivers of sub-central debt

Designing an efficient monitoring mechanism requires understanding the drivers of sub-central debt. SCG deficits and debt have three main causes:

- *Structural mismatch between SCG spending obligations and allocation of revenues*. Sub-central deficits and debts may be the result of impaired fiscal relations between levels of government, where the revenues assigned to SCGs are structurally insufficient to cover their expenditure responsibilities. The result is structural sub-central deficits or under-provision of public goods.
- *Economic downturns can generate temporary sub-central deficits*. Economic downturns contribute to the build-up of SCG debt. While sub-central spending obligations tend to be stable over the economic cycle, their revenues are more often pro-cyclical. As growth recovers, short-term debt should disappear.
- *SCGs may be subject to soft budget constraints and moral hazard*, causing them to over-spend and issue debt in the expectation that upper-tier government will increase transfers to them or bail them out in the event of financial difficulty. Monitoring mechanisms can be one useful way to prevent structural deficits and the accumulation of SCG debt.

Policy measures to address sub-central debt depend on how it originated. Rainy day funds can be a good tool for smoothing out revenues over the cycle, thus preventing SCGs from issuing debt to compensate for falls in revenue (Box 5.2). The formulas used for allocating grants are also crucial. If they are based on current revenues and GDP growth, for example, they can be pro-cyclical. And, on the contrary, if they are based on true sub-central

Box 5.2. **Using rainy day funds to smooth the cyclicality of revenues**

Several countries have introduced so-called "rainy day" funds for sub-national governments. They set aside reserves in the funds in periods of growth and disburse them in times of fiscal stress. Rainy day funds are an alternative to the cyclical "optimisation" of SCG revenue sources for reducing the volatility of sub-national revenues.

Nearly all US states have introduced some form of stabilisation fund over the last two decades, with tight rules regulating the size of their funds. Most states require that the total accumulated amount of deposits in a fund should not exceed 5% of their budget. Other states set a 10% cap, and a few states put no limit on the reserves they can build up. Research tends to find that rainy day funds reduce the volatility of SCG revenues and expenditure (e.g. Sobel and Holcombe (1996), Gonzalez and Paqueo (2003), Wagner and Elder [2005]), but they have not proven sufficient to cope with crises as deep as that of 2009-10 (Blöchliger et al., 2010).

US cities also benefit from a sort of rainy day fund called "ending balances" to smooth fluctuations in revenues. In contrast to states' rainy day funds, there are no trigger mechanisms to force the release of the funds. In 2012, a report estimated that ending balances accounted for 12.7% of cities' expenditures (down from 25% prior to the recession).

In Sweden, county councils have been allowed to build up reserve funds to transfers budget surpluses from one year to another since 2013.

In Mexico, the central government is responsible for the *Fondo de Estabilization de Ingresos de las Entidades Federativas* (FEIEF). This fund is used to provide the federal entities with additional revenues when grants from the central government are reduced in times of fiscal stress.

Source: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A Sub-national Perspective on Financing Investment for Growth II – Creating Fiscal Space for Public Investment: The Role of Institutions", *OECD Regional Development Working Papers*, No. 2014/06, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5jz3zvxc53bt-en*.

needs they can help smooth the cycle (Blöchliger and Égert, 2012). So can the allocation of expenditure if central government assigns areas of least cyclical spending, such as education, to SCGs. Also used are off-budget funds, ad hoc increases of central government transfers and cuts in mandated expenditure (Table 5.2).

Table 5.2. **Mechanisms to protect SCGs against cyclical revenue fluctuations**

	Rainy day funds	Off-budget funds	Higher revenues from CG offsetting projected fluctuations	Higher revenues from CG offsetting actual fluctuations	Special financial support for SCGs facing budget difficulties	Cuts on mandated expenditure	Allocation of less cyclical expenditure
Australia local			x				
Australia state				x			
Austria local							x
Austria state		x					x
Belgium local							
Belgium state							x
Canada local	x						
Canada state	x	x	x				
Chile					x		
Czech Republic		x					
Denmark			x				
Estonia					x		
Finland	x	x	x			x	
Germany local	x		x	x	x	x	
Germany state	x	x				x	
Ireland			x				
Italy local						x	
Italy state						x	
Korea							
Mexico local	x			x	x		
Mexico state	x			x	x		
New Zealand							
Poland							
Slovak Republic		x					
Slovenia							
Spain local				x			
Spain state				x			
Sweden	x					x	
Switzerland local	x						
Switzerland state	x						
Turkey							x
Total answers	10	6	6	6	5	6	4

Source: OECD Network on Fiscal Relations across Levels of Government – Survey on Sub-national Fiscal Rules and Macroeconomic Management, 2015.

The drivers in the growth and composition of aggregate SCG revenues since the mid-1990s seem to be both cyclical and structural in nature. SCGs have suffered from several economic downturns which increased growth in their expenditure and reduced that of revenues. Moreover, SCG expenditure saw a gradual shift towards more spending on social benefits and other transfers, as decentralisation shifted social protection responsibilities to SCGs. Their increased share in SCG spending may have reduced the flexibility of sub-national budgets. Social protection tends to be rather pro-cyclical and the trend therefore seems likely to generate extra SCG debt over the medium term. Still, there appears to be currently no structural, long-term mismatch between SCG spending obligations and revenues.

Central government is usually well aware of the challenges faced by sub-national finances through upward pressure on social spending, particularly in the areas of health and old age pensions. A few countries have implemented reforms to increase efficiency in spending. In recent years, for example, fiscal federalism reforms to relieve pressure on SCGs have been undertaken. They include the health reform and municipal mergers in Denmark in 2007 and the pension reforms for Japanese provinces in 2005. However, other reforms, like the latest reform of the Belgian fiscal federalism system in 2012-13, transferred responsibilities for health and pensions from central government to the sub-national authorities and so are likely to put further long-term pressure on SCG budgets.

Mechanisms for monitoring sub-central debt

Most central governments monitor sub-central debt. Monitoring mechanisms range from pure reliance on market discipline, with no oversight from central governments, to direct control by higher levels of government of the amount and purpose of debt issued by SCGs. Fiscal rules lie somewhere between the two extremes, as they set limits on and conditions for SCG spending, though they do not call for an examination of each loan request by SCGs. This section describes the practices used in OECD countries and the choices they must make when designing a system for monitoring SCG debt.

Market discipline

In the context of market-based discipline, banks and financial markets assess the creditworthiness of SCGs who wish to borrow or issue debt. They then impose higher borrowing costs on the more risky ones. The idea is to give borrowers an incentive to improve their solvability by reducing spending or raising revenues. Pure reliance on financial markets to exert fiscal discipline on SCG borrowing is rare in OECD countries. One exception is Canada where provinces do not follow any federal procedure for issuing debt and they are not subject to any federal borrowing limits.

For market discipline to work, a number of conditions need to be satisfied. First, markets should be open and financially deep and should afford no privileges to SCG debt. Adequate information about the borrower's outstanding debt and re-payment capacity should be available to potential lenders, central government's no-bailout commitment should be credible, and the borrower should have sufficient capacity to ensure a proper policy response to signals from the market before being excluded. In practice, it appears that the conditions above are rarely met, which impairs the effectiveness of market discipline (Box 5.3). A look at the credit ratings of SCGs and their yields reveals a clear lack of monitoring by financial markets. SCG ratings are very closely linked to their sovereign, and SCGs in the same country tend to receive a similar rating, irrespective of their own financial health (Vammalle and Hulbert, 2013).

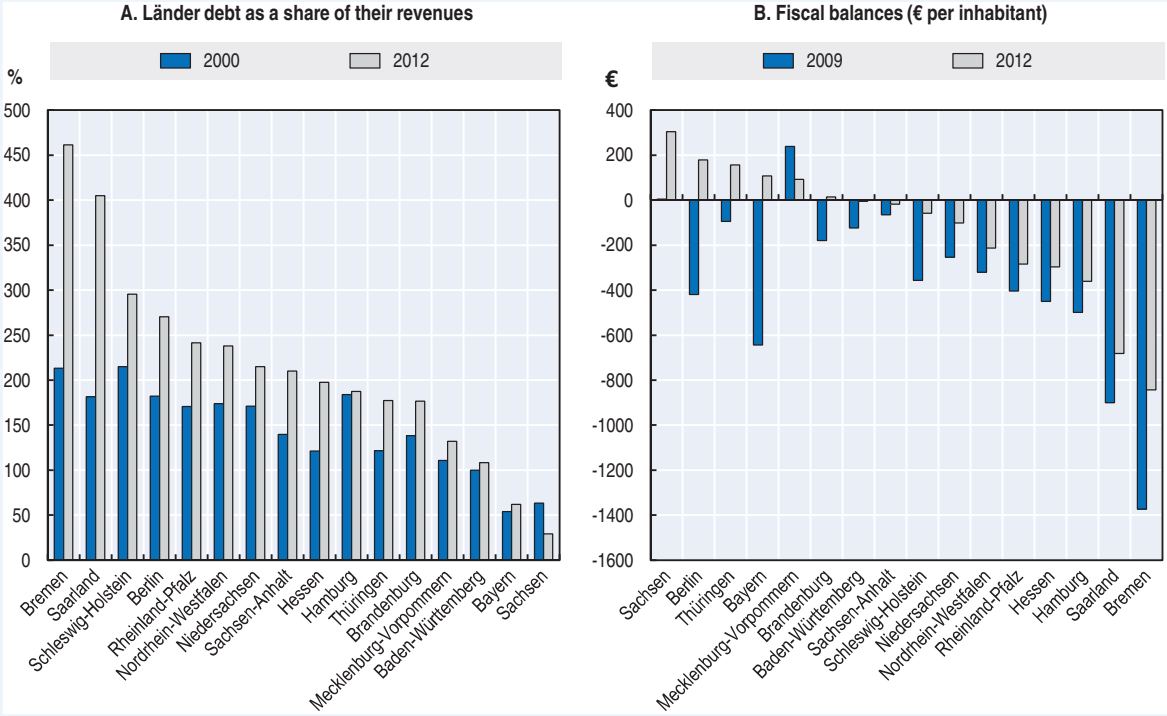
Market discipline may not always work for sub-national governments (European Commission, 2013):

- market funding is typically less important for smaller SCGs, which have less access to credit;
- transfers from other levels of governments usually represent a large share of SCG revenues;
- and the data required to estimate SCG solvency may be scarce.

Box 5.3. **Bailouts, the solidarity principle and bond yields in Germany**

Prior to 2009 when a change in the constitution introduced the debt brake, German *Länder* borrowing was subject to a weak golden rule. In practice, the solidarity principle in the constitution was equivalent to an explicit bailout guarantee or a joint liability system, backed by the financial equalisation system and judgments by the Federal Constitutional Court (Zipfel, 2011). There were two related outcomes. First, large disparities in the ratio of debt to revenues and fiscal balances among the *Länder* emerged (Figures 5.4 and 5.5). Second, financial markets took the bailout into consideration and did not charge higher borrowing costs on the more indebted *Länder* or, in other words, did not contribute to monitoring their debt. Spreads between the *Länder* and federal government were practically zero before the collapse of Lehman Brothers in 2008, and are still very narrow today. In addition, the spreads do not reflect the relative levels of debt. For example, Baden Württemberg has a much lower debt-to-revenue ratio than Berlin, but still pays a higher interest rate.

Figure 5.4. **Debt and fiscal balance of the German Länder**



Source: OECD Network on Fiscal Relations across Levels of Government – Territorial Development Policy Committee Questionnaire on Regional Finances, 2014.

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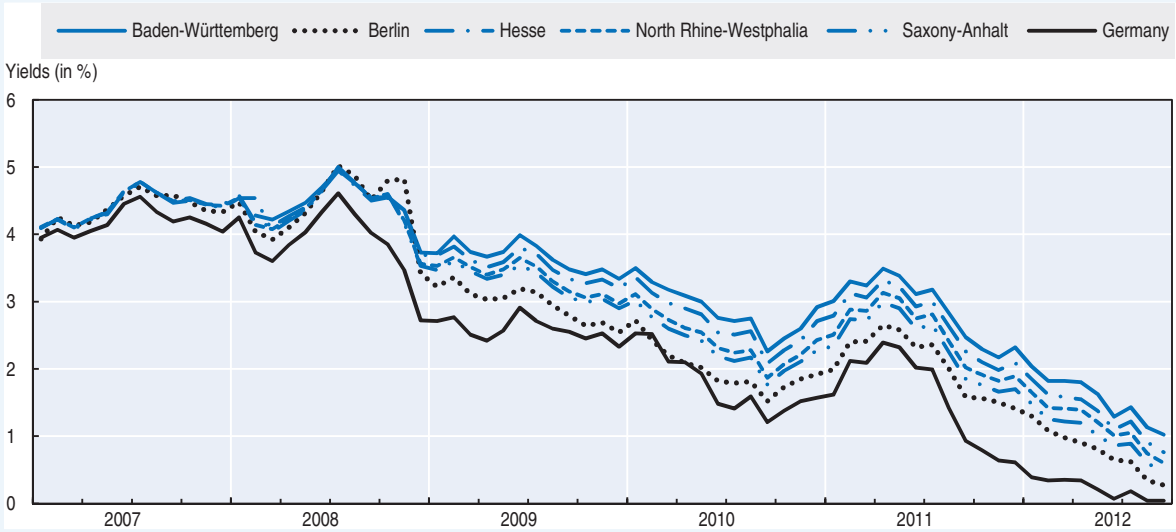
Box 5.3. **Bailouts, the solidarity principle and bond yields in Germany** *(cont.)*

Figure 5.5. **Spreads between the Länder and federal government bonds**



Source: Vammalle, C. and C. Hulbert (2013), "Sub-national Finances and Fiscal Consolidation: Walking on Thin Ice", *OECD Regional Development Working Papers*, No. 2013/02, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5k49m8cqkcf3-en*.

