OECD Fiscal Federalism Studies

Reforming Fiscal Federalism and Local Government

BEYOND THE ZERO-SUM GAME



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BEYOND THE ZERO-SUM GAME

by Hansjörg Blöchliger *and* Camila Vammalle



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Foreword

Efficient and effective fiscal relations across levels of government are key ingredients for sound fiscal management, especially in times when embarking on a fiscal consolidation path is among the top policy priorities. Many OECD countries have reformed their intergovernmental fiscal relations in the last decade by: giving regional and local governments new spending and taxing powers; overhauling intergovernmental transfer and equalisation systems; tightening deficit, debt or spending rules at all levels of government; reforming local and regional tax systems, eliminating existing taxes and introducing new ones; merging municipalities, abolishing counties or creating regions. Although these reforms were meant to make intergovernmental fiscal relations more efficient, more equitable and more stable, many of them faced stiff political resistance. Some of the envisaged and necessary fiscal reform plans were watered down, postponed, or even abandoned. But the need to reform will not wither: it will become even more pressing in the coming years, as state and local governments will have to face an increasingly heavy burden of fiscal consolidation.

The effective management of intergovernmental fiscal reforms in such a challenging political economy environment is at the heart of this book. To better understand the conditions that underpin successful reforms, the OECD Network on Fiscal Relations across Levels of Government has put ten reform cases under the political economy spotlight, using a uniform approach. The country chapters demonstrate that there is not only a common set of challenges, but also a common set of approaches and processes to address them. One of the most salient findings is that "money matters": in the face of resistance, it is easier to reform fiscal relations when economic and fiscal conditions are good and the central government can put additional resources on the table. The first chapter of this book summarises the common findings, drawing out the main drivers of successful reforms from a political economy perspective.

This volume was prepared as part of the wider OECD programme on "Making Reform Happen" steered by Deputy-Secretary General Aart de Geus. I am particularly grateful to delegates from national governments and administrations who contributed to this book with their knowledge and insights. Special thanks go to the interview partners who took part in in-depth conversations, giving us the opportunity to glance at the backstage of the reform process. We believe that the policy lessons in the case studies and the comparative perspective can support member and partner countries' reform efforts for better fiscal relations.



Angel Gurría

OECD Secretary-General

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Executive summary

This book focuses on reforms of fiscal federalism and local government. It identifies the political and economic factors that influence the design, adoption and implementation of changes to intergovernmental fiscal relations. The study is based on the analysis of reform episodes adopted in ten countries (Australia, Austria, Belgium, Canada, Denmark, Finland, Italy, Portugal, Spain, and Switzerland) between 2001 and 2009. A common approach is applied to analysing individual reform cases. Little analysis has been done so far on the political economy of fiscal federalism and local government, both inside and outside the OECD. Identifying the elements that helped overcome past reform barriers will hence provide guidance to policy makers for the design of future reforms that are both effective and politically palatable.

Some factors that determine the success of reforms are outside the scope of policy makers. Fiscal relations are shaped by country-specific frameworks and reforms often touch upon constitutional arrangements, requiring a strong mandate for change. Economic and fiscal conditions may turn during a reform episode, shaping reform design or indeed the chance that the reform will be passed. Short-term distributional effects are highly visible and often result in a focus on the short term, making long-term efficiency-enhancing reforms difficult to attain. But within this context, policy makers have scope to help a reform succeed. They may be able to influence the timing, the scope and the sequencing of the reform. Political leaders may help in securing support, and the administration and external experts can help in developing credible reform proposals. Finally, by adapting the reform design, policy makers may address opposition and secure a reform majority.

The main lessons from the reform episodes are as follows:

- *Good economic and fiscal conditions can help*. One of the most salient findings is that reform success is strongly linked with a good economic situation and sound fiscal positions. While a few reforms were initiated when the economic situation was weak or driven by consolidation needs, implementation of virtually all reforms took place when central and – to a lesser extent – sub-central public finances were in good shape. A sound fiscal position allows central government to compensate sub-central governments, while reform resistance tends to be stiffer and reform failure more likely without central government support. The legacy of the crisis is likely to change the role of economic and fiscal conditions for reform adoption. Weak growth and a lack of financial resources will change reform objectives as well as central government's role as paymaster.
- *Electoral mandates are important but not crucial*. Electoral mandates are an important driver for reforms, although fiscal federalism and local government issues rarely play a prominent role in election campaigns. The stronger an electoral mandate, the more comprehensive a reform tends to be. Campaigns tend to focus on generic objectives such

as "more autonomy", "better public services", "a fair regional distribution" and less on the intergovernmental mechanics that are needed to achieve them. However, fiscal relation reforms can be achieved without explicit mandates. Given their often technical and non-ideological nature, governments have some scope to negotiate a reform without an explicit mandate.

- *Reforms often build on earlier reform attempts, pilot programmes and experiments.* Fiscal federalism and local government reform often touch on the founding institutions of a country, with reforms sometimes requiring constitutional amendments. Reform success is often preceded by several failed reform attempts or even reform reversals. Such attempts build up expectations and pressure for more comprehensive reforms later. Moreover, experiments and pilot programmes, which tend to be easier to implement in fiscal relations than in other policy areas, can show the effectiveness of reforms and pave the way for change on a grander scale.
- *Bundling is required to garner majorities.* Most successful fiscal relation reforms consist of comprehensive packages offering benefits to a large array of actors. Bundling of various elements allows spreading reform benefits more evenly across various types of jurisdictions and stakeholders. Bundling also allows putting more emphasis on long-term aspects, with reforms often bundling efficiency-enhancing elements with distributional objectives. Indeed, wide-ranging fiscal federalism and local government reforms try to strike a balance between efficiency and equity objectives.
- *Transitional compensation is almost always necessary.* Transitional arrangements are a frequent measure to ensure that no jurisdictions and stakeholders are going to lose in the short run. Transitional arrangements have their benefits beyond securing reform success as they help preserve reform consistency, with necessary political compromises being relegated to a transition period. The flipside of transitional arrangements is that they usually come at the expense of the central government. In some cases and in order to deflect categorical opposition by a few jurisdictions, opt-out clauses might be provided.
- *External expertise creates credibility.* Many fiscal federalism and local government reforms are both very "political" and highly technical. Independent experts can tackle both issues. By providing impartial and unbiased scrutiny, independent experts are able to create and sustain credibility among the public. And experts can help set up specific technical support during reform design. In some cases expert panels and reports were considered the crucial pillar for reform success.
- *Communication should emphasise the long-term effects of the reform.* Wide and open communication not only creates support from dispersed winners, often unaware of potential reform gains, but also helps identify potential problems with individual reform elements. Successful communication emphasises the long-term benefits without concealing negative impacts for jurisdictions. Secretive strategies tend to undermine the credibility of the government.

The importance of reforming fiscal relations and of raising the efficiency of sub-central governments has become more urgent in the face of current consolidation needs. A few studies in this book point to the particular challenges that arise when reforms to the institutional framework have to be embedded in a general fiscal consolidation strategy.

Chapter 1

Reforming fiscal relations: Going beyond the zero-sum game

Introduction

How to reform fiscal relations?

One of the salient features of fiscal federalism in OECD countries during the past decade has been a trend toward decentralisation, as policy reforms have increased the power of state and local governments. From 1995 to 2008 the average share of sub-central in general government spending rose from less than 31% to more than 33%, while the share of sub-central in general government tax revenues rose from 16% to 17%. Some countries have embarked on a long-term decentralisation path involving wide-ranging changes to their institutional arrangements (Box 1.1). However, many attempts to reform fiscal relations have encountered difficulties. Various reforms – including the territorial reorganisation of public service delivery, changes to the sub-central tax structure and the tightening of sub-central fiscal rules – have stalled or been introduced only partially and after several unsuccessful attempts. The technical and political obstacles to wide-ranging reforms of fiscal arrangements are formidable. The question arises as to how they may be overcome and the benefits of decentralised policy making fully realised, especially in a context where sub-central governments will have to share in the efforts of fiscal consolidation.

In an effort to help governments understand the obstacles to reform and the best ways to overcome them, the OECD Network on Fiscal Relations across Levels of Government put a set of reform episodes under the lens of "political economy of reform". This concept

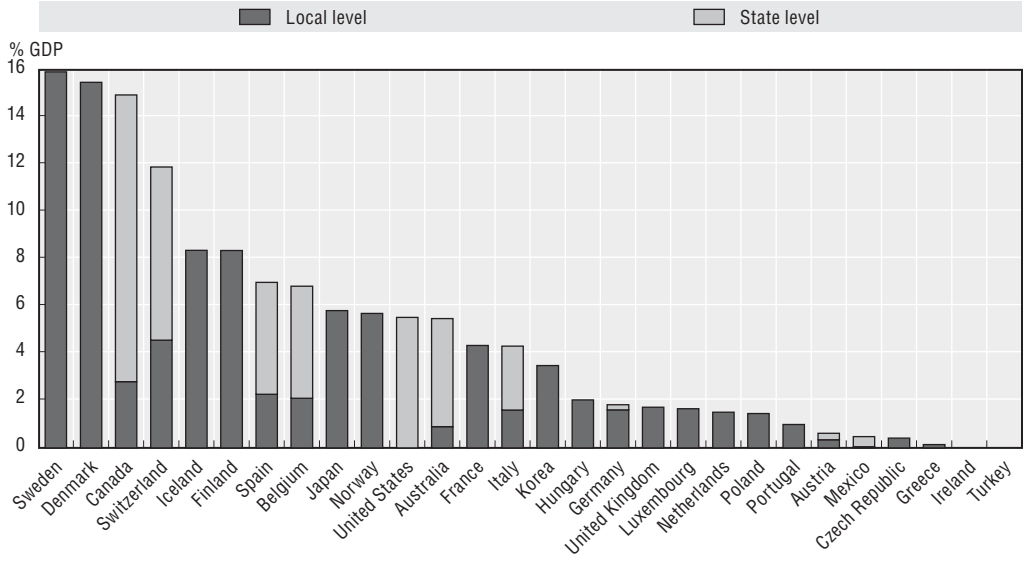
Box 1.1. **Why reform fiscal relations?**

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

refers to how political, economic and institutional factors influence the design, adoption and implementation of policy changes, and how policy design and the reform process are intertwined. Given the idiosyncrasies of fiscal federal institutions, such reforms appear very country-specific, with little scope for cross-country comparison, as exemplified by the wide variation of sub-central tax autonomy across OECD countries (Figure 1.1). But within this context of diversity, policy makers face similar challenges and opportunities to make fiscal relations more efficient, more equitable and more stable. They may be able to influence the timing, the scope and the sequencing of the reform process and thereby change the balance between winners and losers or between short- and long-term effects. By adapting the design of the reform, they may be able to reduce opposition and to secure a majority in favour of the reform. The study is based on ten reform episodes, which show that despite the wide differences in institutional backgrounds, the challenges are similar. Although the effects of the reforms presented here are not evaluated, most of them tend to make a country's fiscal federalism arrangements more efficient, more equitable or more stable.

Figure 1.1. **Taxing power of sub-central governments varies widely across the OECD**

Taxes for which sub-central governments have the right to set the rates and/or the base, as a percentage of GDP, 2005



Source: OECD Fiscal Decentralisation Database.

The stakes in fiscal relations reforms

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

uncertain, tend to emerge later. The asymmetry between winners and losers in the reform process and uncertainty about the size and distribution of the future benefits may weaken the support for reform. A bias toward the status quo, and resistance to reform, may result, even if potential winners are likely to outweigh the losers in the long run. Only under certain circumstances can uncertainty about the outcome of a reform create a "veil of ignorance", *i.e.* a situation where stakeholders, unaware of how they will be affected individually, may be ready to agree to social contracts that increase the overall effectiveness of fiscal federalism arrangements.[1]

Fiscal federalism and local government reforms can be seen as a blend of structural reforms including tax reforms, and public administration reforms, and they can be analysed using the appropriate political economy framework.[2] Fiscal relations reforms have their peculiarities, however:

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

Methodology

This book is based on ten country case studies, and applies the method of "focused comparison" (Table 1.1 and Box 1.2). In order to make reform experiences comparable, all country chapters follow the same structure and methodological framework. The chapters describe and discuss issues such as reform outcomes, the reform context and the issue history, the actors and interests involved, the reform process, the design of the reform, and finally the adoption and implementation of the reform. The reforms studied were adopted between 2001 and 2009, although some reforms were initiated many years earlier. They include the introduction or amendment of fiscal equalisation programmes; the upgrading of (non-equalising) intergovernmental grant systems, particularly a move from earmarked to non-earmarked grants; the introduction or tightening of sub-central fiscal rules; the territorial restructuring of public service delivery, including the merger of municipalities; sub-central tax reforms; enhanced inter-jurisdictional co-operation and the introduction of a new regional layer; and the reorganisation of the competencies across ministries with respect to fiscal relations. In most cases, a reform covers more than one of the topics mentioned.

While the summary might give a comprehensive picture of the reforms recently on the agenda in member countries, the case studies could suffer from selection bias, in the sense that all reforms under scrutiny were adopted and can hence be considered "successful".

Table 1.1. **The ten case studies**

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

Source: Individual country case studies.

Moreover, all reforms, except for the Canadian equalisation reform, some of whose elements became fiscally untenable after the 2008 crisis, were implemented in a sustained way. Once adopted, the reforms were not reversed or watered down. The ten country case studies do not cover reforms that eventually stalled, and they do not analyse the factors that lie behind aborted reforms, nor do they cover situations where the government considers reforms urgent but has so far made no serious attempts to carry them out. Given this selection bias, it is clear that this study has more to say on the factors that promote comprehensive fiscal federal reforms than on the obstacles that impede them.

Box 1.2. **The method of "focused comparison"**

The method of "focused comparison" basically entails asking the same questions across a substantial number of cases in order to discern similarities among them (Tompson, 2009). Findings generated in this way do not enjoy the level of formal verification that may be achieved via quantitative analyses of very large numbers of cases. However, the method of focused comparison offers significant advantages, chiefly by facilitating a more detailed study of the context-dependent nature of certain relationships among variables. In particular, it permits a greater degree of "process-tracing" – *i.e.* tracing the links between possible causes and observed outcomes in order to assess whether the causal relationships implied by a hypothesis are evident in the sequence of events as they unfold. Because it examines specific cases in depth, rather than simply comparing data across cases, a focused case-study approach is better able to explore the policy process, to take account of institutional and political complexities and to explore more complex causal relationships, such as path dependence or the issues that arise when, for example, a given factor may favour adoption of a reform but hinder its implementation. A case-study approach also permits exploration of variables that can be extremely difficult to quantify or code for inclusion in regression analyses.

The reform context

This section describes the factors that shaped and influenced the reforms and the reform process but that were largely outside the control of policy makers.

Favourable economic and fiscal conditions can help reforms succeed

One of the most salient conclusions of the country studies is that a sound economic and fiscal position is strongly linked to the success of a reform. While some reforms were initiated during times of economic slack or driven by the need to consolidate, implementation of literally all reforms took place when central and, to a lesser extent, sub-central public finances were in good shape. Good economic conditions and sound fiscal positions help central governments to "buy" reforms and to grant a reform dividend on the spot. The role of a sound fiscal position is most obvious in equalisation reforms, whose explicit distributional objectives inevitably create short-term winners and losers among SCGs (a zero-sum game). In most reform cases the central government provided additional transfers to the sub-central level so as to make almost every SCG a net reform winner. Portugal's local government reform, part of a strategy of fiscal retrenchment, was the only reform studied that was fiscally "neutral", *i.e.* where the central government did not put additional resources on the table. Even territorial reorganisation and tax reforms, whose distributional impacts are weaker, are often bankrolled with additional resources from the central government. Finally, some reforms were implemented as part of a fiscal stimulus programme, as in the case of Australia. Without considerable financial help from the central government, resistance to reform tends to be much stiffer and failure is more likely.[3]

The recent economic and financial market crisis and its dire fiscal implications are likely to change for some time the economic and fiscal environment for reform. Most of the reforms studied were adopted before central governments had embarked on fiscal consolidation. Few reforms have been adopted during the crisis, although the sales tax reform in the Canadian province of Ontario, which had been delayed for years, was prompted by the crisis and by the need to help the economy out of recession. Weak growth and a lack of financial resources will now limit the prospects for reform and the central government's role as paymaster. Fiscal positions will shape reform outcomes: while good economic and fiscal conditions appear to favour reforms that increase equalisation and more generous handouts to SCGs, economic and fiscal crises will likely trigger reforms that increase sub-central government efficiency and tighten fiscal discipline. The coming years will show what type of reform can be initiated, adopted and sustained under conditions where central governments can no longer afford to pay.