StatLink http://dx.doi.org/10.1787/888933342129

Moreover, relying on market discipline alone may not lead SCGs to adhere to prudent debt levels. Additional mechanisms might be needed, as shown by recent moves in several countries to strengthen limits on the borrowing of their states or regions and local governments. The following sections present the different tools available and how OECD countries use them.

Direct control and approval by higher levels of government

Direct central government control might, at first sight, seem highly effective in monitoring SCG debt. There are two main drawbacks, however:

- *First*, it may be perceived by lenders as an implicit bailout guarantee in case of a SCG default, and thus favour moral hazard.
- *Second*, central governments may not have the appropriate information to assess SCG projects when deciding which ones to finance. It may also generate a heavy administrative burden.

Most OECD countries require some sort of central control over sub-central debt (Table 5.3). In most cases, direct control involves the responsible ministry giving its approval. In Spain, for instance, state and local governments must obtain the agreement of the Ministry of Economy and Finance to issue debt and, in 2014, 6 out of 30 requests were rejected. Under the terms the Stability Act, all new SCG borrowing in Hungary has to be approved by central government. The Slovak Republic, too, is tightening up on the resource requirements for take on additional loans: entities belonging to municipalities or regions will no longer be able to assume liability for loans directly.

Table 5.3. **Types of restrictions on sub-central debt**

	No restriction	Borrowing abroad prohibited	Requires approval from higher levels of government	Only for capital financing	Prohibited both for current and capital financing
Australia local		x	x		
Australia state	X				
Austria local	X				
Austria state	X				
Belgium local				x	
Belgium state	X				
Canada local			x	x	
Canada state	X				
Chile					x
Czech Republic					
Denmark			x	x	
Estonia			x	x	
Finland	X				
Germany local				x	
Germany state	X				
Ireland			x		
Italy local				x	
Italy state				x	
Korea			x	x	
Mexico local		x		x	
Mexico state		x		x	
New Zealand		x			
Poland	X				
Slovak Republic		x		x	
Slovenia		x	x	x	
Spain local				x	
Spain state			x	x	
Sweden	X				
Switzerland local	X				
Switzerland state	X				
Turkey			x	x	
Total answers	**11**	**6**	**9**	**15**	**1**

Note: Borrowing in foreign currency is prohibited except by Auckland Council (NZL).
Source: OECD Network on Fiscal Relations across Levels of Government – Survey on Sub-national Fiscal Rules and Macroeconomic Management, 2015.

National governments may exert control over all SCG levels or only some. In federal and quasi-federal countries, regions/states often enjoy great borrowing autonomy but control local government debt. In Austria for instance, states do not need to request federal permission to borrow, but municipalities need to apply to the Municipal Supervising Authority in their state. In Canada, there is no restriction on provincial borrowing, but municipalities must secure approval either from the provincial ministry in charge of municipal affairs or from an approval board. Most provinces require local governments to submit a capital plan in order to undertake long-term borrowing for capital purposes.

Central government approval for SCG debt may only be required under certain conditions – when SCG debt exceeds a specific ceiling, for example – or only for certain types of borrowing. In Turkey, for instance, provinces and municipalities must request approval by the Ministry of the Interior only if borrowing levels exceed 10% of their revenues. In Denmark, permission to raise loans is automatically granted to municipalities

for certain kinds of investment in public utilities. However, SCGs must seek permission from the economic affairs and interior ministries to raise loans for financing investment in areas such as schools. Moreover, central government may ban financial instruments that could threaten SCG finances (Box 5.4).

Box 5.4. **Prohibition of financial instruments and restrictions on SCG speculation**

Several OECD countries recently introduced legislation to limit risk by prohibiting the use of certain financial instruments or tightening requirements.

In Austria, the national government has been negotiating with the *Länder* on banning the use of public funds for speculative transactions. Salzburg, Tyrol and Vienna have already introduced bans.

In France, a decree came into force in October 2014 stipulating that variable rates relative to local debt will have to be indexed on "usual" rates such as the European interbank market rate. Moreover, variable rates must always be lower than the double of the lowest rate observed during the first three years of the loan period.

In Italy, the 2014 Stability Pact introduced a ban on regions and local entities using financial derivatives.

In the Netherlands, a law passed in 2013 compels local governments to hold their reserves in an account at the Ministry of Finance instead of a bank. The aim is to limit financially risky positions for excess funds.

Source: National sources and OECD (2014a), *OECD Economic Surveys: Netherlands 2014*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_surveys-nld-2014-en*.

SCGs in some countries must consult bodies such as national or regional courts of audit or independent auditors before they can issue debt. However, their recommendations are seldom binding. In Poland, for example, local governments must seek the opinion of their Regional Accounting Chamber on their capacity to repay the debt.

The most extensive control exercised over sub-central debt is central government's direct financing the bulk of SCG debt through specific loans. In Ireland and the United Kingdom, debt arising from loans accounts for above 80% of all SCG liabilities and nearly all of that debt is with the central government (Table 5.1). In the United Kingdom, a public body – the Public Works Loan Board – centralises all loans granted to the local authorities (Box 5.5.).

Fiscal rules

Fiscal rules are designed to restrain sub-national governments' fiscal aggregates and are an alternative to direct monitoring. There are three main types: budget balance rules, expenditure ceilings and borrowing limits. The most common in OECD countries is the budget balance rule (see Chapter 2 of *Fiscal Federalism 2014: Making Decentralisation Work*). Borrowing constraints, for example on levels of debt or debt servicing are also frequently used. Many SCGs are subject to a golden rule, and may borrow for investment purposes only. Direct expenditure limits are less frequent. Fiscal rules usually introduce numerical targets based on ratios that use either the level of GDP, tax, or total sub-central revenues.

Although sub-central fiscal rules have long been in place in many OECD countries, the Great Recession spurred them to tighten their rules (Vammalle and Hulbert, 2013).

Box 5.5. **The UK Public Works Loan Board**

The Public Works Loan Board (PWLB) is an independent public body responsible for granting loans to local authorities. It was established in 1793 and became permanent in 1817. Since 2002, it has operated within the UK Debt Management Office. The PWLB consists of twelve Commissioners considering loan applications and collecting repayments. The Commissioners are authorised "to make loans to any local authority in Great Britain for any purpose for which the authority has power to borrow". Funds are drawn from the National Loans Fund, administrated by HM Treasury. All loan repayments, interest and premiums are paid to the Fund. The 1968 Act limits the total amount to be granted by the PWLB since 2008, this limit has been set at £70 billion. Fixed rates are set twice a day by the Debt Management Office.

Source: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A Sub-national Perspective on Financing Investment for Growth II – Creating Fiscal Space for Public Investment: The Role of Institutions", *OECD Regional Development Working Papers*, No. 2014/06, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5jz3zvxc53bt-en*.

However, the impact of fiscal rules on SCG debt is subject to debate (Box 5.6). Their effectiveness depends as much on SCGs' ability to circumvent them as on requirements for monitoring SCGs.

Box 5.6. **Fiscal rules for SCGs: Do they work?**

Tight fiscal rules are designed to save governments from over-indebtedness, but the empirical evidence as to whether they do so is mixed. Some older studies find that balanced budget rules reduce budget deficits – e.g. Poterba (1994) and Bohn and Inman (1996), both of which look at a selection of US states. Other studies conclude that fiscal rules do not play a prominent role in ensuring better fiscal performance (Escolanoet al., 2012). In this case, a plausible explanation is that sub-central fiscal rules might not be adequate to ensuring good performance when SCG spending mandates are underfunded. In any case, analysis of the impact of fiscal rules is prone to a severe endogeneity problem because, as highlighted by the recent economic crisis, fiscal rules are often the response to deteriorating fiscal balances rather than the cause. Grembi et al. (2011) get around endogeneity by using a quasi-experimental research design. Taking the example of Italy which, in 2001, relaxed fiscal rules for municipalities of less than 5 000 inhabitants, they estimated that, on average, relaxing fiscal rules triggered a shift from balanced budgets to a deficit of 2% of the budget size.

Borrowing restrictions may be easily evaded when dependence on transfers is high, responsibilities are not clearly allocated, or accountability is low. An example can be found in Italy (von Hagen et al., 2000). Italian local public finances went through deep crisis during the 1970s and 1980s due to a tax reform introduced in 1972-73.It reduced the fiscal autonomy of municipalities and made them extremely dependent on central government grants. Their expenditure rose constantly and the inability of local governments to raise revenue led them to borrow from commercial banks. As a result, municipalities verged on bankruptcy and had to be bailed out by central government through an increase in transfers in 1978. The unintended outcome was that over-indebted municipalities were in fact compensated for their poor financial performance through larger transfers. In sum, heavy reliance on transfers can generate a common-pool problem as SCGs do not fully bear the cost of overspending.

Source: Ahrend, R., M.Curto-Grau and C. Vammalle (2013), "Passing the Buck? Central and Sub-national Governments in Times of Fiscal Stress", *OECD Regional Development Working Papers*, No. 2013/05, OECD Publishing, Paris, *http://dx.doi.org/ 10.1787/5k49df1kr95l-en*.

Fiscal rules may be imposed by higher tiers of government or they may be self-imposed by SCGs themselves. The United States has the longest history of self-imposed fiscal rules, with states incorporating balanced budget rules in their constitutions as early as the 1840s.

Today, 49 of the 50 states have a constitutional balanced budget rule (Vammalle, 2008). Intergovernmental and co-operative approaches involve negotiations between tiers of government in the design of fiscal rules for sub-national authorities. Intergovernmental bodies often play an important role in such negotiations and, if SCGs take part in designing formulae, setting objectives and determining limits, they are more likely to heed the rules (Box 5.7).

Box 5.7. **Examples of inter-governmental bodies**

Australian Loan Council

The Australian Loan Council, established in 1923, is a Commonwealth-State ministerial council that co-ordinates public sector borrowing. The Loan Council considers each jurisdiction's borrowing for the forthcoming year with regard to each jurisdiction's fiscal position and the macroeconomic implications of aggregate borrowing. State participation in the Council was initially voluntary. In 1927, the six states and the Commonwealth signed a financial agreement that granted the Council the authority to determine the amounts, conditions and timing of all loans of the Commonwealth and the states (von Hagen et al., 2000). The Council first decided the total amount of borrowing, then allocation to the states. Today, the Loan Council operates on a voluntary basis and emphasises the transparency of public sector financing rather than adherence to strict borrowing limits.

Belgium's High Council of Finance

Belgium's High Council is specifically tasked with fiscal co-ordination between regions, communities and the federal government. Its recommendations are discussed at the Inter-ministerial Budget and Finance Conference. Further discussions between the Council and tiers of government are held at meetings of the *Comité de Concertation*, which is attended by the Prime Minister and federal, regional and communal ministers of budget and finance. Since 1989, the Council has been required to submit an annual report to central government on sub-national borrowing requirements. If the report points to a serious deterioration in a SCG's fiscal position, the Federal Minister of Finance may limit borrowing. However, this *ex post* control mechanism has never been used.

The December 2013 Co-operation Agreement widened the Council's duties to that of an independent body for monitoring budgetary outcomes. Besides advising on the budgetary trajectories of each level of government, the Council monitors the compliance of budgetary outcomes and the implementation of corrective measures in the event of deviation from the rules.

Germany's Stability Council

The German Stability Council, created in 2010, is a joint body that represents the *Länder* finance ministers and the federal finance and economic ministers. Its mandate is to avert serious budget problems. Its main task is to regularly monitor the budgets of the Federation and the *Länder*. To that end, it uses four key ratios and related threshold values to assess budget situations:

- structural financial balance (financial balance per inhabitant);
- credit financing ratio (net borrowing to net expenditure ratio),
- debt-to-revenue level,
- interest-to-tax revenue ratio.

Box 5.7. **Examples of inter-governmental bodies** *(cont.)*

The Stability Council holds regular meetings every May and October. Resolutions require the votes of the federal level and two-thirds (or at least 11) of the *Länder*. However, a *Land* is not entitled to vote if it is affected by the decision to be made. At its second meeting in October 2010, the Stability Council suggested that four *Länder* were close to or actually experiencing a budget emergency. Moreover, as part of the implementation of the Fiscal Compact in Germany, the Stability Council was charged with monitoring compliance with the general government structural deficit twice a year. An independent advisory board was set up to support the Stability Council.

Spanish Fiscal and Financial Policy Council

The Fiscal and Financial Policy Council is the main public body for co-ordinating the central government and the autonomous communities. It is made up of the Minister of Economy and Finance, the Minister of Public Administration and the Economy and Finance Counsellors of each autonomous community. Every five years the Council may negotiate a change in the regional financing system. With regard to fiscal rules, each autonomous community agrees an individual limit on borrowingwith central government. If an agreement is not reached, all communities must seek to balance their budgets (Miaja, 2005). In a further move in 2013, the Independent Authority for Fiscal Responsibility was created. Its purpose is to oversee the sustainability of public finances.

Budget balance rules

Budget balance rules set a ceiling on a jurisdiction's budget deficit. It can be a zero deficit ("balanced budget"), a maximum permissible deficit or even a budget surplus. The main drawback of budget balance rules is that they may entail pro-cyclical policies which would favour the introduction of cyclically adjusted or structural balance rules. There is consequently a trade-off between flexibility and enforcement. Designing balanced budget rules also involves answering the following questions: Should they include capital expenditure or should they apply only to current expenditure? Should off-balance funds be taken into account? Should they apply to submitted budgets, voted budgets or realised budgets? Should a deficit carry-over be allowed?

This section analyses the different options, and describes country practices in designing balanced budget rules (Box 5.8).

Box 5.8. **Reforms of budget balance rules since the crisis**

Austria adopted a new Internal Stability Pact in spring 2012. It sets new fiscal rules which apply to all levels of government, requiring them to balance their budget in 2016. From 2017 a structural balance rule will come into effect, tying deficits to the output gap. It does not take asymmetric shocks into account. The new rules also include a debt criterion, whereby all tiers of government must reduce their level of debt by one-twentieth a year.

Belgium's federal government, communities and regions signed a co-operation agreement in December 2013 that implemented the Treaty on Stability, Co-ordination and Governance. It requires the general government budget to be balanced with nominal and structural targets defined for central government and individual authorities.

The **Czech Republic** is considering a proposal that would require local and central governments to balance their budgets if total public debt exceeded 48% of GDP.

Box 5.8. **Reforms of budget balance rules since the crisis** *(cont.)*

Denmark's Budget Law, approved in 2012, introduced a balanced budget rule which stipulates that yearly structural deficits should not exceed 0.5% of GDP.

Estonia's State Budget Act came into force in March 2014, introducing a balanced budget rule for general government, broken down into targets by level of government.

Germany introduced a constitutionally enshrined debt brake in 2009 to ensure that state budgets were structurally balanced and the federal structural deficit did not exceed 0.35% of GDP. It has also put in place a Stability Council. Its job is to review all public budgets on an annual basis against common benchmarks, monitor public borrowing, and co-ordinate medium-term financial planning in a multi-level government context.

Iceland's Parliament passed a local government act in September 2011 which included two important fiscal rules for local government finances. The first was a budget balance rule, obliging SCGs to balance current revenues and expenditure over a three-year period. The second was a debt rule that limits the total debt of local authorities to 150% of total revenue. Those with total debt exceeding 250% of revenue are prohibited from raising debt except to refinance.

Italy's Domestic Stability Pact, in place since 1999, introduced a budget balance rule for municipalities and provinces. The Stability Law for 2014-16 eases the budget constraints on local governments and excludes capital account payments of up to EUR 1 billion, plus another EUR 500 million to accelerate payment of past-due debts.

Japan introduced its Fiscal Management Strategy in 2010. It includes short, medium and long-term numerical targets to reduce central government's and local authorities' primary budget deficits.

Mexico's Federal Budget Law (Ley Federal de Presupuesto y Responsabilidad Hacendaria [Federal Budget and Fiscal Responsibility Law]), approved in late 2013, incorporates a structural balance rule. Constitutional reform to limit state and municipal debt is currently under consideration.

The **Netherlands** central government signed an agreement in January 2013 with local authorities ahead of the coming into force of the Law on the Sustainability of Public Finances. It introduced a multi-annual budget balance path that local governments are required to follow. In 2013, the total local authority deficit was capped at 0.5% of GDP.

Poland's local authorities have been required to balance their budgets under the terms of the Public Finance Act since 2011. In 2014, new rules came into force. They require local authorities to keep their debt-servicing-to-revenue ratios to less than the average ratio of current revenues (plus asset sales and operating expenditure) to total revenue over the last three years.

Slovenia's Parliament approved a balanced budget amendment to the constitution in 2013. It came into force in 2015.

Spain adopted an amendment to the constitution in 2011 to underpin the fiscal consolidation targets of all tiers of government in line with the EU framework. General government must not exceed the EU limits and local governments are required to balance their budgets. The Organic Law on Budgetary Stability and Financial Sustainability (2012) requires all levels of government to achieve structurally balanced budgets from 2020 onwards. To ensure that the objective is met, debt reduction trajectories are revised in 2015 and 2018.

Source: Vammalle, C., R. Ahrend and C. Hulbert (2014), "A Sub-national Perspective on Financing Investment for Growth II – Creating Fiscal Space for Public Investment: The Role of Institutions", *OECD Regional Development Working Papers*, No. 2014/06, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5jz3zvxc53bt-en*. OECD (2014b), *OECD Economic Surveys: Czech Republic 2014*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_surveys-cze-2014-en*. OECD (2014c), *OECD Economic Surveys: Denmark 2013*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_surveys-dnk-2013-en*. OECD (2013), *OECD Economic Surveys: Japan 2013*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/eco_surveys-jpn-2013-en*. Stability Programme 2014 (Belgium, Estonia, Italy, Netherlands); Convergence Programme Poland (2014); National Reform Programme Slovenia (2014).

- *Should balanced budget rules cover current expenditure, capital expenditure or both?* The most common fiscal rule at the sub-central level is the golden rule – which covers only the current budget – and the budget balance rule, which covers both current and capital spending. The number of countries setting budget balance rules grew in the wake of the 2008 crisis (see Chapter 2 of *Fiscal Federalism 2014*). Targeting only current expenditure (i.e. the golden rule) allows SCGs to carry out public investment. Indeed, SCGs are the largest public investors, accounting for an average of two-thirds of public investment by OECD countries (Vammalle and Hulbert, 2013). Some countries also include off-budget operations in the budget balance rule.
- *Should balanced budget rules target submitted, approved or realised budgets?* Depending on the country, balanced budget rules may target different stages of the budget process. In most OECD countries, the balanced budget rule applies to the approved budget. Countries then go their different ways when it comes to treating realised deficits. Most do not allow realised deficits, but some carry them over and correct them in the following budget period. Such a scheme allows countries the flexibility to adjust to unforeseen events, while still ensuring sound fiscal management over the medium term.
- *Should balanced budget rules target actual or structural deficits?* The most recent fiscal rule reforms have introduced either a structural budget balance rule (as in Germany, Austria, and Spain), or a multi-year balance rule (as Iceland has done). Yet structural budget balance rules for SCGs may be difficult to estimate. In some large decentralised countries, states and regions may project their own potential GDP and compute a structural deficit. If the requisite information is not available, the general government structural balance may be used and a share allocated to SCGs – the practice in Austria where the issue of diverging cycles and asymmetric shocks is considered negligible. Otherwise, a multi-annual budget balance rule may be a sound, pragmatic option. Iceland's Local Government Act, for example, includes a new fiscal rule which obliges local governments to run balanced budgets for current operations over a three-year period.

Expenditure level and expenditure growth ceilings

Only a few OECD countries use sub-central expenditure limits, but they have become more inclined to rely on them since fiscal consolidation started in 2010 (Box 5.9). Canada's provinces and Turkey, for example, cap revenues, while Slovenia and Spain's local authorities link ceilings to objective needs criteria like population growth. However, most countries that do use expenditure ceilings – Denmark, Estonia, Italian local governments and Korea – cap current (operating) expenditure only. In Spain, growth in local public spending must not exceed nominal GDP growth over the past nine years, while local governments in Italy and Turkey have caps on specific budgetary lines, such as staff expenditure. Expenditure limits may apply to a sub-set of SCGs (only state/regional or local), or they may vary from one SCG to another, as in Switzerland, where a few *cantons* restrict their public expenditure when deficits are high (Sutherland et al., 2005).

Debt and debt service restrictions

OECD countries widely use sub-central rules that govern debt levels, new borrowing, and debt servicing. The most common restrictions are limits on the total debt level and the issuance of new debt. They are mostly expressed as a share of sub-central total or current revenues, sometimes as a percentage of GDP and, in rare cases, a ceiling on total debt in absolute terms is set. There is considerable variation across countries: ceilings on the

Box 5.9. **New expenditure ceilings in selected OECD countries**

Austria. The new Internal Stability Pact signed in May 2012 introduces a limit on the growth of SCG expenditure: the aggregate expenditure growth of all tiers of government may not exceed potential GDP growth.

Denmark. A new system of expenditure control was agreed in March 2012, ushering in binding ceilings on the public expenditure of all levels of government. Only spending on investment and unemployment was spared. Municipalities and regions have agreed to limit their expenditure. Should they breach the ceiling in a given year, they will have to make up for it in the next one. Central transfers may also be cut in the event of non-compliance.

Finland. The Basic Public Services Programme, approved in mid-2012, introduced a target for municipal expenditure (average municipal spending growth must be reduced by 0.4% by 2020, assuming that local responsibilities remain the same). Moreover, as of 2015 local responsibilities may not exceed available funding. Municipalities must finance any new responsibilities either through increased revenues or cuts in other expenditure.

The Slovak Republic. Since 2014, a nominal spending freeze on each individual municipality has been in place.

Slovenia. The Fiscal Balance Act, which came into force in mid-2012, introduced several measures to rein in general government debt and deficit – particularly caps on public employee labour-related costs, including at the local level.

Spain. The Organic Law on Budgetary Stability and Financial Sustainability (2012) brought in new sub-central expenditure ceilings. Increases in spending may not exceed medium-term GDP growth (calculated over three years).

overall level of debt range from 60% to 150% of total revenues and those on debt service from 12% to 25% of current revenues (Box 5.10). In federal countries, state/regional governments often place debt and debt service restrictions on their local governments, while in rare cases, like that of New Zealand, local governments self-impose them.

Box 5.10. **Debt and debt service restrictions in selected OECD countries**

Restrictions on the level of debt

Austria: A brake on debt at all levels of government was introduced in 2012.

Czech Republic: The new Constitutional Act (approved in October 2012) ushered in new principles for budgetary discipline and accountability. It particularly restricted sub-central gross debt to no more than 60% of a 4 year average of revenues.

Estonia: SCGs' total debt has been capped at no more than 60% of their total aggregate revenues since 2012.

Greece: Total debt should not exceed annual regular revenues.

Iceland: The Local Government Act introduced a debt rule that limits the total debt of local governments to 150% of their total revenue. Local governments with debt and liabilities above 150% are required to bring the debt ratio back under the ceiling within ten years. Local governments with total debt exceeding 250% of revenue are prohibited from raising new debt except to refinance.

Poland: Over 2009-14, individual local governments' debt must not be higher than 60% of local revenues for the given year.

Box 5.10. **Debt and debt service restrictions in selected OECD countries** *(cont.)*

Portugal: The laws on the Finances of the Autonomous Regions, in force since 2014, stipulate that the autonomous regions' liabilities should not exceed 1.5 times their three-year average net current revenue. At the municipal level, the 2013 law on Local Finances introduced the same requirement for each municipality. Moreover, regional floating debt should not exceed a fraction (0.35) of the three-year average of net current revenue, and local additional debt for a given year is capped to 20% of the financial margin available.

Slovak Republic: Since 2002 the law stipulates that total SCG debt should not exceed 60% of total SCG current revenues.

Spain: The Organic Law on Budgetary Stability and Financial Sustainability introduced overall debt ceilings for all levels of government. Debt may not exceed 13% of the GDP of autonomous communities and 3% of that of local governments. Moreover, SCGs will no longer be able borrow to finance current expenditure after 2020.