Electoral mandates are useful but not crucial for success

Electoral mandates are an important driver in fiscal federalism reforms, although intergovernmental fiscal relations rarely feature as a high priority in election campaigns. Once a new government was elected on a platform that included a fiscal relations reform, it tended to act quickly, as shown by the Australian, Belgian, Danish or Portuguese reforms. Governments without a mandate tend to engage in small and often piecemeal reform attempts. Acting against electoral promises can create strong opposition to a reform by special interest groups and the public at large, even if the reform is financially supported by the central government. Compulsory mandates – *e.g.* the obligation to amend fiscal relations every four years as is the case in Austria – may create a positive climate for reform, but again, the scope and outcome depends on the electoral mandate. The more convincing the mandate, the more comprehensive the result of the reform tended to be. Electoral mandates to increase the efficiency of public services, to reduce fiscal disparities or to increase sub-central fiscal autonomy were stronger than mandates for sub-central

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

Electoral mandates are not always necessary, however. Fiscal federalism itself is a technical topic that arouses few political emotions, except when voters are strongly attached to "their" jurisdiction or "their" local service. Interest in which government level provides a public service is slight; voters are usually more interested that it be tailored to their needs and delivered at a reasonable cost. In the reform cases under scrutiny, campaigns tended to focus on generic objectives such as "more autonomy", "better public services" and "fair regional distribution" and less on the intergovernmental mechanisms that were necessary to achieve them. Only with time did governments become aware that fiscal relations played a pivotal role in their endeavour to reform the public sector, public finances or tax systems. Moreover, it was generally expert or administrative groups rather than politicians that drove reform, which kept the discussion at the technical level and below the radar of party politics. Since fiscal relations are rarely viewed through an ideological prism, governments have some scope to negotiate a reform that was not initially on the political agenda.

Some arrangements provide sub-central governments with considerable leverage

Constitutions and electoral systems may give local and regional governments considerable power to shape the reform or veto undesired outcomes. Very basically, members of a national parliament will represent the interests of their jurisdiction. In several federal countries, reforms have to be approved by two parliamentary chambers, with the second chamber representing the states or regions. In some unitary countries, especially in Scandinavia, municipalities enjoy the right to fiscal and administrative self-governance, putting limits on the central government's ability to change acquired rights against their will. Certain forms of collaborative federalism and comprehensive consultation across government levels and with other social groups add to the constraints. Also, the distribution of sub-central governments in terms of size or economic wealth across the country has a strong impact on the outcome of reform, often favouring small and/or economically lagging SCGs.[4] A system of many small electoral districts is likely to favour redistribution and the interests of certain groups over considerations of efficiency.[5] Finally, SCGs with strong regionalist ambitions and the ability to deliver crucial swing votes can strongly influence reforms of fiscal relations. In sum, an institutional bias toward the status quo can complicate radical overhauls if they do not benefit a large majority of SCGs.

Another complication is the fact that fiscal relations reforms require an administration to reform itself. The public administration at one or more government levels must design and implement measures that may negatively affect part of its own constituency (Charbit and Vammalle, 2010). While an internal distribution of power between ministries may increase administrative efficiency, it may also create resistance within the administration, particularly when the power to oversee fiscal relations is shifted from the line ministries and concentrated in the hands of the Ministry of Finance. Country cases suggest that ministries such as those for education or health care – often closely linked to their respective constituencies, such as the medical or educational sector – may provide impetus for a reform, but they also often slow down the reform process or tilt it towards their own interests. Certain reforms – *e.g.* the move from earmarked to non-earmarked grants – had an impact on special interests within and outside the administration and met with tacit resistance that could often be only partly overcome.

Widening the scope of fiscal federalism reform by an internal market reform (*e.g.* removing trade barriers between SCGs) and incorporating the interests of the business sector, can help overcome this type of status quo bias, but it can also create additional opposition from businesses in protected markets.

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

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

Opinions on reform often diverged more between SCGs than across government levels, leaving the central government to balance diverging SCG interests. SCGs with an efficient public sector preferred tax autonomy over grants and subsidies, while the less efficient jurisdictions opposed it. Poorer SCGs, often in a majority, claimed more equalisation, while wealthy SCGs tried to put limits on redistribution. SCGs with high debt and deficit levels opposed tighter fiscal rules, while those with robust fiscal positions took them more lightly. While poor SCGs tended to favour mergers with those better off, richer ones lobbied hard against such mergers because they feared that average service levels would go down or tax rates up. In some cases, conflicts between SCGs were swept under the carpet in order not to weaken negotiations with the central government. Summing up, most fiscal federalism reforms tend to entail stronger conflicts among SCGs than between the central and the sub-central level, especially when, at an early stage of the reform, the central government aligns with a few reform-minded SCGs.

Finally, the interests of individual jurisdictions or government levels have a stronger impact on the outcome of a reform than party ideologies. In the case studies, political party members often took a different position depending on whether they were acting at the central or the sub-central level. Conversely, parties of different ideological stripes aligned across levels of government to pursue a reform. In some cases, especially in reforms concerning tax autonomy or fiscal equalisation, the same political party held different views across sub-central jurisdictions, although this was not explicitly acknowledged**.** For a reform to be strong and sustainable, it can be helpful if the same parties or a party coalition command a majority at both levels of government, as many elements of a reform depend on political tenets reflected in party ideology.

Timing and scope

Reforms often build upon earlier failures and pilot programmes

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

Pilot programmes can help prepare the way for comprehensive reforms. The municipal reorganisation in several Nordic countries was successful because policy makers could point to successful experiments with a subset of local governments.[6] The experiments showed the feasibility of a new approach and helped to overcome resistance. In Canada, tax accords between the federal government and three small provinces helped pave the way for sales tax harmonisation in larger and economically more important provinces. In Australia, successful public sector reforms in individual states showed the need for reform at the central level, especially in the realm of service funding and delivery. Also, new management techniques can be used in selected policy areas before they become the rule for the rest of the intergovernmental framework. Finally, "asymmetric federalism", *i.e.* an institutional setup in which one or a few SCGs have more prerogatives with respect to tax or spending powers than other SCGs – a common feature in OECD countries on a secular decentralisation path such as Italy or Spain – can also help start reforms. Once a reform covering selected SCGs is implemented, other SCGs may ask for equal treatment, resulting in further reforms that encompass all SCGs. In time, symmetric fiscal relations, under which all SCGs are subject to the same rules, are restored.

Bundling may be necessary to forge majorities

Most fiscal federalism reforms studied in this book consist of comprehensive bundles offering benefits to a large array of actors and interests. Although the inertia of fiscal federalism frameworks points at the difficulties of engineering a wide-ranging reform, a big-bang approach may prove easier to pursue than a gradual, sequential approach.[7] Comprehensive reforms may be necessary if there are many veto players whose support is crucial for success. In many cases under scrutiny, different reform elements, each addressing a subset of actors, were bundled in order to obtain the majority needed to pass the reform. Bundling made it possible to distribute the benefits of reform more evenly across various SCGs and stakeholders. It had the additional advantage of providing governments an opportunity to offer individual actors a "take-it or leave-it" package. Bundling locked in veto players: no single actor could expect to renegotiate reform amendments once the reform proposal was anchored, because that would have threatened the position of other actors and hence the outcome of the entire reform. Bundling also allowed more emphasis to be placed on long-term efficiency. Indeed, while wide-ranging

fiscal federalism reforms attempt to strike a balance between efficiency and inter-jurisdictional equity, small-scale reforms, are largely perceived as distributional.

In the reform cases under scrutiny, elements that enhanced efficiency, such as granting more tax autonomy, tightening sub-central fiscal rules, moving from specific to general-purpose grants or mergers of small municipalities, were often bundled together with distributional objectives, such as more grants for SCGs, a strengthened fiscal equalisation system, tax credits for low-income earners, service guarantees in remote areas and the like. The Swiss fiscal equalisation reform contained elements that tended to satisfy several types of SCGs, such as poor, low-cost rural as well as wealthy, high-cost urban SCGs, as they addressed both low tax capacity and a higher cost of service provision. In several cases, grant reforms, especially the move towards general-purpose grants, were met with an increase in transfers from the central government. Territorial reforms such as mergers gave the municipal level more power and responsibilities – sometimes at the expense of another territorial level – and benefitted both rural and urban areas of varying economic circumstances. A tighter sub-central fiscal rule was sometimes coupled with extra funding for highly indebted or poor jurisdictions. In some cases, the scope of the reform was widened to include other policy areas. For example, Australia's fiscal federalism reform provided incentives to reduce barriers to interstate trade, while Denmark's was coupled with a health care reform.

One important problem with bundling is that if it goes too far and tries to satisfy too many stakeholders, the distributional aspects can detract from the efficiency-enhancing aspects of the reform. Bundling may turn into log-rolling, *i.e.* special interests joining forces at the expense of other, less well-organised groups.[8] As mentioned above, bundling often ends up with the central government "buying" the support of opponents of reform. Although some additional transfers could be justified on the grounds that efficiency gains – such as internalised externalities or lower administrative cost – accrue to the country as a whole, the country studies suggest that fiscal relations reforms are often too costly for the central government. And even strong bundling may not achieve all the desired objectives: further sub-central tax autonomy, which is sometimes on the agenda when a reform is initiated, may be scaled back or dropped completely during the reform process. In several cases, neither the central government, reluctant to lose central budget oversight, nor sub-central governments, fearing higher uncertainty over revenue, showed sufficient interest in greater tax autonomy.

Sequencing may be an alternative strategy for some reforms

Sequencing may be an option if demands for institutional change and decentralisation are persistent and if decentralisation can be partitioned into steps. A sufficient majority must then be mustered at each step without bundling. Countries in a secular decentralisation process like Belgium, Italy or Spain follow such a pattern. Reforms start with the decentralisation of spending responsibilities, while SCG funding is ensured through a set of corresponding earmarked grants. This is followed by a move from earmarked grants to general-purpose grants and to an increase in spending autonomy, sometimes linked to more result-based regulation. At the next stage, grants tend to be replaced by tax-sharing systems and finally by autonomous taxes, thereby increasing sub-central tax autonomy. Such sequencing gives time to test the gains obtained by decentralisation, which, if considered satisfactory, create impetus for further reforms. However, further reform steps are only successful as long as the efficiency gains of

decentralisation outweigh the associated distributional conflicts (Rodrik, 1999). In this respect, spending decentralisation is easier to engineer than tax decentralisation, which can arouse fears of increasing interregional disparities. In several countries, plans to devolve taxing powers to SCGs were scaled back or abandoned. In other cases, distorting SCG autonomous taxes were replaced by tax-sharing systems or intergovernmental grants, supposedly increasing the efficiency of the tax system, but reducing SCG tax autonomy.[9]

In designing reforms of fiscal relations, policy makers may have to consider some trade-offs between bundling and sequencing, *i.e.* between adopting a comprehensive reform as opposed to pursuing an incremental strategy. As described above, the fiscal federalism reforms tended to follow the bundling approach. Most reforms studied were wide-ranging, with little relation to former reforms or reforms in adjacent policy domains. Exceptions were the Italian and Swiss reform which had a sequential pattern, *i.e.* constitutional amendments were implemented before lower-level laws and decrees were adopted or amended. In the Australian case, certain problematic elements of the reform, such as the measurement of public sector performance, were postponed.

Speed may help, but reforms take time

Speed can provide the momentum to bring a reform to fruition and shows that a government is taking an electoral mandate seriously. Opposition may not be well organised after an electoral defeat, and policy makers can take vested interests unprepared. If a reform is adopted soon after an election, its effects have time to unfold before the next election. Moreover, speed may briefly create a "veil of ignorance" that allows stakeholders a general view of the potential effects of a reform but does not leave them time to assess how they will be affected individually. However, speed may discourage debate. The fact that fiscal relations reforms are often highly visible makes it difficult to maintain the "veil of ignorance" for long. Wide consultation with potential veto powers and fine-tuning to adapt reforms to obtain a majority may be needed. Well-prepared reform proposals that are considered impartial can sometimes even be implemented by a new government of a different political persuasion, as shown by the Canadian equalisation reform episode. The trade-off between speed and inclusion depends on the electoral mandate, the number of potential veto powers and the institutional framework to address them, but in general, the specific character of fiscal relations reforms calls for wide inclusion.

Designing the reform process

Political leadership tends to accelerate a reform

Political leadership – *i.e.* a person or a political group closely accompanying and driving the reform process – can be a significant driver of reform. In the end, it is politicians and political parties that must pass a reform and be persuaded that it is in the country's wider interest. In a few reform case studies, best exemplified by Denmark, the involvement of a few determined individuals and political heavyweights helped the reform to succeed where earlier attempts had failed. Conversely, the lack of strong political leadership could explain setbacks that blocked some reform attempts and the inability of stakeholders to reach consensus on controversial elements. The credibility of political leadership may be enhanced if lead politicians or jurisdictions have no direct stakes in the reform and can act as honest brokers across government levels or between individual SCGs, as exemplified by the Austrian, Italian and Swiss cases. In some cases, however, the government was not driving the initiative but was passively following the advice of its administration and

external experts while maintaining a low political profile. Such "de-politicisation", as shown in the case of the Canadian equalisation reform, can be an alternative route to reform, and it may help avoid reversals once a government of a different political affiliation is elected.

External and independent expertise lends credibility to reforms

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

In several countries, expert panels laid out the strategic reform issues, helped to consolidate and streamline the reform proposals, and designed and shaped central pillars of the reform. Government research institutions such as in Finland played a similar role, *e.g.* when their publications launched a reform or accompanied the reform process. Independent commissions provided additional input from outside the traditional realm of fiscal federalism. For example, the case for Australian reform drew on the recommendations of the Productivity Commission. In general, a strong representation of trained economists can be considered to maintain the consistency, simplicity and political feasibility of reform proposals. Conversely, a lack of independent and credible experts can be considered an impediment to reform.

Consultation should focus on a reform's long-term impacts

Given the largely institutional character of fiscal federalism reforms, consultation and involvement of the main stakeholders is unavoidable. Comprehensive consultation can raise awareness of the reform and help build up the necessary majorities, creating a feeling of ownership. Once stakeholders feel they have participated in the design of the reform, they are more likely to defend its outcome. Consultation and involvement can also help to lock in the steps for implementing a reform. Once the different stakeholders have agreed to reform proposals in principle after extensive consultation, it is more difficult for them to contest the reform once individual impacts become more apparent, as exemplified by the sequential approach of the Italian reform. In the reform cases under scrutiny, the scope of consultation largely depended on the number of stakeholders involved. In some countries, the reform concerned mostly government levels. In some cases however, involving stakeholders outside the government sphere complicated consultation especially when sub-central tax systems or frameworks underlying the funding of earmarked grants were to be reformed.

While wide-ranging consultation is often considered necessary to bring the main stakeholders on board, it can also jeopardise reform efforts. Too much consultation can inflame opposition. From the various country studies, it appears that the most successful consultation and involvement processes were those when the government was generally parsimonious with numbers – *i.e.* rejecting a precise assessment of the short-run reform

impact for individual SCGs – but insisted on presenting and discussing the overall objectives of the reform. By doing so, governments hoped to shift the discussion away from distributional effects and onto the long-term efficiency objectives. It is true that this "veil of ignorance" is difficult to maintain in a policy environment where short-term distributional impacts are easier to quantify than long-term effects.

Transitional arrangements may be necessary

Transitional arrangements were a frequent expedient for reducing opposition while maintaining the fundamentals of a reform. In many cases, they were the ultimate resort for securing a majority. This said, transitional arrangements were usually brought in late in the day. Transitional "cohesion funds" as in the Swiss case and other entitlements ensured that hardly any SCG lost in financial terms over an extended period of time.[10] Job guarantees for civil servants for a limited period reduced opposition from the public administration, as was the case in the Danish reform. In several countries a gradual phasing-in of new arrangements helped to reduce sudden breaks and discontinuities in transfer flows. Grandfathering rights and similar compensation mechanisms kept short-term changes in the SCG revenue-ranking position – *e.g.* in terms of tax capacity or transfer size – to a minimum. Transitional arrangements have their benefits beyond securing the success of a reform: distinguishing between permanent and transitional arrangements can help ensure overall consistency of a reform, since all messy political compromises can be relegated to the transitional arrangement. However and in most cases, transitional arrangements put a considerable burden on the central government. As many observers interviewed during the study lamented: "Central government always pays".

In cases where a small number of stakeholders with considerable veto power – especially specific SCGs – categorically reject a reform, the right to opt out may be granted. Some case studies suggest that allowing a few SCGs to opt out can help reduce opposition to reform without much cost and without threatening the principal elements of a reform, provided that these arrangements have little impact on economic and fiscal outcomes and that they do not incur resentment among other SCGs.

The administration should speak with one voice

Organising an efficient process that structures and oversees the reforms was crucial for success. In general, fiscal relations reforms were overseen and managed by a single ministry, usually the central government's Ministry of Finance, the Interior Ministry or a body that comprises all government levels. Given that fiscal relations reforms often had a distinct horizontal character and cut across several policy areas, various line ministries were involved, especially in cases where the allocation of intergovernmental grants was traditionally shared across ministries. Reforms tended to advance more rapidly if the administration spoke with one voice, *i.e.* if one ministry took the lead and relegated the other ministries to heading a working or project group. In some countries, administrative leadership was aided by the creation of new vertical and horizontal intergovernmental bodies that helped select and bundle reform elements, while other countries explicitly pulled back from creating additional bodies on the grounds that they would procrastinate and develop their own agenda.

If administrative leadership was weak or shared between ministries, reforms were more likely to stall. Inter-ministerial infighting tended to weaken a reform. This is why several fiscal federalism reforms were enacted in conjunction with a reform of inter-

ministerial financial management, or the reallocation of administrative powers and responsibilities was made part of the reform. In several cases, tasks such as the responsibility for disbursing intergovernmental grants, previously carried out by a range of different administrations, was concentrated in a single ministry. Indeed, many reforms may have resulted in a power shift from line ministries to the Ministry of Finance.

Communication should present the policy behind the numbers

Governments tended to make considerable efforts to "sell" a reform. Efforts to highlight the long-term efficiency gains helped create support from dispersed winners, who were often not fully aware of the potential gains. Communication with the public also helped identify potential problems with individual elements of a reform. In several instances, reports by expert panels were widely disseminated and discussed at public hearings, bringing the main stakeholders on board. In other cases, special seminars were held for the media to provide journalists with the broad outlines of the reform. "Stealth" reforms in which the attention of the public is not drawn to the reform may at first appear expedient, but they should be weighed against how visible the short-term impacts of the reform may be, and how such an approach could undermine a government's credibility. The case studies indicate that the most successful efforts at communication emphasised the long-term benefits.

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

Notes

1. The "veil of ignorance" is a concept originating in political philosophy that explains how productive arrangements and social contracts evolve (Rawls, 1971). The "veil of ignorance" and the "status quo bias" are opposite outcomes of the same underlying fact, namely uncertainty. Somewhat simplified, the "veil of ignorance" assumes that overall efficiency gains will help to pass a reform because the average gains are assumed to be positive, while the "status quo bias" assumes that uncertainty about individual outcomes will block the reform because risk aversion puts a negative value on the stakeholders' expected average outcomes.
2. Political economy of reform issues in selected areas are reviewed in the OECD publication *Making Reform Happen* (OECD, 2010), with contributions, among others, by Price on fiscal consolidation, by Brys on fundamental tax reform and by Charbit and Vammalle on public administration reform. Tompson (2009) scrutinises pension, product and labour market reforms in ten OECD countries.
3. Indeed, one of the most robust findings to emerge from econometric work in the field of the political economy of structural reforms is that sound public finances are associated with more comprehensive reforms (Tompson, 2009).
4. The Canadian equalisation formula, with its strict reliance on tax-raising capacity, strongly favours poorer provinces with a lower cost of living (Albouy, 2010). The Austrian reform of 2007 has

reduced the equalisation premium for large urban areas, and the new Swiss equalisation formula does not include such a factor at all.

5. See Rodden (2009). This is why constitutional economists have suggested at least partially abandoning electoral districts and running elections at the national level (national election districts). Given that members of a national parliament would need votes from the entire country, they would be more inclined to adopt a "national" and aggregate view of reforms rather than defend special SCG interests (see, for example, for Switzerland: Eichenberger, 2010).
6. However, the Finnish government did not make use of the experiment carried out in the northern part of the country but instead chose a different institutional solution to the problem of municipal fragmentation.
7. In this respect, the political economy of comprehensive fiscal federalism reforms tends to be akin to fundamental tax reforms (Brys, 2010).
8. Log-rolling is an exchange of votes in a legislative process whereby two parties, who each needs a partner to push its priorities through, create a common platform. One group supports the demands of another group with which it has little common ground or that it mildly opposes, in exchange for obtaining the other group's support for its own aims. Log-rolling works if the interests of other parties are relatively weak and dispersed. The benefits of log-rolling are controversial in the economic literature: while some see it as efficiency-enhancing during a reform process, others see it as rent-extracting (Crombez, 2000).
9. In 2000, the Australian Goods and Services Tax replaced a set of inefficient state consumption taxes. Although all tax proceeds are transferred to the states, the latter have no discretion over the tax base or tax rates. At the beginning of the 1980s, Mexico replaced a set of inefficient autonomous state taxes by a tax-sharing system that stripped the states of taxing power.
10. The Swiss reforms provide for a transition period of up to 28 years during which no canton will lose in net terms. In Germany, the new sub-central fiscal rule forbidding the *Länder* from running structural deficits, which was inserted into the constitution in 2009, will be fully applicable only after 2020.

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Chapter 2

Australia: The Intergovernmental Agreement on Federal Financial Relations

Summary

On 29 November 2008, the Australian government (hereafter Commonwealth government) and the states and territories ("the states") agreed on an Intergovernmental Agreement on Federal Financial Relations that came into effect on 1 January 2009 and profoundly changed Australian fiscal federalism. The agreement provided an overarching framework that aims at improving the quality and effectiveness of public service delivery in Australia. The Intergovernmental Agreement consisted of three pillars: *i)* an increase in the states' flexibility in service delivery; *ii)* more state accountability to the public for the quality and effectiveness of services; and *iii)* a considerable increase in the amount of federal funding for some key services. The Intergovernmental Agreement built on previous reforms such as the introduction of the Goods and Services Tax in 2000 and is generally considered to be one of the widest-reaching reforms in the history of Australian intergovernmental fiscal relations (see Box 2.1).

The main factors driving reform success were:

- *Reform ripeness:* The reform benefited from the experience of earlier reform attempts and a broad awareness that the system of intergovernmental fiscal relations had become untenable. At the beginning of the 1980s, some grant reforms were instigated, but they were reversed in 1988. After 2000 and the introduction of the Goods and Services Tax, government commissions and expert groups had repeatedly noted the inefficiencies of transfer spending. Several states had begun to reform their own system of public service funding, but demanded action at the federal level.
- *Electoral mandate*: The government had a clear mandate for reform. For the first time since the 1920s, a single party (the Australian Labor Party) had a majority at both the Commonwealth level and in all states. The election campaign was strongly centred on a reform of the public sector and service delivery, which in turn necessitated a reform of fiscal relations between the federal and the state level.
- *Good economic and fiscal conditions*: The Australian economy was in a strong position when the reforms commenced, with real GDP growth rates above 3% per year. Fiscal positions were excellent, especially at the Commonwealth level, with consistent surpluses since 2004. Good economic and fiscal conditions helped the Commonwealth to bundle the structural grant reform with a considerable increase in transfer funding, by up to 50% in some policy areas. This left all states winners of the reform.
- *Political leadership and quick action:* The Commonwealth government acted quickly after the election, bringing the reform to conclusion within one year. Given the government-to-government nature of the reform, public consultation was limited. Moreover, with the Council of Australian Governments reinvigorated, the government had an efficient administrative body steering the reform process.

Box 2.1. **The Australian Intergovernmental Agreement on Federal Financial Relations**

The Intergovernmental Agreement on Federal Financial Relations of 2009 consists of policy statements covering a set of National Agreements and Partnerships between the Commonwealth and state governments defining policy objectives and funding mechanisms for state or joint Commonwealth-state service delivery. The agreement was endorsed and is overseen by the Council of Australian Governments, a body comprising the Commonwealth government, all states and a representative of local governments. The reform replaced the previous system of specific purpose payments that had served to co-fund state service delivery. The reform consisted of the following elements:

- *A new overarching framework*: The Intergovernmental Agreement provides the framework for collaboration between the Commonwealth and the states through two types of agreements: National Agreements, which set out policy objectives and performance indicators for key service areas; and National Partnerships, to achieve more specific policy objectives across a wider range of government activities.
- *Moving from narrowly defined earmarked payments to more unconditional funding*: On the financial side, the agreement changed the intergovernmental transfer system, replacing the former numerous earmarked and narrowly defined specific purpose payments with a few broad-based per capita grants. The grants must be spent in the sector for which they are provided.
- *Greater accountability to the public:* The framework defines more clearly the roles and responsibilities between the Commonwealth and the states and provides for simpler, standardised and more transparent public performance reporting through the Council of Australian Governments' Reform Council.
- *An increase in Commonwealth funding for state core policy areas*: The Commonwealth government increased funding for core areas such as education and health care by around 30%, compared to the former SPP funding. Moreover, incentive payments are disbursed to states that deliver on national reforms or achieve service delivery improvements.
- *A reform of funding administration*: At the Commonwealth level, policy formulation and service funding were administratively separated. While policy formulation remained with line ministries (health care, education, etc.), funding and associated tasks (allocation formulas, etc.) were transferred to the Commonwealth Treasury.

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

Context of the reform

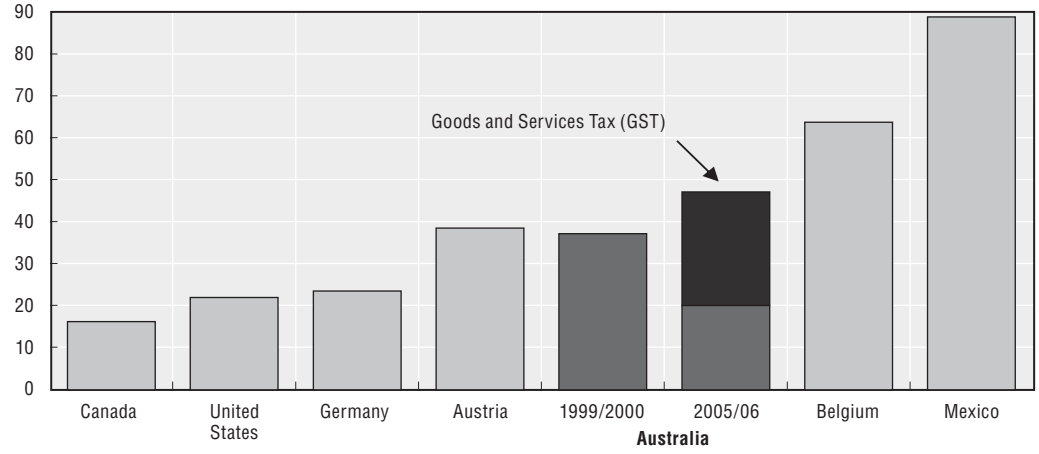
Institutional framework

Australian federalism is characterised by: *i)* relatively strong concentration of power at the Commonwealth level; *ii)* a "co-operative federalism approach" with widespread joint

government involvement in many policy areas; *iii)* low taxing power of the states and *iv)* a comprehensive system of horizontal fiscal equalisation, offsetting fiscal disparities between the states (OECD, 2006). The Commonwealth has strong prerogatives, backed by the Australian constitution, to place conditions on grants to the states, which are used to influence state service delivery. The vertical fiscal imbalance is one of the largest in OECD federal/regional countries, with the federal government collecting more than 80% of total tax revenue, and state revenues consisting mainly of shared taxes and transfers (Figure 2.1). The main state fiscal resources are provided by the tax-sharing-*cum*-fiscal-equalisation system of the Goods and Services Tax (GST), a comprehensive system of intergovernmental grants, the so-called national specific purpose payments (SPP) and Commonwealth funding through National Partnership payments. Given the strong financial entanglement and responsibility overlap, decisions affecting intergovernmental relations must usually be taken by consensus. Financial relations are supported by various intergovernmental commissions such as the Commonwealth Grants Commission.

Figure 2.1. **Australia's vertical fiscal imbalance is one of the largest in OECD federal countries**

In per cent of total sub-central revenue, 2005



Note: SCG revenue comprises both the state and local level.

Source: OECD (2006), *OECD Economic Surveys: Australia*.

Economic and fiscal conditions

The Australian economy was in a strong position when negotiations on the reforms began. Real GDP growth rates from 2000 onwards were usually above 3% per year, fuelled by a global boom in mining commodities, for which Australia is a significant exporter. The concentration of mineral resources in a few states has however led to increasing growth disparities. Fiscal positions were excellent, since the Commonwealth budget had returned almost consistent surpluses since 2004 and Australia was among the few OECD countries where assets exceeded debt. Fiscal positions of state and local governments, while also favourable, were not quite as strong, with some sub-central governments (SCG) running deficits in 2000 and again since 2004/2005. When the economic crisis of 2008 set in, most reform elements were already settled, which enabled the Commonwealth to implement them as fiscal stimulus. In fact, large parts of the Commonwealth's fiscal stimulus package were implemented through National Partnerships. However, some observers consider that

the reform might have been more difficult to implement in 2009, when fiscal policy became tighter.

Issue history

Two main issues had been on the intergovernmental agenda for at least 25 years: *i)* the system of intergovernmental grants that was considered over-prescriptive, and *ii)* the growth in Commonwealth funding for state services was considered insufficient to keep up with state needs. At the 1976 meeting of Commonwealth and state ministers, the prime minister for the first time flagged the need for change, saying that some grants should be slashed and others converted into more general purpose funding. At the beginning of the 1980s, some reforms were instigated, especially with respect to health care funding, which became less conditional, but in 1988 there was a return to the more prescriptive SPP arrangements. The 1990s saw a series of structural reforms that aimed at increasing the productivity and potential output of Australia, including a review of the grant system, but after significant progress was made at the state level and within the Commonwealth administration, the reforms were not implemented by the Commonwealth government. Some observers suggested that the Commonwealth government was concerned about giving too much autonomy to the states. In 1994, the Productivity – then the Industry – Commission listed the various drawbacks of special purpose payments, such as restricted state budget flexibility and administrative complexity. The commission also highlighted the high Commonwealth matching rate, which had increased from 18% to 27% within a few years. Despite its minor impact on policy, the report resulted in some strategic rethinking within the Commonwealth administration. In 1999, the Commonwealth Treasury, together with the states, established a working group aimed at improving the administration of the grants system and facilitating dialogue between the Commonwealth and states. But while the reform proposals were finally endorsed by the states, they were not so by the federal government.

The introduction of the Goods and Services Tax in 2000, which replaced a set of inefficient state taxes, gave a boost to fiscal federalism reforms. Having addressed the states' revenue concerns, the Commonwealth government now turned to the spending side. Demographic change and population ageing had begun to put pressure on state spending, while Commonwealth spending failed to keep up with state spending needs. The system of special purpose payments was quite complex, limiting the flexibility of the states to deliver services. Since the beginning of the 2000s, several states had started their own budget reforms, allowing for more flexibility and more output-orientation of their spending policy. But it became clear to proponents of reform that in order to improve state service delivery, a thorough overhaul of the intergovernmental funding arrangements was required, which only the federal level could initiate. In the second half of the 2000s, a proliferation of expert reports described the system's weaknesses, and the Commonwealth came to the view that reform was indeed required. Reform recommendations were centred on the need for better intergovernmental relations, where all levels of government defined goals jointly but states retained the flexibility to deliver services. The states played a leading role in the setting of the reform agenda,[1] and the Council of Australian Governments endorsed a national reform agenda in 2006 that aimed to reform fiscal relations and joint government decision making. When the 2007 federal elections led to a change in government at the Commonwealth level, the case for the reform of the transfer system was ripe.