Turkey: Sub-central debt cannot exceed 100% of sub-central annual revenue. The ratio is set at 150% for metropolitan municipalities and provinces.

Restrictions on debt service

Czech Republic: SCGs' debt service should not exceed 30% of their revenues.

Greece: Debt repayments should not exceed 20% of regular revenues.

Italian local governments: Interest payments should not exceed 12% of current revenues.

Italian regions: Interest payments should not exceed 25% of revenues from taxes, transfers and property sales.

Poland: The sum of loan instalments and interest payments could not exceed 15% of total debt up to December 2013. Since 2014, local governments' debt service has not been allowed to exceed the three-year average sum of their operating surpluses and privatisation receipts.

Slovak Republic: Loan instalments and interest should not exceed 25% of current revenues from the previous year.

Restrictions on debt maturity

Mexico: A change to the constitution in 2013 placed stricter controls on sub-central borrowing. Debt may not finance current expenditure and should be repaid by the contracting administration.

Source: OECD Network on Fiscal Relations across Levels of Government – Survey on Sub-national Fiscal Rules and Macroeconomic Management, September 2015.

What happens if SCGs breach the rules?

Rules and controls are effective only if enforced. As part of their fiscal consolidation plans, several countries (e.g. Spain and Italy) have tightened sanctions for SCGs that fail to obey fiscal rules. Countries have also strengthened enforcement by improving transparency and reporting requirements, by levying financial penalties on offending SCGs, or by requiring them to follow restructuring plans. Some countries sanction elected officials severely if they flout the rules (Box 5.11).

Should a sub-national government fail to meet the rules, central government or SCGs themselves may take action. And in many OECD countries, central government may do so without making any changes to legislation:

Box 5.11. **Enforcement of sub-central fiscal rules**

Czech Republic. In addition to introducing new debt and deficit ceilings, the 2012 Constitutional Act strengthened enforcement mechanisms. If the debt and deficit limits are exceeded, central government may cut transfers to a municipality or region by 5% of the difference between the amount of its debt and the 60% ceiling.

Italy. Enforcement of the Internal Stability Pact was strengthened in 2011 by the introduction of a wide range of sanctions. Regions breaching fiscal rules may face a number of restrictions on such expenditure as hiring new personnel or borrowing, and may even have their central government grants reduced or suspended. Reporting rules have also been tightened, in particular in run-ups to elections. The regions must post their audited financial statements on their websites. If the results are not consistent with the Italian Internal Stability Pact, elected officials are liable to sanctions and automatic disbarment from office for up to ten years.

Spain. Autonomous communities that far overshoot their deficit restrictions are liable to sanctions under the terms of the Organic Law on Budgetary Stability and Financial Sustainability (introduced in 2012). They must submit a restructuring plan and, if they are recidivists, central government may temporarily reclaim (partially or totally) their budgetary powers.

Germany. The 2010 constitutional amendment put in place the Stability Council to monitor budgetary developments at federal and *Länder* levels. It also ushered in a federation-wide early warning system to prevent budgetary distress. In 2013, the Stability Council was tasked further with twice yearly monitoring compliance with the upper limit on the general government structural deficit under the Budgetary Principles Act. An independent advisory board was set up to support the Stability Council in its monitoring duties.

Austria. The fiscal rules foresee an excessive deficit procedure. If the deficit is exceeded for two years running, penalties apply. The offending sub-national jurisdiction is given two months to design appropriate action to restore its public finances. Sanctions are voted in a co-ordination committee that brings together all levels of government, but where the offending one is not allowed to vote. Financial penalties are equivalent to 15% of the overshoot, to be deducted from shared taxes.

Slovak Republic. The Fiscal Responsibility amendment to the constitution in 2011 stipulates that from 2015 onwards, sub-national governments exceeding the debt limit will pay a fine of 5% of the difference between the debt level and limit.

Turkey. If local authorities do not comply with fiscal rules, the related malpractice provisions of the Turkish Panel Code apply. Central government may sanction responsible personnel and local officials may be prosecuted under the Turkish Criminal Code.

Source: OECD Network on Fiscal Relations across Levels of Government Survey on the Impact of National Consolidation Strategies of SCGs and the Strategy of SCGs, OECD, Paris, 2012; Ministry of Finance of the Slovak Republic (2011).

- The most common procedure consists of central government imposing sanctions on non-compliant SCGs, compelling them to make up for non-compliance with fiscal rules in future budgets or to take measures that ensure they will obey the rules in the future.
- The financial penalties that SCGs may have to pay can be fixed fines, reduced transfers from central government, or cuts in the taxes they share with central government. In the Slovak Republic, the Ministry of Finance may levy a fine of up to EUR 17 000 on SCGs breaking fiscal rules. Austria's fiscal rules introduce sanctions which include a reduction in shared taxes that is proportional to the overspend.

- A few OECD countries use administrative sanctions that curtail the fiscal autonomy of SCGs. They generally take the form of greater central control over sub-national finances through the appointment of a public officer who monitors SCG revenues, spending and borrowing.
- Finally, some countries have provisions for sanctioning sub-national officials. They range from removal from office (Poland sometimes dissolves local government councils or executive bodies) to possible penal sanctions, as in Italy and Turkey.

Main challenges for monitoring sub-central debt

Central governments must contend with a number of challenges when monitoring SCG debt. Some are specific to SCGs, such as the scarcity of financial information that enables comparison between jurisdictions. Others, like transparency, are general and relate to monitoring fiscal situations in all tiers of government. The OECD recently issued a recommendation on budgetary governance (OECD, 2015) that applies to both central and sub-national governments and may be useful for monitoring SCG debt.

This section reviews the different challenges that central government has to address when monitoring SCG debt, and suggests instruments for overcoming them.

Scarce information on sub-central budgeting practices

Sound fiscal management requires good budgeting practices that shape outcomes. The answers to the questions below help gauge SCGs' budgeting practices and how likely they are to achieve positive fiscal outcomes:

- How are economic assumptions made and are they sufficiently prudent?
- Do SCGs carry out sensitivity analyses of economic assumptions and, if so, how?
- Do SCGs have contingency reserve funds to cope with major forecasting errors?
- Do SCG budgets incorporate medium-term outlooks?
- To what extent do SCG budgets focus on performance and results?

In federal and quasi-federal countries, SCGs are often free to draft their own budgeting laws and establish their own practices. Yet central government knows little about them. A survey of the Canadian provinces shows a wide variety of budget practices, with some provinces using more modern budgeting instruments than central government itself (Rigaud and Arsenault, 2013). It would be interesting to replicate the study in other decentralised countries where SCGs enjoy budgeting autonomy so as to assess the impact of budgeting practices on fiscal outcomes.

Scarcity of appropriate, timely information on sub-central financial and debt situations

Budget documents and data should be open, transparent and accessible. Yet, SCGs often submit financial information late and with gaps. Timely information is important if central government is to react fast to deteriorating fiscal situations, identify early deviations from fiscal rules, and take corrective measures. The OECD recently had first-hand experience of the difficulty of obtaining information on sub-central finances. It sent out a survey to build a database of state/region financial variables (revenues, expenditure and debt). Only eight countries were able to provide the required information.

The length of time that SCGs have to report their financial statistics varies widely from one country to another. It is as little as 20 days in the Czech Republic with budgetary data having to be provided monthly. On average, though, SCGs have months to report their budgetary data. The frequency with which SCGs must report their balance sheets ranges from every quarter in the Czech Republic to every year in Poland. Recent EU directives, currently being implemented in a number of European countries, introduce new sub-central budget and financial reporting requirements such as the obligation to publish quarterly sub-national fiscal data. Some countries offer SCGs financial incentives to produce the required information. In 2012, the British government introduced a 20-base-point discount on loans from the Public Works Loan Board for local governments that provided improved, more transparent information on their long-term borrowing and associated capital spending plans (Vammalle, Hulbert and Ahrend, 2014).

Sub-central financial information is not always reliable

Effective public management systems seek to ensure that financial information is reliable. To that end, internal and external financial audits are necessary. They assess the quality of financial reporting and the reliability of financial information. Audits and inspections may be conducted either centrally or, in decentralised countries, sub-centrally. Even in decentralised contexts, however, central government still has an important role to play, setting the standards and monitoring the effectiveness of internal auditing systems at the local level (Baltaci and Yilmaz, 2006). Decentralised audits may be better suited to countries where SCGs enjoy strong financial autonomy, as they are directly responsible for preparing and executing budgets. In most OECD countries sub-central audit offices, or similar bodies, assess and inspect SCGs' finances.

Sub-central data are hard to compare

The financial information that SCGs produce is seldom homogeneous. Local government accounting standards tend to be more uniform than those of states and regions (Figure 5.6). Particularly in federal and quasi-federal countries, state and regional jurisdictions do not abide by the same accounting standards when they draw up their budgets. While homogeneous standards make internal or external auditing easier, there is often strong resistance from SCGs. The harmonisation of regional and local governments' accounting principles – budget rules, the treatment of publicly owned enterprises, depreciation rules, etc. – was one of the most fiercely fought elements in the 2009 reform of fiscal federalism in Italy (Blöchliger and Vammalle, 2012).

Few true, full and fair pictures of sub-central public finances

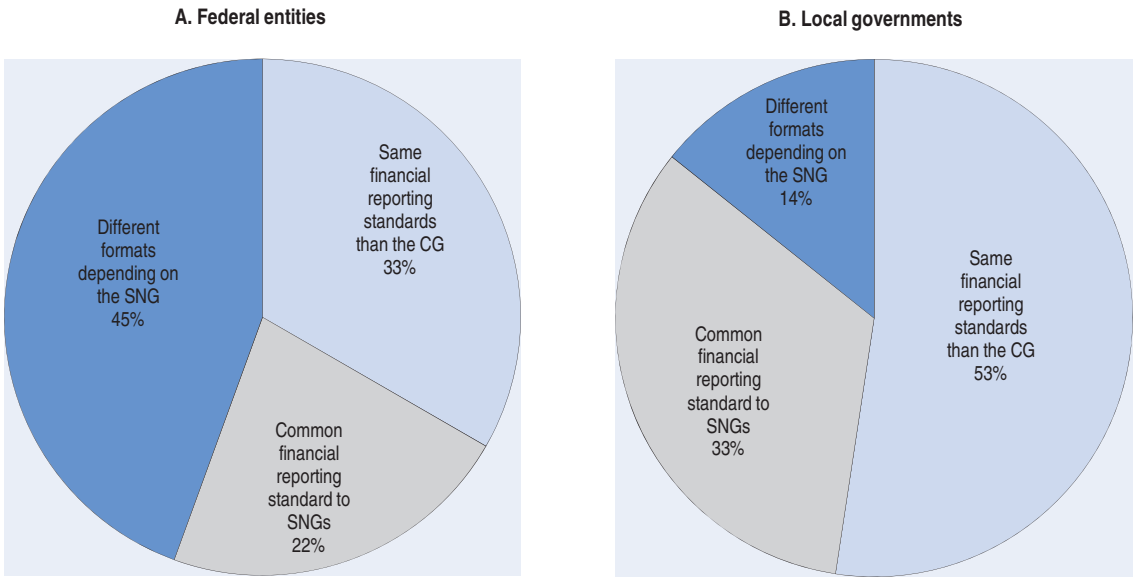
Budgets should paint a true, full and fair picture of public finances. Accounting gimmicks, the use of off-balance expenditure, and other practices obscure fiscal transparency. SCGs frequently use off-budget funds and local public enterprises or agencies, which should be closely monitored.

Off-budget funds

Much less information on off-budget funds is available at the sub-national than at the national level of government. SCGs should be encouraged to improve reporting, if possible in the same format as central government (Allen and Radev, 2007). Fiscal rules in OECD countries differ widely in their consideration of off-budget funds and only a few OECD countries include such funds in their budget balance rules (OECD 2014d, Chapter 2).

Figure 5.6. **Accounting standards for budgets**

2011



Source: OECD Network on Fiscal Relations across Levels of Government, Survey on Sub-national Fiscal Rules and Macroeconomic Management, OECD, Paris, September 2011, updated March 2013.

StatLink http://dx.doi.org/10.1787/888933342135

Public enterprises and agencies

- *Local public enterprises*. In most OECD countries, sub-national governments own local public enterprises which they use to provide public services (water, infrastructure, etc.), sometimes in the form of public-private partnerships. SCGs are able to borrow freely from them with no constraints, which may generate contingent liabilities and obscure financial data. Yet reforms to improve the transparency of public enterprises encounter stiff resistance, as in Portugal when municipalities were required to consolidate their accounts with their enterprises (Blöchliger and Vammalle, 2012). Indeed, reform can be particularly difficult when it includes enterprises that are legally private, but owned by a sub-central government.
- *Local public agencies*. Public agencies are autonomous bodies which are nevertheless closer to the government than public enterprises. SCGs rely extensively on them for the provision of public services. There is no universal system of rules for such agencies and SCG financial statistics seldom capture them. Self-funding agencies in particular escape sub-national governments' control over their aggregate spending. Moreover, agencies may mask inefficiencies through the use of own-source revenues. Agencies that borrow when allowed, may generate significant contingent liabilities for sub-national governments. They should therefore be monitored and booked in sub-central financial documents.