Actors and interests

The main actors in the reform process were the Commonwealth and the states. The Commonwealth's lead bodies were the Department of the Prime Minister and Cabinet and the Commonwealth Treasury, while the states' First Ministers' Departments and Treasuries negotiated through the Council of Australian Governments and related forums (with the Council for the Australian Federation providing additional insights). The newly elected Commonwealth Government wanted to implement its human capital election platform rapidly as a means of improving the efficiency and level of service delivery while reducing the cost associated with policy co-ordination across government levels. The states wanted more co-funding for their core services, more budget flexibility in their spending decisions and a less costly administration for managing the grants. Given that both government levels now held similar views on the system's weaknesses and how to remedy them, their interests were well aligned, and negotiations between the Commonwealth and the states were quite consensual and pursued through a reinvigorated Council of Australian Governments.

Some public and private sector groups also had stakes in the reform. The education and the health sectors had some mixed feelings about the reforms. On the one hand, they welcomed the significant increase in funding for their respective sectors. On the other hand, the removal of earmarked grants and their replacement by grants with limited conditionality raised concerns that Commonwealth line ministries could have less control over the implementation of national policies by the states. Since the reform would inevitably shift some policy debates from the Commonwealth to the states, special interest groups feared that they would lose influence over, and direct access to, potential sources of Commonwealth funding. Some interest groups lobbied hard for privileged specific purpose grants, arguing that some Commonwealth funding dealt with inter-jurisdictional externalities and could not be left to the discretion of state decision making.

The corporate sector and especially the associations representing firms with subsidiaries in several states had a strong interest in the grants reform, since a prominent component – rather unusual in fiscal federalism reforms – was ongoing deregulation and internal market reform. Since the beginning of the 1990s, the Productivity Commission had argued for a more open internal market, including incentive payments for states that would agree to removing trade barriers and to harmonising state regulation. The business sector was also well aware of the strong links between public and private sector productivity, and favoured any fiscal framework that would boost the efficiency of the public sector. Finally, the incoming Commonwealth Labor government – with counterpart Labor governments in all states – was committed to delivering on such reform.

Electoral mandate and political leadership

The reform relied on a strong electoral mandate and considerable political leadership. The Labor Party had based its election campaign on a human capital platform and the need to improve service delivery, which required a reform of Commonwealth-state relations. After Election Day in November 2007, and for the first time since the 1920s, the same party held power at the Commonwealth level and in all states. The Labor Party received a clear electoral mandate for a new political paradigm, and the two levels of government agreed quickly on reform priorities. The new government argued that this reform was long awaited, that the states wanted it and that the only reason for holding it back had been the former Commonwealth government. The Commonwealth government was also aware that

the will for reform generally tends to ebb after the first year of an election cycle, so it decided to press ahead with the reforms as quickly as possible. Putting itself under such time pressure, and given the government-to-government nature of the reforms, the reforms did not involve much public consultation. As several observers noted, strong leadership, combined with exceptional speed, helped keep many opponents off guard. Some observers argued, however, that the reform steps agreed upon in 2008 were the "easy" ones, and that further challenges remain in the implementation stages.

The reform process

Policy formulation and timeline

The existence of uniform Labor Party dominance across all jurisdictions created an environment that facilitated co-operation on national reforms. This may well have been particularly important, as the reforms involved changes to state entitlements and a relaxation of federal controls, requiring considerable mutual trust. The first policy formulations sketched out only a few broad, albeit radical, principles that reassured the states about the Commonwealth's willingness to cede them more responsibilities. In July 2008, the Commonwealth and the states agreed on the reform framework, *i.e.* the need for common objectives for service delivery and to change the intergovernmental funding system accordingly. This spirit of consensus lasted throughout the reform process.

The initial policy foundations were changed little during the reform process. The Commonwealth government, the states and some major stakeholders considered the reform a window of opportunity that would soon close. The states were comfortable with the Commonwealth proposals, as they promised both more money and more freedom to spend it. The allocation formulas, with a consistent and easy-to-understand approach, appealed to the state treasuries. The Commonwealth government hoped to stop the blame game whereby the Commonwealth and states had, on occasions, sought to deflect responsibility for inefficient service delivery. Given the broad consensus, the reform process was rapid. The multitude of simultaneous reform blocks made it difficult for the various stakeholders to keep track of potential reform impacts. Some concessions were made with respect to the grant system, where the Commonwealth government gave in to pressure and retained earmarked funding for selected state services, especially in the health sector. The onset of the financial and economic crisis in September 2008 had little impact on the reform package. From the Commonwealth government's perspective, the package was seen as part of the continuum of economic stimulus packages, so fiscal constraint was an issue but not an over-riding one. From the states' viewpoint, the package was generous and left them better off than prior to the reform.

The reformers put much weight on making the reforms permanent. Some National Partnership Agreements contain a funding arrangement that rewards the states for additional reform steps that go beyond the required minimum. The reformers also put the Council of Australian Governments' Reform Council in place, *i.e.* a body to monitor and evaluate the achievements of the reform. Although the Reform Council cannot issue policy recommendations, its reports and studies are made public and can put some pressure on both the Commonwealth and individual state governments to act.

Bundling and compensation

The reform package agreed to by the Council of Australian Governments provided net benefits to all states: *i)* The Commonwealth government increased transfers considerably, by up to 50% in some policy areas. *ii)* The significant number of reform elements facilitated the bridging of trade-offs. For example, a reform objective in one sector that had unfavourable effects for a single state could be offset against a favourable financial outcome in another policy area. Governments also provided guarantees early in the process that no state would lose Commonwealth funding in absolute terms. *iii)* Notwithstanding this, to address public perceptions, governments agreed to a transition period of five years before the new distribution system for special purpose payments (*i.e.* transitioning to an equal per capita basis) would become fully operational; and *iv)* The government could demonstrate that undesirable distributional effects would be overcome by the equalisation system of the Goods and Services Tax.

Despite the various bundling, compensation and transition schemes, the Commonwealth government met with some resistance outside the public sector. The old system of special purpose payments granted several interest groups direct and privileged access to Commonwealth spending. Once special purpose payments were converted into grants with only limited conditions attached (that the funding be spent in the sector for which it is provided), the use of these funds would be determined at the state level, where different interests would have to compete for budget allocations. This is why some interest groups fought hard to maintain earmarked Commonwealth spending. Health care sector policy makers stressed that inter-jurisdictional externalities called for ongoing Commonwealth intervention or expressed concerns that the states would not spend "adequately" on certain services or maintain service quality, particularly in the realm of preventive health care. Teachers' unions and private schools were also reluctant to accept that some Commonwealth education funding would no longer be earmarked but that policy priorities and fund allocation would be decided by the states. Finally, the concentration of financial power in the Commonwealth Treasury, in particular, may have created some tensions with the line ministries, although some observers argued that the ministries were pleased that they no longer had to administer payment arrangements. The reformers gave in to some demands: in particular, a number of special earmarked grants, especially in the health sector, were retained. The compromises reduced the scope of the reform. At present only approximately half of intergovernmental grants flow through the new system, with the remainder managed by the stricter and more narrowly defined National Partnerships.[2]

Administrative setup and intergovernmental collaboration

One of the first steps of the newly elected Commonwealth government was to strengthen the role of the Council of Australian Governments (COAG). COAG had existed since 1992, but had in recent years held rarely more than one meeting per year. Under the new government, COAG quickly became the leading reform driver, with a Secretariat for administrative work and regular meetings at the political level, and with a large network of Commonwealth and state officials working closely together. From the mid-2000s, the states also utilised the states-only Council for the Australian Federation as a forum to discuss their interests. In 2008 the role of the COAG Reform Council (CRC) was significantly expanded under the reform arrangements to strengthen public accountability of the performance of governments through independent monitoring, assessment and reporting.

COAG, assisted by Treasurers, drove the reforms. Below this strategic level, eight ministerial working groups were dealing with the different policy areas affected by the reform. The strong federal commitment to the reforms had implications for the dynamics of meetings between government levels: while the federal level was generally represented by ministers, the states were often only represented by high-level officials. The financial calculations were done by the Treasury. The efficient and univocal leadership within the federal administration might explain why the reform timetable, despite the enormous workload, was strictly adhered to.

The role of experts

Reforms in Australia are often based on a series of expert reports authored by government-sponsored bodies. Some of these bodies are highly regarded in Australia because their policy recommendations are seen as impartial and objective. The Productivity Commission and the National Competition Council are among those that produced several studies that identified the inefficiencies of the system of special purpose payments. In particular, a report by the Productivity Commission (then the Industry Commission) in 1994 described the negative impact of the system on state budget flexibility. After 2000, when the Commonwealth government appeared reluctant to pursue further fiscal federalism reforms, the state governments of Victoria, New South Wales and Western Australia jointly commissioned their own experts to develop policy recommendations (Garnaut and Fitzgerald, 2002). The Australian Labor Party, which was in opposition until late 2007, also commissioned its own study (Keating *et al.*, 2007). Taken together the reports identified the main weaknesses of the grant system as regards efficiency, equity, simplicity and transparency and prepared the ground for a common approach to reform. Some observers argue that the high quality of the experts was essential in delivering the reform framework relatively quickly once the government had taken the decision to go ahead.

Adoption and implementation

In November 2008, the federal government and the states and territories adopted the reforms, signing the Intergovernmental Agreement on Federal Financial Relations, the six National Agreements and an initial 36 National Partnerships. After the Commonwealth Parliament passed the *Federal Financial Relations Act*, which dealt with the financial aspects of the reform, putting special purpose payments gradually on a per capita basis, with a transition period of five years between the old and new funding systems. Special purpose payments were quickly merged and their number thereby reduced considerably. The Council of Australian Governments defined several reform targets – one being that by 2015 in each state at least 90% of all students should complete upper secondary schooling, with the Reform Council to assess their achievement. However, the establishment of a set of indicators measuring outputs and outcomes has proven more difficult than expected. Sanctions for those that do not achieve the goals are not part of the framework, but COAG has agreed to a system of facilitation, project and reward payments to create an incentive for improved service delivery.

Communication

Both the Commonwealth and state governments made great efforts to sell the reform to the general public, and clearly explained the objectives the reform was aiming at. The

"ripeness" of the reform made communication relatively easy. Both government levels used the multitude of studies, reports and analyses available to show that an overhaul of the old system was overdue and that the reforms pointed in the right direction. The Commonwealth government focused on the general communications strategy, which was to emphasise the final objectives – better services, higher productivity and growth – rather than getting lost in the reform's technicalities. Moreover, the government pointed to the collaborative and consensual character of the reform, especially with respect to Commonwealth-state relations, an approach that was very well received. The Commonwealth government informed the media regularly on reform progress, and a few press journalists became intimate observers and companions of the reform episode.

Some unfinished reform elements

Some reform elements are not yet fully in place. Performance measurement in several policy areas is still being refined. Roles and responsibilities in many policy areas remain entangled, particularly in the health sector. Some observers suggested that not clarifying the roles of each government level was a missed opportunity that will compromise the financial reforms' gains in efficiency, not least given that new joint tasks were likely to evolve over time. It is also argued that effective disentanglement of roles and responsibilities will be even more difficult to achieve than the move towards unconditionality. While the financial aspects of the reform were quickly implemented, the Commonwealth is sometimes reluctant to cede additional power to the states, and the states are reluctant to assume higher accountability. A review commissioned by the Council of Australian Governments in 2010 pointed to the remaining inconsistencies of agreements with the design principles of the reform; the proliferation of agreements; and the need to improve performance monitoring and administrative efficiency.

Although Australia's vertical fiscal imbalance – the gap between spending and own tax revenue of the states – was seen as a central issue prior to the reform, it was not its focus**.** The issues of this imbalance and state taxes were considered in the context of the review of Australia's Future Tax System, a broad review of the tax and transfer system including state taxes that was commissioned by the Commonwealth government in May 2008. The final report was provided to the government in December 2009. However, while this report included a number of recommendations on existing state taxes, the report made no reference to the vertical fiscal imbalance, or to whether the states' taxing power should be increased.

Conclusions

The Intergovernmental Agreement on Financial Relations was one of the widest-reaching reforms in the history of Australian fiscal federalism, built on a number of failed attempts to reform the inefficient intergovernmental grant system. The reason for its successful implementation can be traced back to several elements: *i*) the reform was "ripe" in the sense that it had been discussed for years or even decades; *ii*) a "reform coalition" of both government levels, several important stakeholders and experts had credibly argued that reform was necessary and that the existing situation was untenable; *iii*) a newly elected government had a clear electoral mandate to reform the intergovernmental framework for the delivery of services; *iv*) an astute combination of bundling and additional funds left almost no losers; and *v*) a rapid and determined implementation

process focused on high level objectives rather than technical details that could have derailed the reforms.

The reform also showed the formidable difficulties fiscal federalism reformers face, and possible constraints. Implementation of the Australian reform is still in its early stages, with significant challenges remaining on the measurement of state performance. More generally, although the vertical fiscal imbalance between states' spending and own revenues is regularly on the political agenda, ceding more taxing power to the states was not considered a policy option. However, one of the big achievements of the reform is the lock-in of the reform process, particularly through the role of the independent umpire, the COAG Reform Council, which is likely to have succeeded in instilling a lasting commitment to reform. Indeed, institutionalising the process should help maintain the momentum for reform once the political drive weakens.

Notes

1. The State of Victoria was a leading driver of reform. In 2005 its premier and Cabinet published *The Third Wave of Reform*, in which it called for a broad reform agenda across competition, regulation and human capital to deliver greater productivity and higher labour force participation.
2. The picture is slightly skewed since the National Partnerships were a part of the fiscal stimulus programme. Once this expires, it is expected that a greater proportion of funding will flow through the National Agreements.

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Chapter 3

Austria: The reform of the fiscal equalisation law

Summary

In 2008 the Austrian parliament endorsed a new fiscal equalisation law that changed the revenue mix of both the state and the local level, and amended federal funding for social benefits and the health care system (Box 3.1). The reform consisted of several elements: *i)* a transformation of most intergovernmental grants into a higher sub-central government (SCG) share in federal tax revenue; *ii)* an increase in intergovernmental transfers for mandated health care and social welfare responsibilities; *iii)* a change in the equalisation formula that allocates payments between small and large sub-central governments; and *iv)* a change in underlying population statistics. In addition, procedural legislation for levying taxes and fees was harmonised across the nine states. The 2008 fiscal equalisation reform was considered quite significant and also seems to have provided a push for a wider-reaching institutional and fiscal relations reform.

The main factors driving the success of the reform were:

- *Reasonably good economic and fiscal conditions*: The Austrian economy was in good shape when the reform started, with several years of strong growth, and tax revenues rising above expectations. The 2001 domestic stability pact led to improved budget positions of all government levels, although structural deficits remained at 1% to 1½% of GDP. The federal government could therefore raise the chances of success for the reform by considerably increasing transfer funding for selected state services. Also, buoyant tax revenues made it easier for the states to accept a switch from (stable) intergovernmental grants to (cyclically fluctuating) shared taxes.
- *Bundling and compensation*: The reform consisted of several elements, in order to win the support of the various stakeholders. It benefitted both urban and rural jurisdictions as well as wealthier and poorer ones. Any redistributive effect of a reform element was compensated by another reform element, so that no single state lost in absolute or relative terms. Stakeholders outside governments were compensated in indirect terms. For example, greater budget flexibility for sub-central governments was accompanied by new spending regulations, minimising changes to public spending patterns and hence not having a considerable effect on vested interests.
- *Political leadership and alignment across political parties*: The reform was put through by a coalition of a centre-left party (*SPÖ*) and a centre-right party (*ÖVP*), creating broad support for the reform. Politicians of different parties aligned across government levels to create consensus. The finance minister succeeded in creating enthusiasm for the reform that was embraced by most other interest groups and administrative levels.

Box 3.1. **The Austrian fiscal equalisation reform**

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

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

While the move from transfers to tax sharing was considered fiscally neutral, the increase in hospital and child care funding and the compensation for the change in population statistics was not, entailing additional expenses of around EUR 180 million per year at the federal level. The issue of greater tax autonomy and of performance-oriented transfers was briefly discussed at the beginning of the reforms but later dropped.