Sub-central insolvency procedures

This section provides a preliminary overview of OECD practices in insolvency regulations and procedures for alleviating the financial distress of SCGs. Insolvency is a core element in credible no-bailout commitments. Be it through sub-national bankruptcy regulations or administrative procedures specifically for SCGs in financial difficulties, insolvency procedures help limit moral hazard and implicit guarantees. Bankruptcy

procedures are particularly important when it comes to implementing hard budget constraints on SCGs.

In most OECD countries considered in this book, local governments are not able to go bankrupt.[2] Where bankruptcy is not permitted, local governments in financial distress usually apply to central government for additional funding, although central government in some countries (e.g. France) can step in at an early stage to pre-empt bankruptcy. Bailout provisions often include financial consolidation plans for SCGs and/or sanctions for SCG officials.

Sub-central bankruptcy regulations

Sub-central bankruptcy procedures differ sharply from similar regulations in the private sector. Insolvency rules tend to be less stringent in order to safeguard key public services such as health, education and social protection. SCGs cannot be wound up and the ability of creditors to get hold of SCG assets is very restricted. Sub-central insolvency procedures involve debt restructuring rather than asset liquidation (Liu and Waibel, 2010).

Insolvency procedures also aim to put sub-national finances back on a sound footing so that SCGs can go back to the financial markets. To that end, and to give SCGs incentive to repay debt, they are required to balance their potential future revenues – chiefly from taxation – with reimbursements to their creditors. Bankruptcy procedures must also address the issue of holdout, i.e. the ability of a few individual creditors to threaten the restructuring process by imposing their own claims (McConnell and Picker, 1993). Debt may be restructured – i.e. transformed into longer maturities – or discharged, even partly, within a new binding legal framework.

Insolvency procedures may be voluntary or mandatory. In the United States, for example, municipalities file voluntarily for bankruptcy under Chapter 9 of the United States Bankruptcy Code. In Hungary, by contrast, local governments with commercial arrears must notify the court. In some countries, creditors are also able to trigger bankruptcy procedures.

The insolvency framework can be judicial or administrative (Box 5.12). When proceedings are judicial, the courts are responsible for allocating resources between the different creditors. Typically, a bankruptcy agreement is reached once a majority of creditors agree on a restructuring plan – even if there is a dissenting minority. The advantage of judicial procedures is that they neutralise political pressures during restructuring (Canuto and Liu, 2010). Administrative procedures usually consist of central authorities intervening directly and taking control of sub-central finances – by appointing an administrator, for example. Although administrative procedures may be faster, they may also trigger expectations of central government intervention among lenders and thus increase the risk of moral hazard. In most cases, bankruptcy frameworks require SCGs to draw up a consolidation budget.

Specific administrative procedures for governments in financial difficulty

Few OECD countries have bankruptcy procedures specifically for sub-central governments. Instead, central government intervenes directly, often with discretionary grants, to support them. Whether sub-central bailouts are institutionalised or case-by-case, they should come at a sufficient political or financial cost to the bailed-out entity to reduce moral hazard. Indeed, bailout expectations may have serious consequences, as creditors may consider that sub-central debt is implicitly guaranteed by central government. Consequently they continue willingly to lend to sub-central governments, which ultimately leads to higher debt (Box 5.13).

Box 5.12. **Sub-central bankruptcy procedures in selected OECD countries**

United States

In the United States, sub-central government insolvency is regulated at federal level under Chapter 9 of the United States Bankruptcy Code. The code was enacted in 1937 during the Great Depression in response to multiple municipal defaults. The United States combines judicial and administrative procedures (Liu and Waibel, 2010). Under the provisions of Chapter 9, a debt restructuring plan acceptable to a majority of creditors may be binding on a dissenting minority. Since 1994, municipalities have been required to obtain state approval to file for bankruptcy. There may be several conditions attached to approval, and municipal governments may be denied the ability to file for Chapter 9. A few states, such as Georgia and Iowa, actually prohibit it. However, many states have introduced their own municipal insolvency regulations, so there is no nationwide procedure.

Hungary

The Hungarian Municipal Debt Adjustment Law came into effect in June 1996 after several years of acute sub-national financial distress which saw numerous bailouts by central government. One purpose of the law was to impose hard budget constraints on local authorities to lessen moral hazard. If a municipality fails to pay a supplier within 60 days of the due date, it must notify a court. Creditors, too, may petition the courts. Once a court initiates a debt adjustment procedure, creditors are no longer able to sue the local authority. At the inception of the procedure, an independent debt adjustment committee is formed. Its job is to draw up a debt restructuring programme. A crisis budget must then be adopted. A bankruptcy compromise can be reached if more than 50% of creditors consent to it, provided that their claims amount to at least two-thirds of all claims.

New Zealand

A bankruptcy procedure for insolvent SCGs exists, but has not been tested since 1930. Most local authority borrowing is secured against local property taxation, and legislation allows creditors to claim on property taxes in the event of a loan default.

Box 5.13. **The effects of bailout expectations**

In a situation of economic stress and under soft budget constraints, SCGs may expect central governments to bail them out with additional resources. Clearly, there is a moral hazard problem at play, as both SCGs and their creditors assume that there is a probability of bailout, and debt continues to accrue.

The likelihood of being bailed out, in turn, is determined by several factors. First, according to the "too-big-to-fail" hypothesis (Wildasin, 1997), a highly populated sub-national jurisdiction is more likely to be bailed out because the negative externalities from a sub-national default would affect too many people. This hypothesis, though, has found no empirical evidence to support it. Indeed, if anything, the evidence points the opposite way. As noted by von Hagen et al. (2000), the two German states bailed out in the 1990s were the smallest in the West German federation. In Italy, too, smaller municipalities and regions seem to have a higher propensity to request bailouts. The reason may be that central governments are more willing to bail out smaller regions since the costs of doing so are lower.

Second, following the "too-sensitive-to-fail" hypothesis (Bordignon and Turati, 2009 and Sorribas-Navarro, 2011) the externality at stake is not the size of the population but the extent to which SCGs provide key public services such as health, education or social services.

Box 5.13. **The effects of bailout expectations** *(cont.)*

Third, regions may be "too weak to fail" when large vertical imbalances exist. For example, central governments may feel obliged to bail out regions that depend heavily on central government transfers as they may not have the capacity to raise adequate resources by themselves. Although SCGs with large fiscal imbalances tend to be subject to borrowing restrictions (Eichengreen and von Hagen, 1996), it does seem, in practice, to prevent the need for bailouts.

A last factor that can influence the likelihood of bailout is the political clout of sub-central governments. As noted by Rodden (2002) "when constitutionally or politically constrained central governments take on heavy co-financing obligations they often cannot credibly commit to ignore fiscal problems of lower-level governments". In other words, the more political pressure a regional government can exert on central government, the greater the likelihood that it will obtain a bailout.

Source: Ahrend, R., M. Curto-Grau and C. Vammalle (2013), "Passing the Buck? Central and Sub-national Governments in Times of Fiscal Stress", *OECD Regional Development Working Papers*, No. 2013/05, OECD Publishing, Paris, *http://dx.doi.org/10.1787/5k49df1kr95l-en*.

Many OECD countries have introduced procedures specifically for bailing out sub-central governments (Box 5.14). Procedures frequently share the following features (similar to elements in the procedures being put in place to sanction or bring back into line SCGs that breach fiscal rules):

Box 5.14. **Addressing serious fiscal difficulties at the sub-central level**

Countries have developed different procedures for addressing serious sub-central financial and fiscal difficulties. A few examples are shown below.

South Korea

In 2011, South Korea reformed its procedures for dealing with serious financial difficulties at the sub-central level and introduced a four-step "early warning system":

1. Sub-central debt is monitored through seven indicators that include the fiscal balance, debt service ratio, and local public enterprise liabilities.
2. The indicators are analysed.
3. A risk control committee deliberates.
4. SCGs may be required to implement a consolidation plan.

Central government can intervene if it identifies SCGs as being in fiscal distress. In accordance with the Local Finance Act, central government issues an official statement to that effect. SCGs must then propose a budget deficit management plan that has to be approved by the Ministry of Public Administration and Security and local councils. During the process, local governments' ability to issue debt is restricted.

Slovak Republic

A local government in serious financial difficulties may be forced to follow a "healing regime" if:

- Its liabilities exceed 15% of current revenues of the previous year.
- It has failed to repay a debt 60 days after the due date.

Box 5.14. **Addressing serious fiscal difficulties at the sub-central level** *(cont.)*

A local government with those liabilities and that overdue payment must propose fiscal consolidation measures. Ninety days after the beginning of the "healing regime", it has to make a progress report to the Ministry of Finance on the measures it has taken. If the ministry deems that they are inadequate, it may decide to introduce forced administration, appointing an administrator to design additional consolidation measures. Under forced administration, SCGs may use local financial resources only with the permission of the administrator.

Spain

Since early 2012, the Spanish central government has introduced three mechanisms to alleviate financing and liquidity pressures:

- A credit line of EUR 10 billion. It was opened by the national debt management office Instituto Credito Official (Official Credit Institute) to take over management of regional debt.
- A fund to convert payment arrears into financial debt given the high levels of SCG debt to suppliers. This fund was allocated EUR 30 billion in the form of loans from 26 Spanish banks.
- Fondo de Liquidez Autonomico (Autonomous Liquidity Fund). This fund was created in July 2012 to open lines of credit to autonomous communities unable to refinance their debt on the financial market. The fund is lead-managed by the Official Credit Institute under the aegis of the Ministry for the Economy and Competitiveness. In 2012, the fund was allocated EUR 18 billion, followed by another EUR 23 billion in 2013.

Source: OECD Network on Fiscal Relations across Levels of Government, Survey on Sub-national Fiscal Rules and Macroeconomic Management, OECD, Paris, 2015.

- *SCGs are required to implement drastic fiscal consolidation plans*, and additional transfers are provided only if plans are sufficiently credible. In Estonia, local governments in financial difficulty can apply for central government aid. They must then prepare a four-year recovery and financial plan which is analysed by a special commission. It makes the final decision as to whether to grant financial aid. Central government in Finland may compel municipalities to follow a recovery programme. It appoints an advisory committee that makes recommendations to that effect.
- *Local government officials may be sanctioned*. In Italy, if a region experiences serious financial difficulties, its president is compelled to resign. The regional council is dissolved and new elections are called.
- *An administrator appointed by central government may take over SCG finances*. In Austria, the state government can dissolve a local government for serious breaches of the Local Government Act and appoint an interim administrator until an election is called. The state government has also the power to appoint a financial controller with statutory powers in certain circumstances. In Italy, when a local authority is in deep financial trouble, a commissioner may be appointed to take the measures required to put its fiscal position back on a sound footing.

Summary and conclusions

The finances of sub-central governments deteriorated strongly in the aftermath of the 2008 global crisis under the combined impact of dwindling tax revenues and rising demand

for social services. The result was a significant increase in debt. Subsequent efforts by OECD countries to stabilise sovereign debt resulted in a tightening of fiscal rules at all levels of government. Sub-central fiscal rules vary widely from one OECD country to another in many respects such as design:

- the targeted variable – deficit, debt or expenditure – may differ from country to country;
- threshold values may differ as well;
- rules may apply to annual outcomes or cover several years;
- public investment may or may not be excluded from the rule;
- rules may be set for SCGs as a whole or for individual SCGs.

Good fiscal rules ensure economic stability and sound fiscal management. They also allow sufficient flexibility to cope with unforeseen events and safeguard SCGs' financial capacity to deliver public services, particularly public investment. Monitoring and early-warning systems should help avoid pro-cyclical policies at the sub-central level. The harmonisation of accounting frameworks within a given country, as well as the consolidation of off-budget funds and local public enterprise budgets with SCG budgets, would enhance financial transparency and provide central government and the public at large with better information. Where there are provisions for sanctions and no-bailout rules, they should be strictly enforced to be credible. Rules should be carefully worded in order to prevent any circumvention. Lastly, an insolvency framework, whether judicial or administrative, should clearly spell out the procedure to follow in the event of sub-central government defaults.

Notes

1. For example, Danish municipalities receive specific financial help from central government if they get into financial difficulty and are put under administrative control (Mau-Pedersen, 2011). In Germany, the constitutional court ruled that the federal government had to help out two Länder (states), which were in financial distress.
2. These are Australia, Canada, the Czech Republic, Finland, France, Germany, Ireland, Italy, Korea, Mexico, Poland, the Slovak Republic and Turkey.

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Chapter 6

Spending power of sub-central governments

A common way to compare and assess sub-central spending power – defined as the extent of control that sub-central governments exert over the budget – is the share of sub-central in general government expenditure. Yet upper-level government regulation can powerfully shape sub-central spending and jurisdictions may lose their discretionary power over various budget items. This chapter provides evidence of sub-central jurisdictions' restricted power over their own spending and of the potentially negative effects on public service efficiency. It then goes on to develop a novel approach for measuring true sub-central spending power and looks at the results of a pilot study carried out in a number of countries in 2009. The new approach might be extended to all OECD countries in the future, thereby helping to re-design the assignment of spending responsibility across all tiers of government.

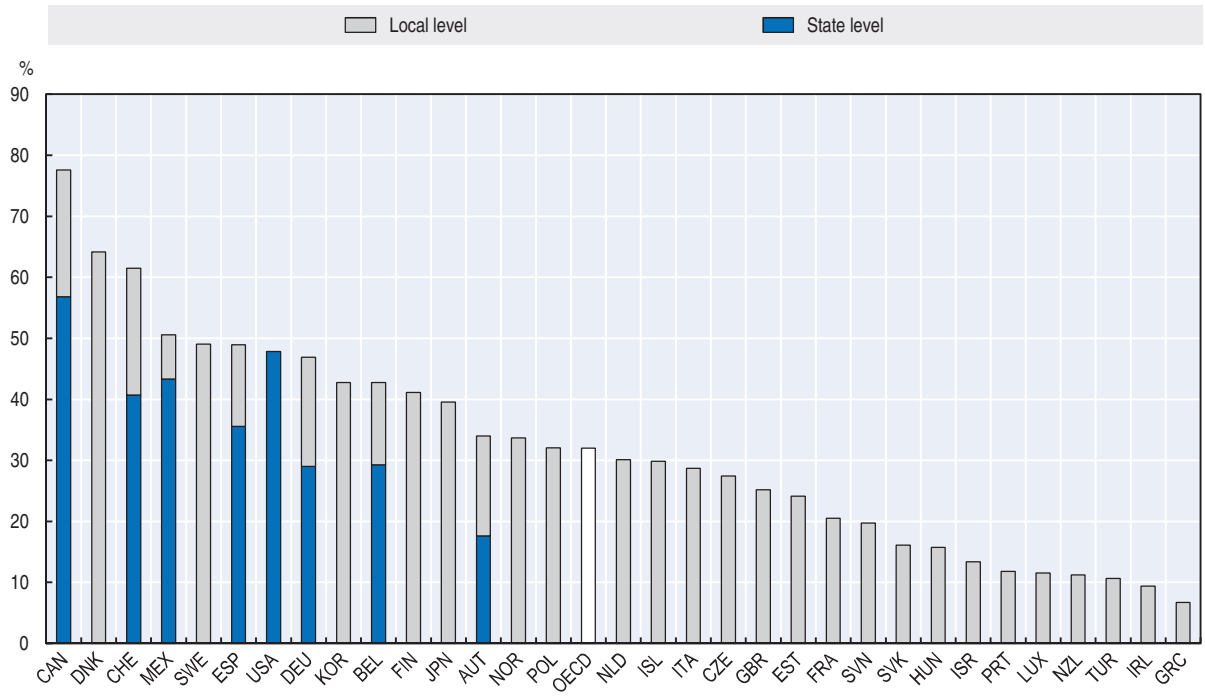
Spending shares: The traditional way to assess sub-central budget autonomy

At face value spending autonomy is considerable

The sub-central share of general government spending is the most common way of assessing fiscal autonomy on the expenditure side. OECD National Accounts data show that, in 2014, it accounted for 32% of all spending in the OECD area as a whole. Within that percentage, though, there was considerable variation from one individual member state to another –, from nearly 70% in Canada to less than 6% in Greece (Figure 6.1). Sub-central shares in federal and quasi-federal countries are above average and, in three countries (Canada, Denmark, and Switzerland), exceed 50% of total government spending. Between 1995 and 2013, it rose from 29% to 33%, followed by a decline to current levels. On the face of it, spending autonomy at the sub-central level is considerable and has actually increased over the past decade or so.

Figure 6.1. **Sub-central spending shares vary widely from country to country**

Percentage of general government spending, consolidated, 2014 or latest available year



Note: Latest available year is 2012 for Australia, 2013 for Japan, Mexico and New Zealand, and 2011 for Turkey.
Source: OECD National Accounts, *http://dx.doi.org/10.1787/na_glance-2015-en.*

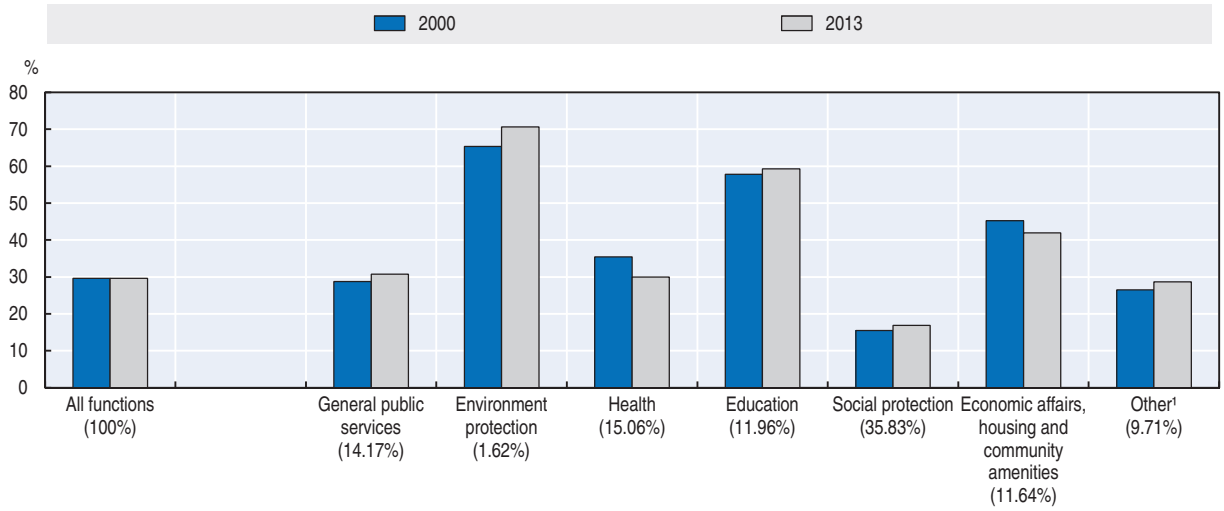
StatLink http://dx.doi.org/10.1787/888933342144

Sub-central spending shares vary across policy areas

Sub-central spending shares do not only vary between countries, but also across policy areas (Figure 6.2), as revealed by data on government functions from the National Accounts COFOG database.[1] State and local governments are more active in policy areas that account for smaller shares of total public budgets, such as environmental protection or housing and recreational services. The only exception is education, where the sub-central spending now makes up an average of 60% of total public outlays, with state/regional and local governments funding virtually all education in some countries. Between 1995 and 2013, sub-national shares rose in general public services – chiefly administration, the environment, education and social protection – but fell considerably in healthcare and, albeit to a lesser degree, in economic affairs and housing and community services.

Figure 6.2. **Shares of sub-central government spending by main function**

Unweighted average of OECD countries, 2000 and 2013



1. "Other" includes defence, public order and safety as well as recreation, culture and religion.

Note: Percentages in brackets indicate the share of that policy area in total general government expenditure in 2013.

Source: OECD National Accounts, http://dx.doi.org/10.1787/na_glance-2015-en.

StatLink http://dx.doi.org/10.1787/888933342154

Spending shares do not reflect true spending power

The first inkling that sub-central spending shares might not be a faithful indicator of policy autonomy arises when looking at healthcare expenditure. Healthcare spending ratios vary widely across OECD countries, seemingly suggesting that responsibility for healthcare ranges between almost completely sub-central and almost completely central. While in countries such as Canada, Denmark, Italy, Sweden, Ireland and Finland, the sub-central governments (SCGs) account for more than 80% of all healthcare spending, in others, like France, Greece, Luxembourg, New Zealand or the United Kingdom, they have no or very low financial responsibility for healthcare. Comparisons of the institutional set-up of healthcare systems with sub-central spending shares suggest that the spending share paints a distorted picture of the true power of sub-national governments over healthcare (OECD, 2010).

Generally speaking, the spending share as a measure of sub-central autonomy comes up against limitations. Sub-central spending may be extensively shaped by upper-tier

government regulation, so losing discretionary power over various budget items. Sub-central governments often act as mere agencies, implementing policies determined by central government and financed through earmarked transfers. In some countries, the transfer of financial responsibility for education and healthcare was hardly more than a change in accounting procedures, while essential regulatory and financial power remained at the central level. Spending power could be partially assessed by the percentage of grants earmarked for certain purposes. Some central governments regulate sub-central spending outside the grant system, however, making earmarked grants an unreliable indicator. An accurate picture of sub-central spending power requires a refined set of institutional indicators.

Definition and scope of spending power

Going beyond financial data

Spending power is the extent to which sub-central governments can control their budgets. The concept of spending power thus goes beyond financial indicators to cover all facets of policy making. A few attempts have been made to measure them all. There is a regularly updated OECD dataset on the decentralisation of educational functions and school autonomy (OECD, 2014a). There are some one-off data on sub-central spending power in selected policy areas such as education (Gonand et al., 2007) and, as mentioned above, healthcare (OECD, 2010). In general, though, it is more difficult to develop indicators of spending power than of tax autonomy because a) the spending side of a budget covers many policy areas, not just tax policy, and b) "autonomy" is more multi-faceted on the spending side than on the revenue side, where it essentially boils down to the ability to set tax rates, the tax base, or both.

Spending power may shape the efficiency and sustainability of intergovernmental fiscal frameworks. Effective public service delivery hinges on clearly assigned responsibility, i.e. governments at each level exert control over the services they are funding. Large gaps between spending shares and power hint at opaque responsibility arrangements between governments that lessen accountability. Spending power may also determine such fiscal outcomes as deficits and debt and the extent to which central government may have to shield SCGs from fall-out from the business cycle. The more central government impinges on sub-central spending, the more it has to help in the event of financial difficulties – by increasing intergovernmental transfers or sub-central tax shares, for example. In some instances, low spending power might undermine fiscal rules because SCGs have no leeway for adjusting expenditure and taxation to required budget targets.

Categories of spending power

To fully grasp the idea of "spending power", it is probably best to consider sub-central governments as service providers. They spend money on services that range from local public transport and garbage collection through to the police and judiciary, healthcare, education and regional development. A set of laws, rules and regulations governs each service and the more they are determined or shaped by upper-level intervention, the weaker is SCGs' effective power to determine the size and structure of their own budgets. SCGs exert little control over the education budget, for example, if teachers' salaries, class sizes, length of school days and other rules are mandated by an upper-tier government. Consequently, a SCG's spending power depends on the extent to which regulations in a policy area are under its control. Conceptually, rules and regulations may be grouped into five categories of autonomy (see also Bach, Blöchliger and Wallau, 2009):

- *Policy autonomy*. To what extent do sub-central governments exert control over main policy objectives and main aspects of service delivery? To what extent are sub-central governments obliged to provide certain services, e.g. through constitutional provisions or central government legislation?
- *Budget autonomy*. To what extent do sub-central governments exert control over the budget (e.g. by limiting expenditure autonomy through earmarked grants or expenditure caps)? Do fiscal rules specifically limit fiscal autonomy in a certain policy area (through spending floors and ceilings in certain policy areas and functions)?
- *Input autonomy*. To what extent do sub-central governments exert control over the civil service (e.g. staff management and salaries) and other input-side aspects of a particular function? To what extent can SCGs negotiate and shape civil servants' wages and wage structure? To what extent are SCGs free to tender or outsource services?
- *Output autonomy*. To what extent do sub-central governments exert control over the standard of the public services they deliver? To what extent can SCGs define output criteria such as school curricula, the number of hospitals to be funded, or local public transport fares?
- *Monitoring and evaluation autonomy*. To what extent do sub-central governments exert control over evaluation, monitoring and benchmarking? To what tier of government do service providers report (e.g. financial control, school tests)?