Context of the reform

Institutional framework

Fiscal federalism reforms in Austria are framed by extensive spending decentralisation; low sub-central (SCG) taxing power; institutionalised negotiations between vested interests; and widespread enthusiasm for consensus. While the states' spending responsibilities include core areas such as education, health care and transport infrastructure, SCGs' revenue sources consist essentially of a share in federal tax revenues and intergovernmental grants. Moreover, the states have wide-ranging co-determination prerogatives in a number of policy areas, leading to what is often called "co-operative federalism". Since tax sharing and fiscal equalisation cover all three government levels (the federation, states and municipalities), the number of actors with an interest in fiscal federalism issues is unusually large, and the various groups often become entangled in a joint decision trap, with a tendency to veto each other (Tsebelis, 2002). Reforms are usually negotiated and agreed upon between the main social partners before they reach the parliamentary stage. Although the federal level has constitutional supremacy, and

although no double majority is needed to approve changes to the fiscal federalism framework, the institutionalised negotiation power of SCGs demands consensual decisions and means that reforms with redistributional consequences are particularly difficult to achieve.

Economic and fiscal conditions

The Austrian economy was in good shape when the reform started in 2007, the fourth consecutive year of strong growth. But fiscal equilibrium was never reached, with the structural government deficit hovering around 1% to 1½% of GDP, as a result of a series of cyclical stimulus packages during a period of stagnation between 2001 and 2003; a far-reaching tax reform including tax cuts; and delays in expenditure cuts (OECD, 2005). The domestic stability pact requires all government levels to reach certain deficit targets and even provides sanctions in case of non-fulfillment, but these targets were not met during most of the period under scrutiny, especially at the state level (Schratzenstaller, 2008). The fiscal equalisation reform negotiations took place under the assumption that further consolidation at the state level was needed and that budget constraints should be strengthened; but most observers agree that fiscal positions played only a small role in shaping the reform. However, the federal government's relatively favorable fiscal position enabled it to fund a reform that was essentially structural in nature. Most observers agree that after 2008, in a context of rapidly deteriorating public finances, passing the reform would have been impossible.

Issue history

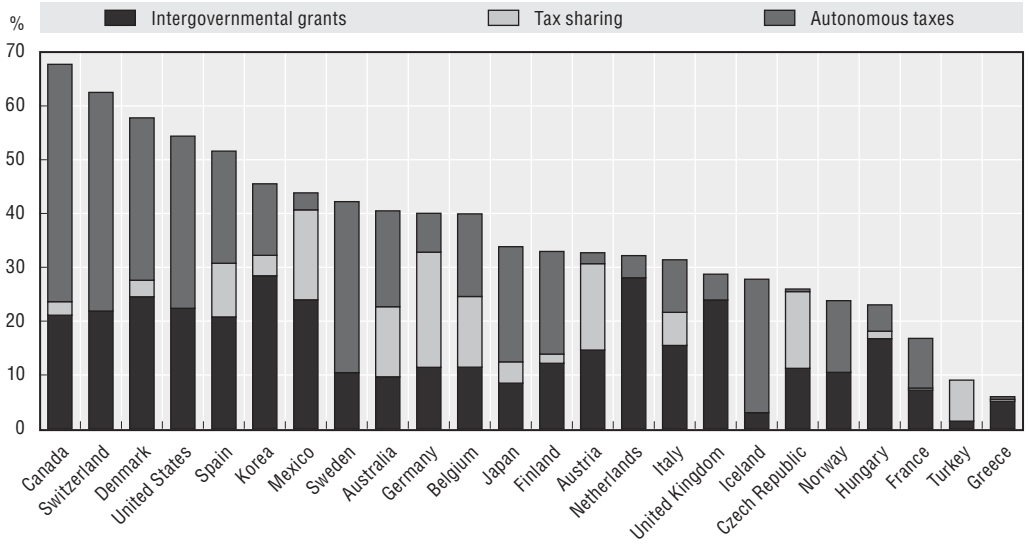
Fiscal equalisation is enshrined in the constitution and governed by the Fiscal Equalisation Law. The law provides a multi-year agreement on revenue sharing and transfers negotiated between the federal government, the *Länder* (states) and municipalities. Since its implementation in the 1970s, the law was renegotiated roughly every four years, lending fiscal relations a sense of permanent change, although the main pillars of the system were never thoroughly amended. Since the mid-1990s, increasing the efficiency of public spending had occupied an important position on the intergovernmental agenda. Two issues had become particularly important: *i)* the proliferation of federal transfers softened the states' budget constraint and put considerable pressure on federal finances; and *ii)* the lack of tax autonomy reduced the accountability of the state and municipal level. In 2001, a centre-right government made considerable modifications to the law, resulting in the devolution of spending power to the states and a simplification of the tax sharing system. However, neither transfers nor tax autonomy were broached. The 2005 negotiations resulted in some minor changes to the law.

At the start of the reform in 2007, intergovernmental fiscal relations were relatively cumbersome and opaque. This lack of transparency reduced accountability. Tax autonomy was minimal, with autonomous SCG taxes covering less than 1% of general government tax revenue and less than 4% of state revenue (Figure 3.1). The *Länder* disliked the restrictions of earmarked grants, and the federal level disliked the administrative burden of administering those grants. Moreover, the fiscal equalisation law relied on population census data updated only every ten years, and made it difficult to factor in demographic changes and cross-state mobility. The infrequent adjustments led to abrupt changes in SCG revenues after a census year, putting large and urbanised regions with above-average

population growth at a disadvantage. When a new coalition government was elected in 2006, it felt that the fiscal equalisation law needed a wider-reaching reform, and in 2007, the federal government decided to start negotiations with the relevant social groups before the four-year-term of the law was up.

Figure 3.1. **Austrian sub-central governments depend largely on central government**

Autonomous taxes, tax sharing and grants as a percentage of general government tax revenue, 2006



Source: OECD Fiscal Decentralisation Database.

Actors and interests

The federal level, the states and the municipalities were the main actors in the reform. The federal level, mainly represented by the Ministry of Finance, favoured an increase of the states' share in federal tax revenue, in exchange for a reduction of intergovernmental grants. The Ministry of Finance was also interested in conferring additional tax autonomy on the states, *e.g.* in the form of a surcharge on the personal income tax. The *Länder* had an interest in reducing the strings attached to intergovernmental grants, enabling them to increase budget flexibility, but they opposed higher tax autonomy on the grounds that this could compromise the stability of their revenue base. Not a single state was openly in favour of more tax autonomy. The municipal level was represented by two different associations, the *Städtebund* (association of cities) and the *Gemeindebund* (association of municipalities), with distinct interests and different political affiliations. While both associations were basically in favour of the federal proposals, they had opposing views on the equalisation formula and population statistics.

Further interests included the sectors affected by the move from intergovernmental grants to tax sharing. The construction sector in particular benefited from earmarking and hence risked losing its direct channel to the federal coffers. Other groups lobbied in favour of an increase in intergovernmental transfers, especially in the social and health sector, and were ready to compromise on other aspects of the reform. Finally, business associations, especially those representing large firms with subsidiaries in several SCGs, put pressure on harmonising procedural legislation for levying taxes and fees across the states. Party affiliation at the three government levels played no strong role during the

negotiations, except probably for the local government associations. As one observer put it: "In fiscal federalism negotiations, you are a delegate of your government and not of an ideological stream". The complexity of fiscal federal relations – where any change in the funding formula has an impact on all government levels – and the many stakeholders in the system made the joint decision trap quite obvious.

The reform process

Policy formulation

In spring 2007, a few months after the federal elections, the finance minister of the new coalition government announced an early reform of fiscal relations. Although the fiscal equalisation law stipulates intervals of four years between renegotiations, the coalition parties agreed that a reform was urgent, particularly since states and municipalities required further federal funding for their health care systems. Since the federal government generally acknowledged these demands, the first phase of the negotiations went well, and in July 2007, the social partners were able to present the cornerstones of funding arrangements for health care, social welfare and climate change. The federal level had created a "good negotiation spirit" (Matzinger, 2007), and the states and municipalities now agreed to tackle the more structural issues, such as the reform of the grant system. Within only a few months, the Ministry of Finance and its various working groups prepared an internal report proposing the move from grants to tax sharing (known as *dynamisation* in Austria); the harmonisation of state tax legislation; the replacement of census by registry data and to update these data annually; and some smaller reforms with respect to the funding of state-owned enterprises.

Sub-central governments were surprised by the relatively bold approach of the federal ministry. Although actors are usually well aware of the positions and aspirations of other actors, the need for a quick reaction forced some of them to take decisions without being fully informed. The states aligned their position during the late summer of 2007, trying to resolve a few internal conflicts, and finally came up with a common proposal to the federal level. The federal government helped reduce inter-state tensions by adding funds for health care and social welfare that were intended to head off potential distributional conflicts resulting from the structural reform. For that reason, some horizontal conflicts did not surface. Expectations and uncertainty with respect to *dynamisation* may also have played a role: for several years, the growth of federal tax revenue had always been above official projections and clearly above grant revenue growth, so the states anticipated sharing a revenue source that grew faster than the politically determined grants. When federal tax revenues started to decline in the aftermath of the economic crisis, the states were forced to recognise that *dynamisation* also carried a downside risk.

In a set of final negotiations during September, the three government levels agreed on the details of the reform, and in October signed a binding agreement called the *Paktum*.

Bundling and compensation

During the reform process, several distributional issues aroused resistance. In order to avoid a veto from one of the many stakeholders, several reform elements were added and bundled in order to ensure that changes in the relative fiscal position of states, groups of municipalities or even some interest groups were kept to a minimum. The states accepted *dynamisation* under the condition that its redistributional effects were offset by the

additional hospital and child care funding. The move from earmarking to non-earmarking was approved mainly because the new federal housing and climate change regulations ensured that, despite the increased budget flexibility, the pattern of SCG spending was not substantially changed. The change in population statistics that tends to favour large and fast-growing cities and regions was compensated for by a change in the fiscal equalisation formula that reduced the advantages of these jurisdictions. Moreover, transitional compensation by the federal level made sure that no single state would lose out either as a result of the new population statistics or the new fiscal equalisation formula.

The federal level, in addition to bundling, was prepared to compensate states and municipalities that could be regarded as potential losers of the structural part of the reform. The federal level made an initial step in announcing that it was ready to increase funding for SCG health care and social services. No SCG was supposed to lose in absolute terms as a consequence of the reform. During the negotiations, the federal level was also ready to absorb any redistributive effects and to ensure that the ranking order in terms of federal contributions would not change. The federal government even compensated for changes balanced by other reform elements: although the impact of the new fiscal equalisation formula was largely offset by the new population statistics, states negatively affected by the fiscal equalisation change were given additional compensation for a transitional period. At the end, net federal transfers to the states increased by around EUR 180 million annually. An Austrian aphorism sums up the essence of the reform's political economy: "Fiscal equalisation is a conspiracy against the taxpayer."

The non-reforms

Tax autonomy was initially part of the reform project, but was dropped during policy formulation. Tax autonomy had long been on the agenda, first as a request of the states in the face of an unwilling federation, and from the mid-1990s onward as a federal offer to unwilling states. In 2007, the federal level had initially proposed to introduce a "piggy-back" system in which states would have the right to choose – within limits – a state surcharge on the federal income tax rate. The states, however, unanimously rejected this, pointing at the growing uncertainty over tax revenues and over the potential increase of disparities across the country. No state was ready to opt for greater tax autonomy. Some observers pointed out that states have little interest in tax autonomy because spending autonomy and the power to allocate subsidies allows them to target and to privilege selected constituencies, individuals and firms more easily.

Finally, the federal government also dropped the issue of a task- and performance-related intergovernmental transfer system, whereby grants would be linked to outputs and outcomes at the sub-central level. The negotiators decided to postpone this issue until the ongoing state reform and the next fiscal equalisation reform were decided. Some observers argued that efficiency-enhancing measures in the transfer system would only be tackled at the time of a crisis.

Box 3.2. **The political economy of population statistics**

Timely and accurate population statistics are a precondition for fiscal equalisation, since the headcount is a core variable in fund allocation. The method of counting is thus a major political issue. Over the previous decades, demographic change and internal migration had

Box 3.2. **The political economy of population statistics** *(cont.)*

changed the size and structure of the population across jurisdictions. These changes were not adequately reflected in population statistics, which relied essentially on new census data every ten years. The pre-reform fiscal equalisation system therefore had two major drawbacks: *i)* the statistics did not adequately reflect changes in population structure and could lead to SCG overspending or funding shortfalls, and *ii)* the use of new census data triggered large increases in the allocation of resources to individual jurisdictions. Moreover, in the absence of new data, some jurisdictions had an incentive to keep spending at artificially high levels. Changing census methodology hence soon became an important reform proposal of the federal government.

Shortly after the three government levels had signed the basic reform agreement in October 2007, the Ministry of Finance commissioned Statistics Austria to prepare the shift from census to registry data. Registry data are available at the municipal level and are updated annually. Statistics Austria quickly delivered a report that showed, based on an experimental phase back in 2006, that municipal registry statistics could reliably be updated, allowing fiscal equalisation formulas to be revised annually. Statistics Austria showed that a register count not only increased the accuracy of fiscal equalisation formulas but reduced the incentives for states and municipalities to manipulate statistics in order to obtain more grants. Technological progress in data collection and processing made the move palatable to sub-central governments and kept the cost of the transition to the new system relatively low. As of 2011, fiscal equalisation will be based on annually revised statistics from the registry tally.

The new population accounting was politically well received. However, despite a wide-reaching consensus on principles and positive feedback from stakeholders during the experimental phase, the reform met with tacit opposition from several jurisdictions, mainly smaller and more rural, that were liable to lose funding because of their shrinking population base. In a series of working groups and seminars, delegates from Statistics Austria had to defend the feasibility and the advantages of the new system for all governments. SCGs were strongly involved in creating the framework for gathering improved registry data and in accepting the outcome. At some points, it was only the credibility, procedural transparency and authoritativeness of Statistics Austria that ensured the passage of the statistical reform. Even then, a compromise was necessary to win approval for the change in the population data. A change in the fiscal equalisation formula reduced the weight of the large jurisdictions to compensate for the most conspicuous differences between the old and new population statistics. In addition, the new statistics were due to be introduced only in 2011.

Electoral mandate and political and administrative leadership

The elections of October 2006 replaced the former centre-right government, and after lengthy negotiations, resulted in a new grand coalition between the centre-left *SPÖ* and the centre-right *ÖVP*. During the election campaign, economic policy in general and pension and education reforms played a central role, but state reforms and fiscal federalism issues did so only marginally. The coalition agreement contained only a single reference to a potential reform of the fiscal equalisation law. The lack of consensus across levels of government and across parties made it difficult for the grand coalition to develop a common platform, and negotiations turned essentially on the question of who was to extract the most out of a fiscal bargain. Earlier reforms had shown the significance of an

electoral mandate: the 1999 elections, which led to a change in government, were driven by a mandate to consolidate public finances and to re-organise intergovernmental fiscal relations. The ensuing reforms, adopted in 2001, resulted in significant decentralisation of spending and a simplification of the equalisation formula.

Nonetheless, political drive and leadership played some role in the 2007 reforms, and the change in government was clearly seen as a window of opportunity. When the finance minister announced in spring 2007 that the fiscal equalisation law should be reformed before the term expired, he also declared that he would promote the reform and attempt to involve the federal government. The finance minister also succeeded in getting close support from a state prime minister from the other coalition party, so two government levels and both parties of the grand coalition joined forces to push for the reform. When the main negotiation partners closed ranks, they created a spirit of co-operation that filtered through to most other interest groups and to the administrative level. The Ministry of Finance became the lead actor at the administrative level, organising and managing the working groups with other line ministries and other government levels through the *Verbindungsstelle der Bundesländer* (liaison office of the states), a body co-ordinating the position of the various states toward the federal government.

The role of experts

National experts and expert groups played a limited role during the reform process. Reports were in general written by the administrations, either at the federal or the state level, and then discussed and analysed in the various working groups. Some states commissioned reports from external experts, but this was the exception rather than the rule. External experts are not highly rated in Austria, since most have ties with a political party or, worse, with a level of government. Academics are also often seen as partisan, while the administration, especially the audit courts, are held in higher regard. The Austrian Institute for Economic Research WIFO is one of the few institutions dealing with fiscal federalism that is regarded as neutral and evidence-based, and its reports were well-received at the federal finance ministry. International organisations, on the other hand, are well respected because they are seen as impartial, and can have considerable influence on policy discussions in the country, even if, from an Austrian perspective, they provide few new insights. A few observers noted that the *OECD Economic Survey* of 2005, with "fiscal federalism" as one of its core chapters, had a considerable impact on the design of the 2007 reform.

Adoption and implementation

The *Paktum,* a legally binding agreement between the various parties on the cornerstones of the reform, was signed in September 2007. Final technical negotiations were concluded in the autumn and winter of 2007. The new fiscal equalisation law was voted by the federal parliament in spring 2008. Most elements of the reform were implemented as of 2009, although some exceptions were built in, especially with respect to population statistics and the move from grants to tax sharing, and including transition periods to avoid any sharp increases in the funding of states and municipalities. Since its adoption, all elements of the reform have been implemented on schedule, and no stakeholder has asked for either partial or total reversal of the reform. But the crisis has turned the tide of tax revenues: while the states assumed in 2007 that they had tapped into

an ever-buoyant fiscal source, they have had to cope with a stronger than expected decline in tax revenue since 2009.

The success of the reform sparked new zeal at both the political and administrative level. In February 2009, the coalition government appointed a high-level working group on fiscal consolidation (*Arbeitsgruppe Konsolidierung*), working on a state and administrative reform. The group is headed by the Federal Chancellor and the Minister of Finance and includes representatives from all government levels. The group is divided into 11 working groups, of which several will explicitly deal with issues of intergovernmental fiscal policy and fiscal equalisation. Among others, a stronger relationship between SCG tasks and the intergovernmental grant system will be developed, and tax autonomy is again on the agenda. These issues are less technical than the reform of 2007 but also tend to be more politically contentious. Finally, the reform also increased pressure on fiscal relations between the *Länder* and municipalities, in particular to reform the large and complex set of earmarked grants.

Communication

Communication did not play a central role in the reform strategy of the federal government, and it appears that this is why the reform was not very well received by the media and by the public at large. Issues including tax sharing, earmarked grants and population statistics were highly technical and unlikely to raise emotions or ownership of the reform. Most observers agree that the population is less concerned about who is responsible for what service and under what funding arrangements they are delivered, and more interested in decent services and low taxes. The federal government failed to emphasise the long-term objectives of the reform (better public services, more accountable state governments, fiscal consolidation, etc.) and insisted instead on the compromise character of the reform, *i.e.* on the simple fact that the reform was carried out. Little information on intermediate steps and agreements was made public. When the minister finally presented the reform package to the media in spring 2008, it was received with suspicion. Both the media and the public mocked the reform, characterising it as the act of a disheartened federal government at whose expense the *Länder* balanced their budgets, while blocking further steps towards greater accountability or commitment to the domestic stability pact. At a second media conference, the finance minister addressed some of the critical issues raised after the reform was made public and underlined its long-term impact.

Conclusions

Fiscal relations in Austria must be reformed at regular intervals, as stipulated by the law on fiscal equalisation, while the accomplishment of real reform is always the result of intense negotiations and a search for consensus. Given the large number of players with veto rights over enactment, radical changes to the federal fiscal framework are relatively rare. Electoral mandates and political leadership are crucial in promoting reform, since they act as countervailing forces against the many vested interests in intergovernmental fiscal relations. In comparison, the 2007 reforms were more significant than those made in 2004, but less wide-ranging than the 2001 reforms, which were based on a strong mandate for decentralisation. The 2007 reform was concluded successfully because the federal government was ready to provide additional funds to subsidise core state services. Favourable economic and fiscal conditions also helped. While the central government

could reduce spending on intergovernmental transfers without destabilising sub-central budgets, the states welcomed an apparently attractive opportunity to increase their tax revenues. Had the states anticipated the tax revenue decline in the aftermath of the 2008 crisis, they would hardly have given up their relatively secure grants in favour of insecure tax sharing. The 2007 reform episode has, however, opened the window for a more thorough state reform, whose shape is slowly emerging.

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Chapter 4

Belgium: The Lambermont Agreement

Summary

In 2001 both Chambers of the Belgian parliament endorsed a special law that substantially changed the revenue structure of Belgium's regional entities and the financial balance between the federal and the regional level. The Lambermont Agreement, as it was called, consisted of two distinct elements: *i)* the re-assignment of several taxes to the regions and further tax autonomy for them; and *ii)* a considerable increase of federal transfers to the communities. The Lambermont Agreement was the latest in a succession of fiscal decentralisation reforms and the widest-reaching tax assignment reform since Belgium had started to decentralise in the 1970s (Box 4.1).

The main factors driving the success of the reform were:

- *Pressure for more decentralisation*: The Lambermont reform must be seen in the context of the secular decentralisation process in the Belgian federation. Since the 1970s, the country had undergone several reforms that gave the regional level more responsibilities and spending power. However, despite regional demands, taxing power remained limited, and funding of the regions depended on intergovernmental transfers. Moreover, resources were considered to be insufficient, and the regions were persistently demanding more funding for education.
- *Reasonably good economic and fiscal conditions*: During the 1990s, Belgium had undergone considerable fiscal consolidation, reducing the general government deficit from around 7% of GDP to an almost balanced budget. Its economic growth hovered around the European Union average. At the time of the Lambermont Agreement, the budget was in a relatively sound position, allowing the federal level some leeway to embrace a reform and to increase transfer funding for education.
- *Electoral mandate and political leadership*: After the 1999 federal elections, the same parties held power at both the federal and regional level. Although Belgium has no "national" parties, since all its parties reflect regional interests, the coalition government facilitated co-ordination across government levels. Federalist issues had played a minor role during the election campaign, but the new government considered state reform an important priority and wanted to prove that it was able to resolve federalist disputes.
- *Bundling*: Probably the most crucial factor in the success of the reform was the bundling of two elements: tax autonomy for the regions and additional transfer funding for education. The Flemish region had essentially asked for more taxing power, and the Walloon region for more education funding, and neither region was particularly opposed to the other region's demands. While bundling helped secure the necessary majorities at both the federal and regional level, it put considerable strain on the federal budget.

Box 4.1. **The Belgian Lambermont Agreement**

The Lambermont Agreement (*accord du Lambermont*), concluded between the parties of the governing coalition in 2000 and adopted by the national parliament in 2001, was a financial and fiscal reform that bundled two distinct strand: *i)* the re-assignment of several taxes and taxing power from the federal to the regional level, and *ii)* an increase in financial transfers from the federal level to the communities, mainly for education. The reform also included minor institutional aspects, with new tasks transferred to the regions. The reform consisted of:

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

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

Context of the reform

Institutional framework

The Lambermont Agreement must be seen in the context of a Belgian federation that is characterised by strong centrifugal and bipolar forces, and an institutional set-up that mirrors linguistic and cultural differences. The country is divided into three regions, responsible for services linked to the "territory", such as transport, economic affairs or housing, and three communities, which are responsible for services linked to the "individual", such as education or cultural affairs. Regions and communities overlap.[1] Any institutional reform requires a two-thirds majority, plus a simple majority in each of the linguistic groups in the national parliament. These rules imply a need for broad consensus and prevent a single region from imposing its demands unilaterally. One of the major political issues in fiscal federalism reforms in Belgium is *first*, that decentralisation demands are asymmetrical, being stronger on the Flemish than on the Walloon side, and *second*, that the small number of regions allows little scope for negotiations or coalition building. A proposal in the 1980s to devolve power to the ten provinces rather than to the three regions – with a view to reducing the sometimes confrontational manner with which federalist issues are discussed – was widely dismissed. Reforms are complicated by the fact

that all political parties are aligned with cultural and linguistic groups and no longer represent or defend the federal level.

Economic and fiscal context

Fiscal consolidation prior to the introduction of the euro might have helped shape the Lambermont reforms. During the 1990s, Belgium underwent considerable fiscal consolidation in order to comply with the European Union's Maastricht criteria, thereby reducing the general government deficit from around 7% of GDP to an almost balanced budget at the turn of the millennium. Most observers argue that at the time of the Lambermont Agreement, the budget was in a sound position, giving the federal level some leeway to buy into a reform, while a minority disagree, citing the still high debt-to-GDP ratio. Economic indicators for Belgium as a whole and for its regions had changed little during the 1990s. National GDP was a little higher than the European Union average; the Flemish region was clearly above and the Walloon region clearly below. The transfer system had hardly changed, with financial transfers flowing from the Flemish to the Walloon region and, since the mid-1990s, also to the Brussels capital region (Dury *et al*., 2009). While fiscal conditions were not directly responsible for the reform, which was essentially institutional in nature, they may have contributed to shaping the process and financial outcome.

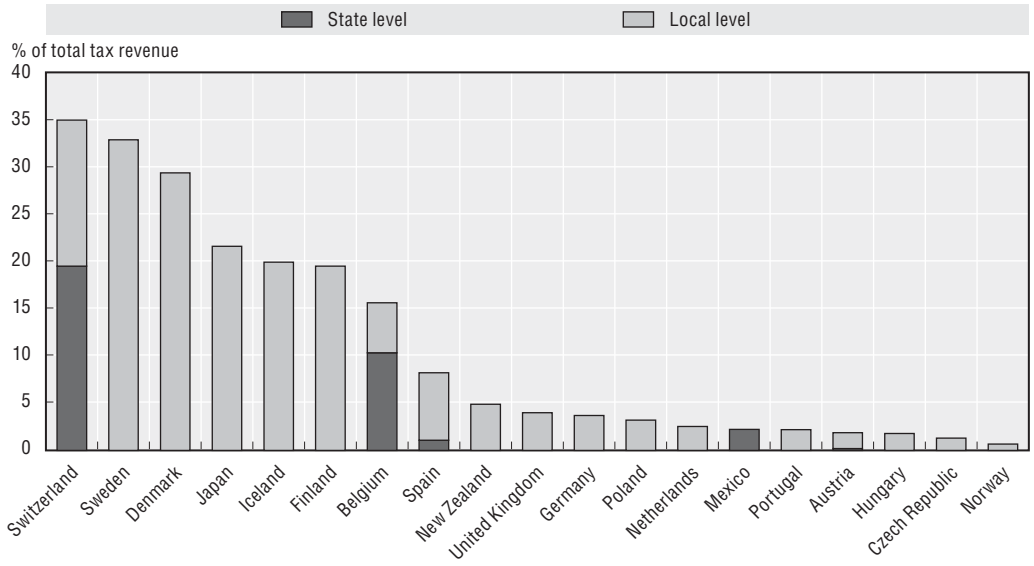
Issue history

The Lambermont reforms were the fifth in a series of steps to assign more fiscal power to the regions and to transform the former unitary state into a federal one. The 1970 constitutional amendments were the starting point for decentralising the Belgian state, giving birth to the regions and communities that at the time were endowed with very limited executive and legislative powers. The 1980 reform laid the foundations for a federal country with the assignment of significant responsibilities to the sub-federal entities. Responsibilities and spending power were increased, while funding rested essentially on a set of earmarked grants. In 1989, Belgium became *de facto* a federal state, with the creation of the Brussels region, and the regions and communities gaining greater power over education, housing, transport, environment and economic affairs. The grant system was reformed to rely more on SCG's needs, and earmarking was mostly abandoned. In 1993, Belgium officially became a federation. The mechanisms for funding the regions and the communities were further revised, resulting in an even more comprehensive transfer and tax-sharing system.

At the time the Lambermont Agreement was negotiated, the taxing power of the regions was limited. It was greater than in Germany and Austria but lower than in the "classical" federations like Canada, Switzerland or the United States (Figure 4.1). Regions depended largely on taxes shared with the federal level, such as the personal income tax, with no autonomy to change tax rates or to set the tax base. The communities do not have taxing power, to avoid the creation of two distinct tax systems within the same region. The Lambermont Agreement aimed both to increase regional tax autonomy – a request that had long been on the Flemish agenda – and to strengthen regional fiscal responsibility, reducing the pressure on the federal budget from ever-increasing grants. Funding for the communities, last revisited in 1993 at a time when federal finances were not in a robust condition, were considered insufficient, especially by the French-speaking community. Simultaneously, in an effort to lower the tax burden, the federal government reformed the

Figure 4.1. **Tax autonomy in Belgium was relatively low**

Taxes for which sub-central governments may set tax rates and/or the tax base, as a percentage of total tax revenue, 1995



Source: OECD Fiscal Decentralisation Database.

personal income tax, but most observers agree that the personal income tax and the Lambermont reforms were largely unconnected.

Actors and interests

The two main reform actors were the regions and communities and the federal government, the latter represented by the prime minister and the deputy prime ministers. The regions and communities, especially Flanders, had strong stakes in the reform, which was likely to offer them both more taxing power and more federal transfers. The federal level, partly in response to the interests of the regional entities, was not necessarily antagonistic to those demands, since they were supposed to impose a tighter constraint on regional budgets. Moreover, the federal level was interested in shedding some of its financial responsibility for state pension funds onto the regions. Since the initial reform proposal foresaw fiscal neutrality, i.*e.* no net burden for any government level – a principle that was disregarded only late in the reform process – negotiations between the regional and the federal level were not particularly confrontational. The education sector was an additional actor with strong stakes, given its interest in higher funding for the communities. The municipal level played no role, as it was not directly concerned by the reform.

Regions and communities had various interests that were quickly bundled. The Flemish region was interested in more tax autonomy, while the Walloon region was less so, not least because of fears that this would result in lower tax revenue and stronger cyclical movements of its revenue base. Meanwhile, the Walloon region had an interest in higher funding for the communities, to which the Flemish region was not strongly opposed. The regional interests thus became symmetrical: on the Flemish side, the desire for taxing authority was strong and opposition against more community funding was weak. Meanwhile, the Walloon side preferred community funding, but opposition against more

taxing power was weak. The drive for fiscal neutrality was abandoned, and the negotiations became a give and take – sometimes called "log-rolling" – between the two regions.[2] Most observers agree that in order to push their priorities through, the two regions joined forces and bundled a reform at the expense of the federal level.

The Brussels region had no strong stakes in the Lambermont reform. Additional taxing power was potentially beneficial for the region, especially as the decentralised property tax was likely to bring in higher tax revenues. On the other hand, the Brussels region had no interest in a decentralised personal income tax, for fear that the shrinking metropolitan population would result in lower tax revenues and an unbalanced budget. In fact, one of the consequences of the reform was a shift in the tax mix from personal income tax to registration fees, which increased the volatility of tax revenue. In addition, since Brussels is not a community, it could only indirectly benefit from an increase in community funding. Brussels seems to have been bypassed by the reform and is still suffering from metropolitan imbalances, especially from the fact that residents of suburbs located in the Flemish and Walloon region benefit from Brussels' central services without providing the respective funding (OECD, 2009).

Electoral mandate and political leadership

The federal elections of September 1999 brought in a new government, whose political leadership commanded significant trust. The same parties held power at both the federal level and in each region, which made political alignment across government levels and between regions easier. Although Belgium has no "national" parties, since all parties reflect regional interests at the federal level, the coalition government allowed for easier co-ordination and information exchange across government levels on reform issues. Differences between regional and federal political parties of the same colour did not arise. Although federalist issues had played a minor role during the election campaign, the new government saw state reform as a high priority, especially in the wake of a Flemish parliament resolution pushing for more decentralisation in the summer of 1999.

The new government wanted to prove that it was able to solve federalist disputes that the former government had supposedly been unwilling to resolve. Some observers note that the prime minister pushed hard to get the Lambermont agreement on track, and that he was ready to compromise on several reform elements. This might partly explain the relatively strong concessions the federal level was ready to make. As the federal government was at the origin of the agreement, it was willing to put resources on the table. Unlike the 1993 reforms, it put the new grant formulas on a permanent basis, thereby assuming an additional permanent financial burden. The Lambermont negotiations received an additional boost from two preceding agreements voted by the new government coalition, the "Saint Eloi" agreement in December 1999, and in May 2000, an agreement on the funding formula for the communities and on fiscal transfers between the Walloon region and the French community (Stichele and Verdonck, 2001).