The five categories of autonomy could, in theory, apply to every policy area for which spending power is assessed – some 70 in all if the OECD National Accounts' COFOG classification is anything to go by. Clearly, evaluating all policy areas would be very painstaking. For practical reasons, therefore, a spending power database should cover only a sub-national government's main expenditure items – probably between 10 and 12 policy areas covering around 80% to 90% of sub-central public spending. Accordingly, the pilot study presented towards the end of the chapter analyses four policy areas that account for large shares of sub-central expenditure.

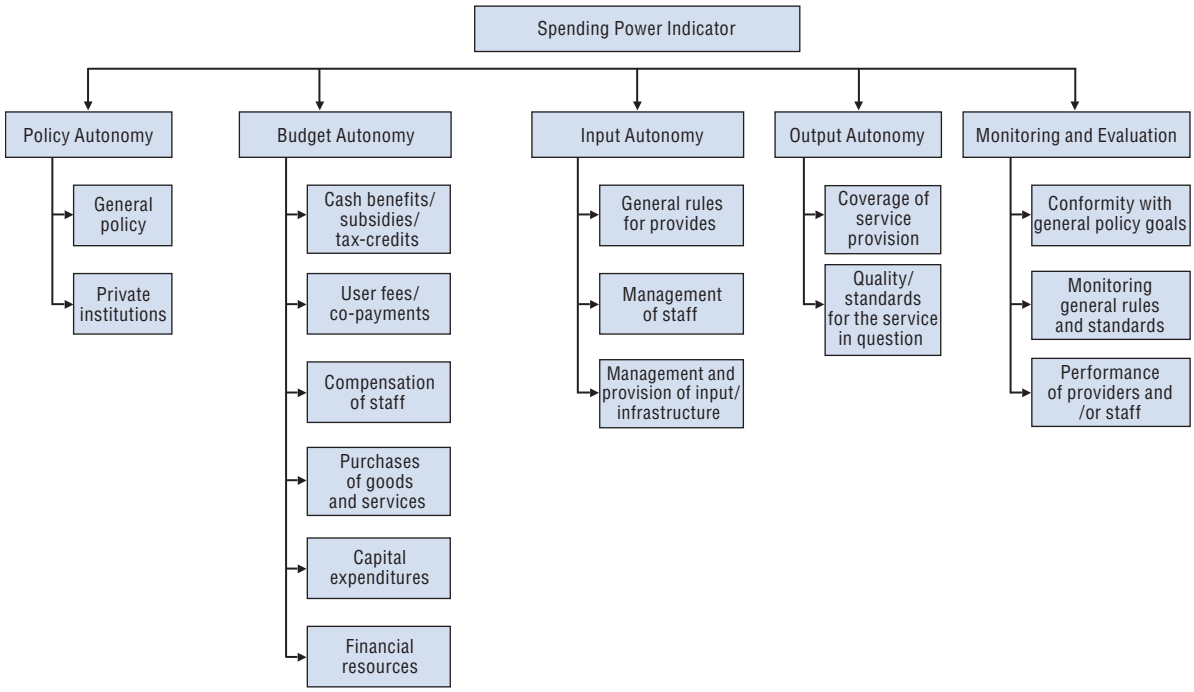
Measuring spending power

Developing institutional indicators

Spending power is an element in a country's intergovernmental fiscal framework. To compare countries' spending power and assess its impact on economic and fiscal outcomes and the well-being of citizens, it must be quantified by means of *institutional indicators*. These are quantitative gauges of a country's institutional and policy arrangements. Applied to spending power, they measure the extent to which SCGs enjoy autonomy in the design of public services, i.e. whether they have influence over how public services are provided, organised, regulated and financed and, if so, how much. The spending power indicators developed here are intended to be purely descriptive and contain no explicit or implicit evaluation of whether a given arrangement is "better" or "worse" – that is the objective of further empirical analyses. The OECD has published several guidelines on how to establish institutional indicators (see, for example, OECD, 2010).

Institutional indicators of spending power are brought together in the form of an *indicator tree* comprising three levels of indicators: low-level (LLIs), medium-level (MLIs), and a single high-level indicator (HLI) (Figure 6.3). Building a spending power indicator tree starts with LLIs that describe a specific aspect of spending autonomy. They are then aggregated using the random weights technique to form five MLIs – one for each of the five autonomy

Figure 6.3. **Example of a spending power indicator tree**



categories discussed above (for details of the random weights technique see Sutherland et al, 2015). The MLIs are, in turn, aggregated to yield a single high-level indicator that measures spending power in a single sub-central policy area. Although the indicator tree template is the same for all policy areas, the LLIs must be adjusted to the specifics of each one. They are usually coded with the help of multiple-choice questionnaires for each policy area, which requires highly detailed *ex ante* knowledge of countries' institutions.

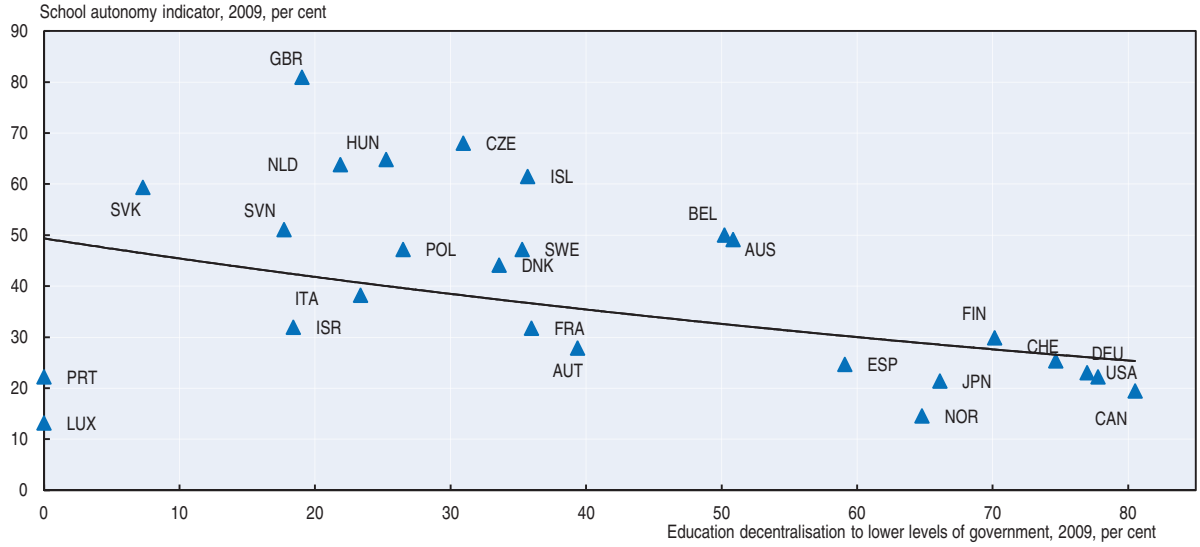
The role of public service providers

In many countries public service providers – schools, hospitals, transport companies and other public and private bodies – enjoy considerable budget autonomy. They are allowed to set the prices of their output and/or negotiate wages and other input prices. Giving them greater budget autonomy can sometimes be seen as an alternative to decentralising the delivery of services to lower government levels and generally produces similar levels of accountability and efficiency. Indeed, while some countries – especially federal ones – assign spending and some regulatory powers to lower tiers of government, others grant providers with financial and regulatory leeway. In reality, sub-central and provider autonomy are alternatives rather than complements, as evidenced in the assignment of responsibility in education, where decentralising to SCGs and giving schools autonomy seem to be alternatives (Figure 6.4).

The question of whether the autonomy of service providers and jurisdictions can be compared and assessed using the same concept of spending power remains open to some extent. While the allotment of power to providers can be considered a form of "decentralisation" that brings services closer to citizens, it does not necessarily increase a SCG's ability to influence service delivery, particularly as providers and the organisations managing them seldom answer directly to an elected body. Nevertheless, the inclusion of

Figure 6.4. **Decentralisation and school autonomy are alternatives rather than complements**

Education is either devolved to lower government levels or to schools but rarely both



Source: Adapted from OECD (2014b), *Fiscal Federalism 2014: Making Decentralisation Work*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933342169

service providers does help paint a fuller picture of a number of budget and regulatory questions. Assessing the role of service providers creates a link between the policy issues of fiscal federalism and those of market regulation in public service provision. "Spending power" thus spans all issues of how to bring public services to the people in an efficient, equitable fashion.

Results of a preliminary study into spending power

To assess the feasibility of the spending power concept, the OECD Fiscal Network conducted a pilot study in 2009. It involved five countries in four policy areas. A detailed questionnaire was sent to the five governments, which then had to assess the institutional and regulatory environment of service delivery in each policy area. This section looks at the summary results. (More detailed findings are in Bach, Blöchliger and Wallau, 2009).

Policy areas and coding

The four policy areas selected for quantitative assessment were "primary and secondary education", "public transportation", "childcare" and "elderly care". The questionnaire through which data were obtained for each policy area was structured to reflect the five above-mentioned classes of autonomy – policy, input, budget, output, and monitoring and evaluation. "Public transportation" deviated slightly from the template, as the questionnaire contained four categories because input autonomy and budget autonomy were merged. As far as possible the questions were multiple-choice. Of the five countries taking in the pilot study, Germany and Switzerland are federal and Denmark, Portugal and the Slovak Republic are unitary. Ireland, too, returned a questionnaire on "primary and secondary education".

Coding the answers to the questionnaire is a relatively simple matter. Each one is converted into a low-level indicator using the values shown in Table 6.1. The lower the level

Table 6.1. **Coding low-level indicators**

Level of government responsible	Indicator value	
	Federal countries	Unitary countries
Central	0	0
State	3	
Local	7	5
Service provider	10	10

Source: Bach, Blöchliger and Wallau (2009).

to which a certain responsibility, role or task is assigned, the more decentralised the spending power and the higher the indicator value. Indicator values are scaled from 0 to 10 and can easily be converted into percentages. Local governments in unitary countries were assigned 5, the average of the regional (3) and local level (7) in federal countries. This arbitrary value can be interpreted as local governments in unitary countries partially fulfilling tasks incumbent on state/regional governments in federal countries. While it makes spending power in federal and unitary countries comparable, this arbitrarily assigned value rests on the assumption that local levels in both types of country government can be set against each other.

Spending power varies across countries and services

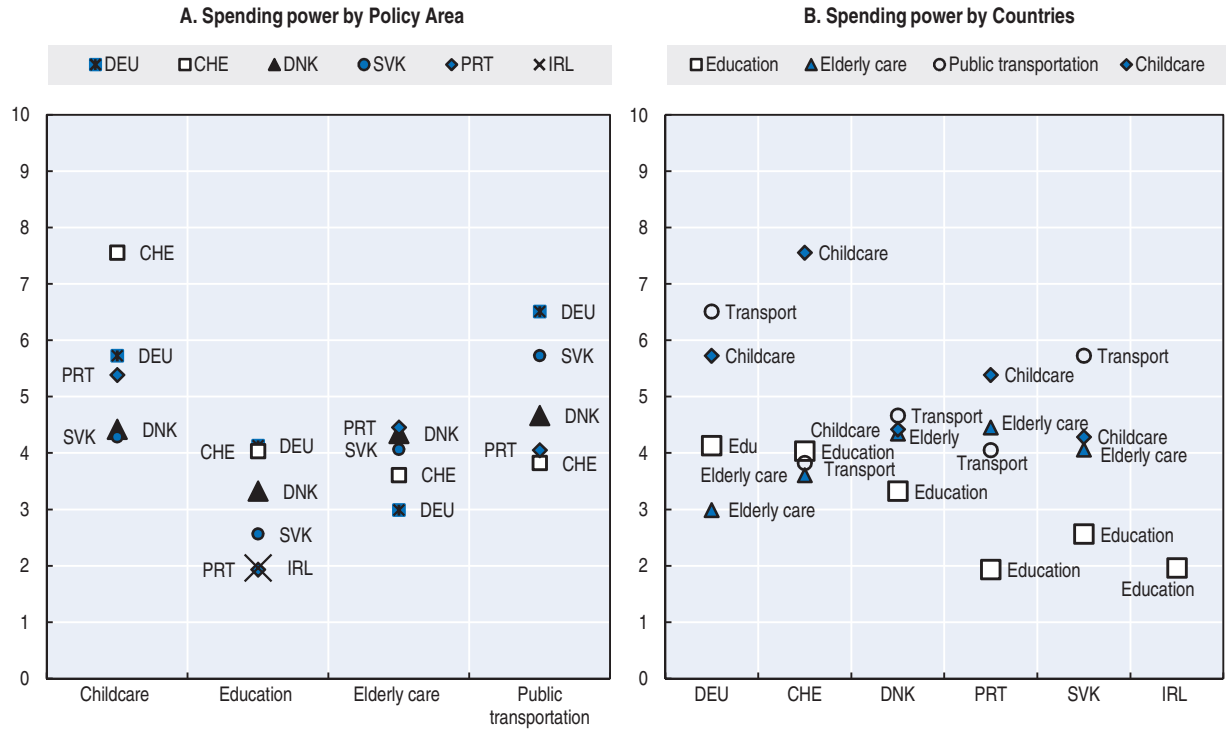
Although spending power indicator values are widely dispersed across countries and services, it is possible to discern (Figure 6.5). Sub-central spending power is highest in childcare and lowest in education, particularly in Ireland and Portugal which both appear to have strongly centralised school systems. Spending power is generally greater in federal than in unitary countries apart from elderly care. As mentioned above, spending power indicators are purely descriptive, not normative, so there is no "optimal" value to which the actual values can be compared.