The reform process

Policy formulation and timing

The reform process started in October 1998, with the publication of a report by the High Council of Finance on tax assignment across government levels. The report found that in order to increase the efficiency of the tax system, the regions needed to take over

more fiscal responsibility and cover a bigger share of their spending through own tax revenue. It analysed several issues such as potential tax competition, the integration of Belgium into the European Union, made an international comparison on tax assignment in federal countries, and finally recommended giving some autonomy over the personal income tax and re-assigning a set of minor taxes entirely to the regions. On equalisation, the report mentioned that fiscal disparities were often larger within a region than between regions, and that Brussels could be negatively affected by tax decentralisation, especially of the personal income tax. On the other hand, it explicitly mentioned that tax autonomy had so far not had any negative distributional impact. The report also pointed out that tax autonomy – restricted as it was – had never been fully exercised by the regions, which put the proponents of further tax autonomy in a slightly embarrassing position. The report was seen as very plain-spoken and helped to structure the ensuing discussion.

Three forces then helped create momentum for reform:

- Under the Finance Act of 1989, some aspects of the VAT tax-sharing system were scheduled to be renegotiated at the end of the transitional period in 1999. Negotiations were therefore long foreseen for that period.
- In March 1999, the Flemish parliament voted a resolution asking for a new transfer of competences and more autonomy over taxes whose yield responded to economic growth. Despite the lack of such a mandate on the Walloon or Brussels side, this increased the political drive at the federal level for tax decentralisation.
- Finally, the federal elections of June 1999 shifted the balance in the federal government, resulting in more political alignment across government levels.

In July 1999, the new government announced the creation of an intergovernmental and interparliamentary conference for institutional modernisation. Two working groups were set up: one to discuss the powers of the federal government to be transferred, and the second to examine the financing of the communities and regions. In December 1999, both the federal government and the regions reached what was called the Saint Eloi Agreement, which changed the formula for the value added tax share allocated to the communities. However, the French-speaking political parties still considered the funding of the communities insufficient, and the Flemish parties remained unhappy with the extent of fiscal decentralisation. At the beginning of 2000, the two regions agreed to start the reform process again and to bundle them in a way that would benefit them both.

Bundling the two strands of reform

The political negotiations quickly focused on a deal on "tax autonomy for the regions against more funding for the communities", and although the two elements did not have an obvious common denominator, the solid bundling of the two aspects became the common thread of the reform. During the negotiations, the Flemish proponents for more taxing power had to give in on a few elements, such as far-reaching autonomy on the personal income tax and regionalisation of the corporate income tax, but the Walloon region's demand for additional community funding went through almost unquestioned. The negotiations were accomplished in record time, and in March 2000, the cornerstones of the agreement were set. An irony of the Lambermont reform is that the funding of the communities benefitted the Flemish community more in relative terms than the French-speaking community, because the new formula gradually linked federal transfers to

regional personal income tax revenue, which was higher in Flanders than in Wallonia and in Brussels.

The "autonomy against more transfers" deal came at the expense of the federal level, however. While the initial tax autonomy reform was based on the premise that it would be fiscally neutral – more tax revenue was thought to be compensated for by fewer grants in total *and* for each region – the funding of the communities that was finally agreed upon resulted in a net fiscal transfer from the federal to the sub-federal level. Moreover, since one of the cornerstones of the Lambermont Agreement was to ensure stable and non-renegotiable allocation formulas – as opposed to the provisional 1993 reform, which entailed lengthy and cumbersome renegotiations – the pressure on the federal budget became permanent. The new transfer formula for the communities relies almost entirely on the evolution of national GDP rather than on the fiscal position of the federal government, while the federal level still assumes spending on behalf of the regions, for example in the case of the decentralised state pension funds. As one observer put it, the federal level was too weak to defend national public goods like fiscal stability, and "put the money on the table to get the deal through". Indeed, the Lambermont Agreement was later criticised as running counter to the interests of federal taxpayers, who were seen as one of the weakest interest groups in fiscal federal reforms (Choudhry and Perrin, 2007), and as putting new and permanent pressure on a federal budget that was already structurally unbalanced (OECD, 2009).

The non-reform: more autonomy against more efficient equalisation

Several negotiators, particularly at the federal level and in the High Council of Finance, wanted a reform that offered more regional tax autonomy against more horizontal fiscal equalisation. At the time of the Lambermont reform, Belgian fiscal equalisation was – and still is – characterised on the one hand by the principle of the *juste retour*, *i.e.* a tax-sharing system under which taxes are allocated to the regions where they are collected, and on the other hand by partial vertical fiscal equalisation, with grants flowing from the federal level to regions with below-average fiscal capacity (Cattoir *et al.*, 2009). Overall equalisation effects are difficult to assess, given the opacity of the system; some federal grants appear to have strong equalising effects for the Walloon region and Brussels but not for Flanders. The regions however showed little interest in more tax autonomy coupled with more transparent horizontal equalisation. Flanders rejected horizontal equalisation on the grounds that it would put an implicit tax on its tax revenue, while Wallonia and Brussels would have lost some existing, strongly equalising gap-filling transfers. The political drive to reach consensus as in Portugal or Switzerland – where fiscal equalisation reforms acted as a balance against fiscal disparities resulting from higher tax autonomy – was weak (Cattoir, 1998).

Safeguards, guarantees and transition periods

As in the case of the reforms implemented in 1993, the new formulas were introduced gradually over several years, in order to give the different stakeholders time to adapt to the new rules. This was particularly true for the formulas that govern the allocation and distribution of the VAT share to the communities. The Walloon region also feared that giving the Flemish region more tax autonomy would lead to "unhealthy" tax competition and to stronger interregional disparities, which led the federal government to deny regional governments the right to adjust personal income tax rates, thereby reducing tax

progressivity. Moreover, the Finance Act of 2001 specifies that the regions cannot engage in unfair competition, although this idea was not further elaborated upon. Regional tax credits and reimbursements must comply with these rules. Another tax, the *taxe de circulation*, became regionalised, but tax rate changes were allowed only if all three regions agreed to a change. Since this never occurred, tax autonomy was by no means fully realised.

Adoption and implementation

The agreement was negotiated in early September 2000, in the prime minister's residence, the Lambermont, from which it took its name. It was then presented to the opening session of parliament in October 2000 and submitted and approved in January 2001. The agreement was voted by both parliament chambers (*Chambre* and *Sénat*) in July 2001. The parliament made no major amendments to the texts drawn up by the negotiators. The adoption of the agreement was seen as a political success far beyond its purely fiscal implications, because it was seen as easing intergovernmental and interregional tensions in the country.

The new coalition government lacked the two-thirds majority needed to pass the reform in the two federal chambers. A minority of Flemish parties vigorously opposed the reform because it was not considered far-reaching enough, and the concessions made by the French-speaking community were seen as insufficient in exchange for the more generous financing of the communities. Besides, some Flemish parties feared that it would preclude any hope of future reforms, as the French-speaking community would have no further demands against which the Flemish could barter. The coalition government therefore depended on the tacit agreement of a Walloon opposition party that had no strong stakes in the reform but demanded additional federal funding for private schools. The coalition government obtained the abstention of this party in exchange for an agreement between the French-speaking parties to allocate a large share of the new funds to private schools. The Lambermont Agreement hence became to some degree a school finance reform, fulfilling a promise made in the 1950s.

After the agreement was voted, the Flemish region made swift use of the new taxing powers. The region reduced the inheritance and gift taxes and introduced a new tax allowance and reimbursement scheme for the personal income tax. The Walloon region made less use of its newly acquired autonomy. Strong growth after 2001 helped increase tax revenues for the regions, especially property tax revenue in the Brussels region. The federal government, on the other hand, did little to adjust its fiscal policy to its higher transfer obligations for the communities, and its spending remained high despite lower interest payments. Some observers note that the federal government missed an opportunity for fiscal consolidation and efficiency increases after the Lambermont agreement had been signed.

The role of experts and the administration

Experts from academia and government agencies played a significant role before and during the reform process. A critical role was played by the High Council of Finance and its initial 1998 report on tax decentralisation. Reports by the council usually enjoy high credibility, even though its recommendations are not binding for the government. Indeed, the report was generally considered even-handed and of high quality, and the members, in the foreword, underlined that its conclusions and recommendations were reached with

unanimity. Earlier drafts of the report, including the Excel spreadsheets showing the effects of tax reallocations, were made by the research arm of the Finance Ministry.

The tax decentralisation part of the reform closely followed the ideas and recommendations of the council's report. The report was somewhat technical, dry and neutral, avoiding any partisan bias. Its main conclusions and recommendations were largely maintained through the reform process. The only one of the council's proposals negotiators did not follow was on a piggy-backing system for the personal income tax, which was abandoned in favour of tax reimbursement. A proposal to combine extended tax autonomy with a bolder, horizontal fiscal equalisation system was also finally rejected during political negotiations.

Communication

The issues covered by the Lambermont Agreement were technical and difficult to communicate. Public interest in the reform was initially low. However, the government succeeded in drawing out the policy issues behind the numbers, such as the need to increase the autonomy of the regions, to secure financial support for education and to improve the relations between the sub-federal entities and the pacification of the country. Little was communicated about fiscal issues and the need to enhance the regions' fiscal responsibility. The fact that the increase in intergovernmental transfers was a financial burden for the federal government in the long term never became an issue during the debate over the reform. However, the government concentrated on the "cost of non-reform" both in political terms and in terms of the underfunding of education in the communities.

Conclusions

The Lambermont Agreement was the largest tax decentralisation reform ever enacted within the Belgian federation. Its principal consequences were more regional autonomy over the personal income tax and the devolution of several taxes from the federal to the regional level. To make the reform palatable to all sub-federal entities, tax decentralisation had to be coupled with a considerable net increase in transfers from the federation to the communities. The Lambermont Agreement was the last successful federal reform in Belgium. The negotiators preparing a subsequent reform in 2007 could not find common ground, and their attempts at reform were abandoned. Several factors can help to explain why that attempt failed and the Lambermont Agreement succeeded: *i)* party coalitions were no longer the same at the federal and sub-federal level; *ii)* while further tax autonomy remained a priority on the Flemish agenda, there was no countervailing demand from the Walloon side to fund sub-federal entities, so the scope for bundling was limited; and *iii)* the federal level, contrary to the Lambermont episode, had no resources available to accommodate the diverging interests of the two main regional entities. Over the next few years, institutional reforms will be even more difficult to pursue, since they will take place in the context of fiscal consolidation.

Notes

1. Flanders, Wallonia and the capital region of Brussels constitute the three regions, while the French, the Dutch and a small number of German speakers represent the three communities. The bilingual Brussels capital region does not have its own community, since community responsibilities are shared between the French- and the Dutch-speaking community. The German-

speaking community does not have its own region, and its responsibilities are assumed by the Walloon region. The Flemish region and the Dutch-speaking community are merged.

2. Log-rolling is an exchange of votes in a legislative process whereby two parties, each of which needs a partner to push its priorities through, create a common platform. The process is explained in the synthesis chapter.

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Chapter 5

Canada: The equalisation reform

Summary

In 2007, the Canadian government reformed its federal-provincial fiscal equalisation system. Equalisation was simplified, the distribution formula overhauled, and total equalisation payments were no longer subject to a cap. The national fiscal capacity standard was redefined, including a new assessment of provincial revenues from natural resources. The reform, considered as one of the farthest-reaching since the inception of the scheme in 1957, was meant to appease some long-lasting controversy between the federal government and the provinces as well as among the provinces (Box 5.1). Overall, it led to considerable spending increases for the federal government, in large part driven by the interaction of the new formula with record oil prices. After the financial and economic crisis struck in 2008, the reform was revisited and total federal equalisation payments were again submitted to a ceiling.

The main factors driving the success of the reform were:

- *Good economic and fiscal conditions*: After the turn of the millennium, Canada's economy grew solidly, with growth rates hovering around 4%. The fiscal position had improved significantly after sharp consolidation in the mid-1990s. In the ten years leading up to 2007, the federal government boasted uninterrupted budget surpluses, although some provinces struggled to restore their fiscal balances. Buoyant revenues allowed the federal government to increase equalisation payments considerably in terms of total federal spending.
- *Reform ripeness*: A thorough reform of equalisation had been on the agenda since the 1990s, when various weaknesses of the system had become apparent. The provinces complained about an increasing gap between revenues and spending obligations. All governments agreed that equalisation should again become "formula-based", but they could not agree on what the formula should look like. The treatment of natural resources in the equalisation formula remained particularly controversial. Equalisation remained a perennial issue, and the population, tired of federal-provincial and inter-provincial bickering, wished to "de-politicise" the issue.
- *A report by highly regarded experts*: The reform as adopted by Parliament was largely based on a report prepared by five high-ranking senior officials. This expert group consulted extensively with academics, politicians and the public at large and put strong pressure on politicians to adopt a global and "neutral" view on equalisation. The report was considered well documented and unbiased and was highly regarded by the public. It even survived a change in government. When it was published, a new government of a different political complexion had come to power that nevertheless endorsed the report's recommendations with only minor modifications.

Box 5.1. **The Canadian equalisation reform**

In 2007, the Canadian Parliament endorsed a wide-ranging reform of fiscal equalisation, making the system more principle and formula based and injecting additional federal resources for the provinces. The reform overhauled a system that had become pro-cyclical, opaque and prone to the influence of special interests. The reform also changed the allocation formula for revenue from natural resources, a much contested issue. The reform consisted of the following elements:

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

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

Context of the reform

Institutional framework

Canada is the most decentralised OECD federation in terms of spending and taxing power, with around 65% of spending and 50% of taxes accruing to the sub-central – provincial plus municipal – level. Provinces have wide-ranging tax autonomy, *i.e.* they can define rates and, to a large extent, the bases of their taxes. Provinces also enjoy the proceeds from natural resources (fees, royalties, etc.) exploited on their territory. Provinces are largely responsible for main policy areas like education and health care, and interference from the federal level remains limited. The considerable differences in provincial fiscal capacity are reduced by equalisation, *i.e.* a transfer from the federal

government to the provinces inversely related to provincial fiscal capacity and accounting for around 20% of federal payments to the provinces. Equalisation has been enshrined in the constitution since 1982. Its objective is to ensure "that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation".

Economic and fiscal context

After a relatively weak performance during most of the 1990s, Canada embarked on a solid growth path in the new millennium, with growth rates hovering around 4%. The long period of strong growth brought per capita GDP closer to the level of the United States. Prudent policy had contributed to this result, but this was also partly due to the increase of prices for natural resources such as oil, for which Canada is a significant exporter (OECD, 2008). Firms in the energy sector have been the main beneficiaries of the oil price increase. The manufacturing sector, especially in the industrial heartlands of Ontario and Quebec, suffered to some extent from the Dutch disease, *i.e.* the strong appreciation of the Canadian dollar in the wake of high energy export prices. Economic growth favored resource-rich provinces, and economic and fiscal disparities tended to widen during that period. Indeed, differences in size and economic capacity across provinces are a key feature of the Canadian federation, with per capita GDP of the provinces ranging from CAD 31 000 to CAD 71 000. When the financial and economic crisis started in 2008, the Canadian economy had to cope with the twin problems of lower export prices and still a high exchange rate.

Canada's fiscal position improved significantly after the federal government embarked on a sharp consolidation path in the mid-1990s. From 1997 to 2007, the federal government boasted uninterrupted budget surpluses. The provinces, on the other hand, recorded a surplus for a part of that same period only, with some provinces struggling to restore a sound fiscal position. Provinces claimed that part of the federal consolidation was at their expense and that the fiscal gap, *i.e.* the structural imbalance between taxing power and spending obligations, was increasing, especially due to higher health care spending (Robson, 2007). During the consolidation period, disparities in fiscal capacity between rich and poor provinces increased, putting some strain on fiscal equalisation. Moreover, given the specificities of Canadian equalisation, the system tended to exacerbate rather than attenuate cyclical movements of receiving provinces' revenues (Boadway, 2005). In sum, when the reform started, the federal government was in a position to show fiscal generosity.