Sub-central governments exercise more oversight over input and budget than over policy and output in any given public service (Figure 6.6). In most countries, they are granted some leeway in such input-related areas as determining the administrative and organisational framework of service delivery, while output autonomy is often low, especially in education. In a few countries and services, output-oriented autonomy is greater than input-oriented autonomy (not shown in Figure 6.5). SCGs struggle to manage such arrangements since they lack the means to shape service delivery for which they are held responsible. Monitoring and evaluation values range widely across services and countries, suggesting that some monitoring activities are organised at lower government levels while others are subject to high degrees of central control.

Spending power is often shared

Government levels share many tasks and responsibilities (Table 6.2). Although shared responsibilities may be the result of a co-ordinated approach to service delivery between central and sub-central governments, they may also blur accountability and foster a perception that shared responsibility means no responsibility. Although shared responsibilities are a feature common to all countries, federal countries tend to share more than unitary countries, probably because more government levels means more overlapping. The extent of responsibility sharing also depends on the service in question. It tends to be greater in public transport than in child or elderly care, probably because public transport is a network industry and so requires enhanced co-ordination.

Figure 6.5. **Spending power by policy area and country**

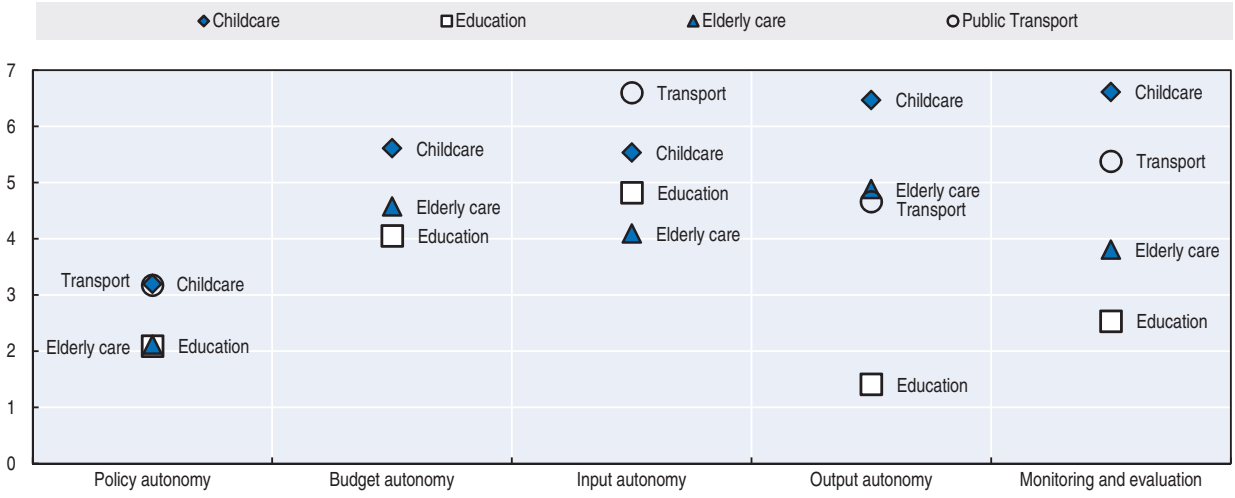


Source: Based on Bach, Blöchliger and Wallau (2009).

StatLink http://dx.doi.org/10.1787/888933342178

Figure 6.6. **Spending power indicators by category of autonomy and policy area**

Averages of sample countries



Source: Based on Bach, Blöchliger and Wallau (2009).

StatLink http://dx.doi.org/10.1787/888933342182

Comparing SCG spending power and SCG expenditure shares

Finally, a comparison between spending power indicators and simple spending shares can help produce a nuanced picture of sub-central fiscal autonomy. Figure 6.7 sets spending power indicator values against sub-central expenditure ratios in the four policy areas. To be

Table 6.2. **The sharing of responsibilities is a feature common to all countries**

Number of rules and procedures where more than one government level is involved

		Childcare	Education	Elderly care	Public transport	**Total**
Federal countries						
Germany	Policy Autonomy	7	4	3	4	*18*
	Budget Autonomy	7	1	4	8	*20*
	Input Autonomy	3	2	4		*9*
	Output Autonomy	2	0	3	5	*10*
	Monitoring/Evaluation	2	0	3	4	*9*
	Total	*21*	*7*	*17*	*21*	**66**
Switzerland	Policy Autonomy	6	4	3	4	*17*
	Budget Autonomy	9	11	8	10	*38*
	Input Autonomy	3	9	11		*23*
	Output Autonomy	0	0	3	5	*8*
	Monitoring/Evaluation	4	0	0	4	*8*
	Total	*22*	*24*	*25*	*23*	**94**
Unitary countries						
Denmark	Policy Autonomy	3	0	1	2	*6*
	Budget Autonomy	2	3	0	9	*14*
	Input Autonomy	5	7	2		*14*
	Output Autonomy	0	1	0	5	*6*
	Monitoring/Evaluation	3	2	1	2	*8*
	Total	*13*	*13*	*4*	*18*	**48**
Ireland[1]	Policy Autonomy	-	2	-	-	*2*
	Budget Autonomy	-	0	-	-	*0*
	Input Autonomy	-	4	-	-	*4*
	Output Autonomy	-	1	-	-	*1*
	Monitoring/Evaluation	-	2	-	-	*2*
	Total	*0*	*9*	*0*	*0*	**9**
Portugal	Policy Autonomy	0	6	0	3	*9*
	Budget Autonomy	2	11	2	11	*26*
	Input Autonomy	2	12	1		*15*
	Output Autonomy	1	0	1	5	*7*
	Monitoring/Evaluation	0	3	0	7	*10*
	Total	*5*	*32*	*4*	*26*	**67**
Slovak Republic	Policy Autonomy	1	3	1	3	*8*
	Budget Autonomy	6	7	6	5	*24*
	Input Autonomy	4	2	8		*14*
	Output Autonomy	2	0	4	1	*7*
	Monitoring/Evaluation	4	2	2	6	*14*
	Total	*17*	*14*	*21*	*15*	**67**
	Grand Total	*78*	*99*	*71*	*103*	**351**

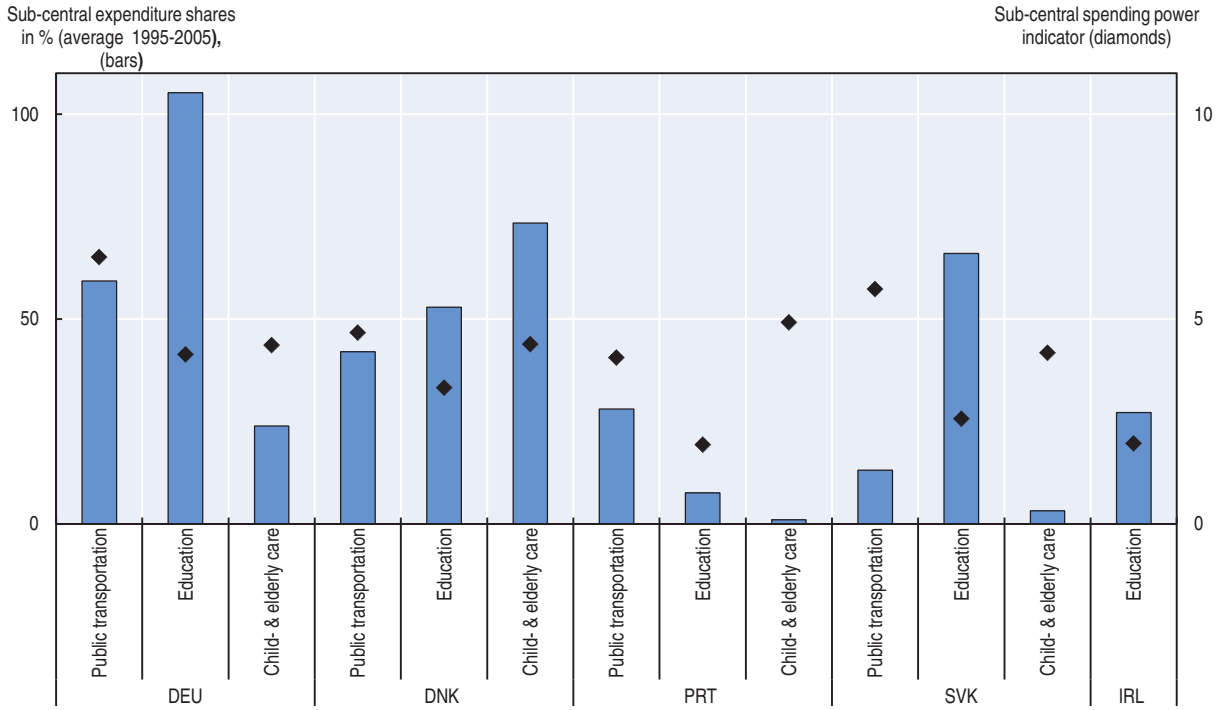
1. For Ireland, only data on education are available. For public transport, input and budget autonomy were merged to form a single category.

Source: Based on Bach, Blöchliger and Wallau (2009).

precise, it compares the "public transportation" policy area to the COFOG I "economic affairs" function, the "education" policy area to the "education", function, and child and elderly care to the "social protection" function.[2]

Figure 6.7 supports the view that simple expenditure ratios often poorly reflect effective sub-central spending power. Whereas expenditure ratios frequently exceed the 50% threshold, the corresponding spending power indicator is rarely above 5, which indicates that sub-central spending power is lower than expenditure shares suggest. The finding is particularly true of education, where SCGs spend large sums of money but have

Figure 6.7. **Sub-central expenditure ratios and spending power indicators often diverge**



Note: Bars and the left hand scale represent SCG expenditure shares as percentages, while the dots and the right hand scale represent spending power indicators. Switzerland is not shown due to lack of COFOG I data. The German education share is above 100%, because the data are not consolidated.
Source: Based on Bach, Blöchliger and Wallau (2009).

StatLink http://dx.doi.org/10.1787/888933342199

little control over expenditure. By contrast, public transport spending power is greater than indicated by the shares of expenditure in the COFOG I function "economic affairs". In some countries and functions, spending power seems to outstrip spending shares, which points to arrangements whereby sub-central governments exercise power over the delivery of some services without actually paying for them.

Summary and conclusions

Spending power is a sub-central government's ability to determine the size and composition of its budget and a measure of fiscal autonomy. While sub-central fiscal rules provide guidance to and put limits on the overall budget, spending power refers to rules and regulations that govern policy areas and individual government functions. Gauging spending power entails detailed assessments of each policy area's regulatory environment and intergovernmental fiscal frameworks. For that reason, spending power should be assessed with the help of institutional indicators that capture all facets of autonomy in each policy area. Once the values of the spending power indicators are obtained, they may be compared with traditional financial statistical indicators, especially sub-central expenditure shares. A pilot study conducted by the OECD Fiscal Network shows that spending power indicators paint a more comprehensive, varied and policy-relevant picture of the autonomy SCGs actually enjoy than simple spending shares.

Knowledge of true spending power is policy relevant from both a structural and macroeconomic point of view. Spending power determines the extent to which:

- sub-central governments are accountable for the delivery of sub-central public services, their responsibilities overlap, and sub-central administrations true control of the efficiency and distribution of the services they fund;
- SCGs can adapt their budget to changing economic and fiscal circumstances and whether central governments must shield them from revenue fluctuations by adjusting intergovernmental grants or tax-sharing systems.

Intergovernmental fiscal relations should be designed to align spending shares with true sub-central policy and budget autonomy.

Notes

1. COFOG stands for National Accounts Classification of Functions of Government. COFOG I divides government expenditure into ten functions or policy domains. They are: general public services; defence; public order and safety; housing and community amenities; economic affairs; environment protection; health; recreation, culture and religion; education; social protection.
2. Working with the COFOG I classification can give a rough spending share approximation only. Yet spending shares that match the four policy areas for which spending power indicators were developed can only be estimated once COFOG II data, with altogether 70 detailed functions, are available.

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