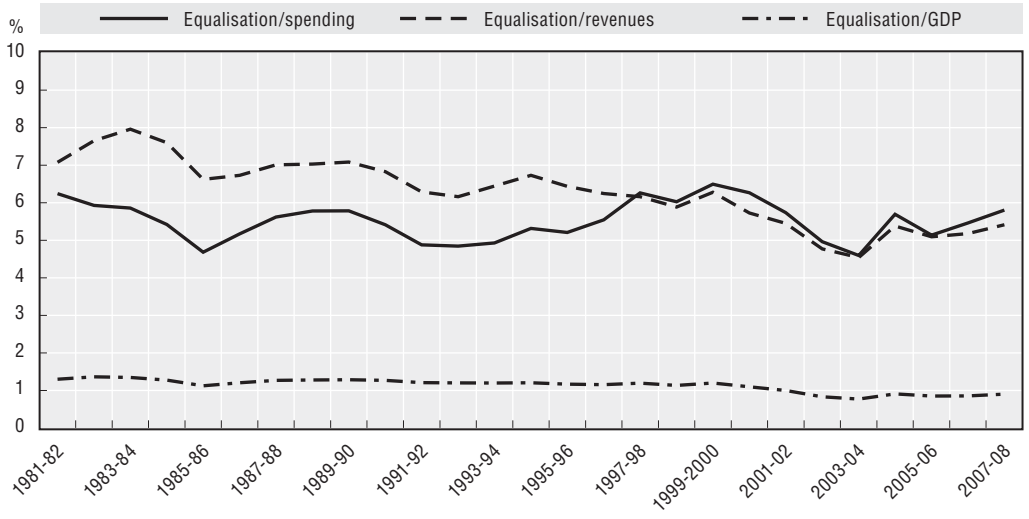
Issue history

The Canadian equalisation system, created in 1957, consists of a vertical transfer from the federation to the provinces whose tax-raising capacity lies below a certain standard. This principle had not changed since its inception, but the specific formulas and the standard below which payments set in were regularly amended. Traditionally, most provinces were on the receiving side, while only two or three had a fiscal capacity above the standard. Amendments usually oscillated around three issues: *i)* the definition of the standard, *i.e.* whether the average fiscal capacity of two provinces, five provinces or all provinces should define the standard to which a province's fiscal capacity should be equalised; *ii)* whether payments should be open-ended or closed-ended, *i.e.* whether or not a cap on total federal equalisation payments should be set; and *iii)* to what extent natural

resource revenue should be included in the definition of fiscal capacity – 100%, 50% or not at all. Equalisation accounted for a little more than 1% of GDP until the end of the 1990s (Figure 5.1). After equalisation had been enshrined in the constitution in 1982, wide-ranging political consensus kept the system stable for almost 20 years, except for purely technical modifications (Courchène, 2010).

Figure 5.1. **Canadian fiscal equalisation fluctuated over time**

Equalisation spending as a percentage of federal spending, federal revenues and GDP



Source: Provincial Economic Accounts, Statistics Canada, 2010.

Towards the end of the 1990s, fiscal equalisation came back on the political agenda. Although the consolidation period that started in 1996 did not affect equalisation, as a result of the provinces' economic structure and volatile commodity prices, equalisation became pro-cyclical, with reduced payments at a time when receiving provinces needed them most. Windfall gains from rising commodity prices raised the question of how to treat natural resource revenue in the equalisation formula. In order to increase the incentives for off-shore exploitation, the federal government in the late 1990s amended a set of special accords with certain Atlantic provinces enhancing the existing preferential treatment with respect to off-shore natural resource revenue in the definition of their fiscal capacity. The special accords made the equalisation system opaque and difficult to manage and aroused further demands. In September 2004, the federal government announced an increase of the health care transfer, but the provinces complained that this was merely to compensate for lower equalisation transfers. Finally, in October 2004, the government announced an interim arrangement that set a global level for equalisation transfers and guaranteed the provinces a regular increase for the coming years (Holden, 2006). Simultaneously, the government declared that it would set up an expert group to prepare a more thorough equalisation reform.

Actors and interests

The two main reform actors were the provinces and the federal government. Since equalisation is vertical, the two government levels tend to have antagonistic interests. The federal government wanted a return to a formula-based equalisation system with no

special treatment for individual provinces, and it wanted some ceiling provisions to keep total equalisation payments under control. The federal government also thought that full inclusion of resource revenues would pose some affordability challenges, but considered that inclusion would lead to a more equitable distribution of equalisation transfers across provinces. The provinces argued mainly in favour of a return to a level of equalisation payments that was last reached at the end of the 1990s. The provinces were also keen on reverting to a formula-based system, but they were even more interested in an open-ended transfer with floor provisions that smoothed cyclical movements and lifted all provinces to the national standard. The federal government was mainly represented by the intergovernmental fiscal relations division in the Ministry of Finance (Finance Canada), while the provinces co-ordinated their interests through the Council of the Canadian Federation, an interprovincial body created in 2003.

The provinces were not a united force dealing with the federal government, however. The inclusion or exclusion of natural resources in the fiscal capacity standard was the most contentious part of the reform. Natural resource revenues are unequally distributed across provinces, so that any arrangement strongly affects their relative position in the equalisation system. Resource-rich provinces, especially those with above-average fiscal capacity, favoured exclusion of resource revenues. The non-resource provinces favoured inclusion because it lifted the standard and thereby increased equalisation payments. The "off-shore" provinces enjoying special accords were keen on keeping this privilege. Other diverging interests centred on property taxes. Some provinces were in favour of a reform of property taxation based on market value assessment for residential property, while others – especially those with high property prices – were against. In sum, the fact that the stakes were multi-faceted and that there was no simple fault line separating the receiving from the non-receiving provinces allowed the federal government to bundle several reform elements and to form majorities across provinces.

Political leadership and electoral mandate

The fiscal equalisation reform of 2007 was neither the result of a grand political design nor of strong political leadership. During the campaign for the June 2004 election, all major parties except the Liberals had claimed that there was a fiscal imbalance between Ottawa and the provinces and spoke of plans to reduce it. The Liberal prime minister was somewhat on the defensive when he declared in a speech in February that the issue of the vertical fiscal imbalance would be tackled and the special accords with resource-rich provinces respected. The Liberals were re-elected; but they had to form a minority government and had no obvious electoral mandate to launch a fiscal federalism reform. Once the government had declared in September 2004 that it would increase health care funding, it soon had to announce an equalisation reform, thereby reacting to growing demands from the provincial level and the – albeit divided – opposition parties. At the provincial level, no party held a clear majority that seemed willing to align with the governing federal Liberal Party and to forge a radical reform.

Despite weak political support from the government, there was a large consensus across parties that equalisation needed to be "de-politicised". The lack of strong political leadership (and interference) may well have fostered rather than hindered the drive for reform. The population was tired of intergovernmental bickering on fiscal issues. The creation of an expert panel was therefore seen as a step towards a more technical approach. This might even have helped the reform to survive a change in government.

When the expert group had published its recommendations in May 2006, the Conservatives had come to power, having declared that the issue of the federal-provincial fiscal imbalance needed to be addressed. Although the new minority government had not initiated the reform, it was supportive of the expert panel's proposals and endorsed and implemented them with few exceptions. As it turned out, intergovernmental relations issues were as much driven by the stakes and interests of individual governments as they are by ideology and political parties.

The reform process

Policy formulation

The reform process started in 2005 – and several months later than initially planned – with the creation of the expert panel. The panel consisted of high-ranking senior officials, of whom most had been involved in federal-provincial fiscal relations. The panel's mandate was initially quite limited. It focused on how to allocate the global amount set by the federal government among the provinces, on streamlining the distribution formula, assessing the Representative Tax System, and on developing new measures of fiscal disparities. Many cornerstones of the 2004 transitional measures were expected to remain unchanged. But the panel chose a much bolder approach to policy formulation. It started an extensive consultation process and held several hearings with stakeholders in order not only to get information on all weaknesses of the current system but to portray its own views on the reform. Moreover, the panel asked the opinion of most academics working in the area of fiscal policy and intergovernmental relations, making it possible to draw up a comprehensive assessment. When the panel presented its recommendations in May 2006, they were much more fundamental than the government had initially expected.

Time also played a role. Policy formulation lasted less than a year and covered many areas, which might have helped to complete the reform successfully. The provinces were regularly informed about possible new approaches and principles, and they knew that the federal government was ready to increase total equalisation payments, but they did not have the exact number to gauge how they were individually affected. The panel did a lot to portray the overall positive effects of the reform, and put much weight on explaining the advantages of the reform, but the Ministry of Finance, which was responsible for the calculations, was parsimonious with numbers. Stakeholders were therefore obliged to act without the full details, which forced them to gauge the overall effects of the new system rather than the effects on each individual province. When the panel finally came out with the financial assessment of its proposals, the provinces could not contest the results of a reform they had previously agreed to in principle. Another reason for the relatively rapid reform process was that the federal government and the provinces were the only negotiators. No other stakeholders were involved.

The issue of resource revenues proved the most controversial. In the formula that was in place prior to the 2004 transitional amendments, resource revenues were fully accounted for in the definition of fiscal capacity. Inclusion not only put pressure on the federal government, especially when energy prices were high, it also meant a disincentive for poor provinces to exploit their resource base. This disincentive was at the origin of the special accords with the Atlantic provinces, shielding them partially from the disincentives embedded in the equalisation scheme. The panel finally proposed a compromise that could satisfy both the federal government and most of the provinces, *i.e.* 50% of resource

revenue would be taken into account in the fiscal capacity estimation, with an additional cap on provinces whose total fiscal capacity after equalisation (with full resource inclusion) would surpass that of the non-receiving province with the lowest fiscal capacity. This proposal was economically well-conceived as it capped equalisation payments for resource-rich provinces while maintaining incentives for provinces with undeveloped resource wealth to exploit their potential. While some observers think that the resource revenue issue was the main reason for the late publication of the report – May 2006 instead of December 2005 – others argued that the delay was mainly due to the thoroughness of the panel's work.

Compromises and safeguards

The recommendations of the panel put an additional financial burden on the federal government, however. While the move from the five- to ten-province standard could be defended on the grounds both of efficiency and equity, it also meant an increase of the standard, raising the total amount of equalisation payments. Also, the inclusion of natural resources meant more volatility of the standard. Meanwhile, a set of safeguards such as floor provisions and minimum guarantees ensured that no province would be a net loser after the reform. The special accords provinces in particular were not ready to give up their privileges if the new equalisation formula did not at least maintain their previous entitlements. Some provinces obtained opt-out clauses from the new fiscal equalisation system, *i.e.* they had the option to remain under the previous formula. The federal government saw these concessions as a part of its strategy to reduce the vertical fiscal imbalance with the provinces, and at the time of implementation, it had the budgetary means to do so. Within a short time, equalisation in terms of federal revenue or spending reached again the level of the mid-1990s (Figure 5.1). While the reform entailed a major departure from the provisional 2004 framework, it led to further transfer spending increases.

The role of experts

The panel that authored the expert report (O'Brien Report) played a pivotal role in preparing the reform and defending it in public, partially making up for the lack of strong political leadership. Initially endowed with a restricted mandate, the panel took its task of disentangling the equalisation knot seriously. The five members of the panel were mostly high-ranking senior officials, some of them with political experience. All panel members were economists, and their work and the final recommendations combined economic rigor with political feasibility. Since the provinces could not agree on the composition of the panel, the federal government finally selected the panel members, taking care to ensure a balanced representation. During the preparation of the reform, the panel conducted extensive consultations with academics and organised round tables in most provinces. Several interview partners argued that the intellectual beauty of the recommendations came from the strong links of panel members with academia and the strong pressure they put on politicians during the hearings to adopt a global and neutral view on equalisation. In the public and in the political sphere, the panel was held in high esteem and considered impartial, which ultimately allowed the government to adopt its recommendations with only a few amendments.

Adoption and implementation

When the expert report was published in May 2006, a new Conservative minority government had replaced the previous Liberal minority government. Despite its political colour, the new parliament endorsed the expert recommendations almost entirely, with only two exceptions: *i)* an allowance was made for resource revenue to be entirely excluded, following a promise given during the election campaign, and *ii)* after some hard lobbying of the concerned provinces, the special accords with an opt-out clause for the new equalisation system remained in place. Moreover, the transition period from the old to the new system was extended, and some minimum guarantees were reinforced. Although recommended by the expert group, the government never really took the necessary steps to improve transparency, communication and governance of equalisation. As recommended by the panel, the government abstained from creating a permanent body – comparable to the Council of Australian Governments or the Commonwealth Grants Commission – that would regularly assess the equalisation system.

In the end, the reformed equalisation system only remained in place unmodified for less than two years. In November 2008, and in the midst of the financial and economic crisis, the federal government had to announce radical changes to equalisation, in order to cope with its rapidly increasing cost. For the first time in history, Ontario qualified for and received equalisation payments, given the double effect of the exceptional fall of the province's fiscal capacity and a persistently high standard due to high resource prices. Given its size, Ontario tipped the balance of the system. The open-ended equalisation transfer was once more converted into a closed-ended one, with annual growth equal to a three-year average of nominal GDP growth. This effectively lowered the national standard to which provincial fiscal capacity was equalised. The federal government prepared the new changes in a largely unilateral way, without much consultation of the provinces and other stakeholders. Ironically, after the emergency amendments of 2008, equalisation resembled the 2004 provisional framework, which was the starting point for the 2007 reform.

Communication

Despite its political nature, fiscal equalisation is a dry and technical matter. It has been largely ignored by the population and is understood by only a few academics, experts and officials across the country. The government therefore had to show the policy behind the formulas and how they affected the well-being of the ordinary citizen. Much weight was put on the principal objective of the equalisation framework, namely to provide the population with similar public services at similar taxation levels across the country. Given that the effectiveness of the programme in achieving this goal had been increasingly questioned, the government put much emphasis on the fact that the reform would bring equalisation "back on track". The government consistently used the term "formula" or "principles-based approach" (although equalisation had always been based on a "formula"), showing that the reform would end *ad hoc* approaches and special arrangements with individual provinces. The expert report was written in plain language, and the 18 recommendations were easy to understand.

Conclusions

The 2007 equalisation reform was one of the farthest reaching in the history of the Canadian equalisation programme. Beginning in the mid-1990s, the national consensus on

both principles and technicalities of equalisation had been crumbling, especially with regard to the treatment of natural resource revenues. The reform made equalisation more principles-based and technically less complex. The reform was announced in 2005 together with a transitional *ad hoc* programme widely based on individual agreements with some provinces, so the need for reform became even more apparent. The reform was prepared by an expert group that combined economic rigor and political savoir-faire, and its high reputation put the government under pressure to endorse and implement most of its recommendations.

However, a main reason that the reform was implemented so smoothly was that the federal government considerably strengthened the programme, increasing its financial contribution by around 20% within two years. The new arrangements no longer capped total federal equalisation payments. Transitional arrangements and minimum safeguards ensured that no province would lose equalisation entitlements in absolute terms. Although contrary to the principles-based approach advocated by the reform, some special accords and opt-out clauses with individual provinces remained in force, further reducing opposition from individual provinces. When the financial and economic crisis struck in 2008, the government reversed parts of this reform, arguing that it was unsustainable, especially since natural resource prices remained high. With the newest amendments, equalisation currently is quite similar to the framework that prevailed prior to the reform.

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Chapter 6

Denmark: The Local Government Reform

Summary

On 1 January 2007, a new administrative map of Denmark was created, as the Danish Local Government Reform came into force. The number of municipalities was reduced from 271 to 98 by mergers, and the 13 counties were abolished and replaced by five regions (Box 6.1). A process of "controlled voluntary mergers" resulting from a political agreement between the main political parties forced municipalities to merge until they reached a minimum size of 20 000 inhabitants, while leaving them freedom to negotiate with their neighbours to create the new boundaries. The main objective of the reform was to adapt public service delivery to technological change and increasing demand, while leaving the Danish public sector decentralised. The public sector and service levels had grown over the years, and small municipalities could no longer provide the level of services that was now required. Municipal mergers were therefore seen as an alternative to recentralisation.

The main factors driving the success of the reform were:

- *Bundling reforms together:* The Local Government Reform bundled together three reform areas: a territorial reform (merging of municipalities), a re-allocation of tasks across levels of government, and a financing and equalisation system reform. This made it possible to compensate the costs and benefits of one reform element with the others, thus reducing opposition.
- *Strong political leadership:* The Minister of Interior and Health was highly motivated to carry out a local government reform. The aim was to reform the health care system by transferring responsibilities to larger municipalities, and thus to ensure local provision of high-quality health care services.
- *Electoral constraints demanded a tight calendar:* The time schedule for implementation was strongly influenced by the local elections in November 2005. New municipal borders had to be drawn up before the elections took place, and the new division of tasks had to be decided before the merger process could begin. This created a very tight schedule, giving municipalities only about six months to carry out the negotiations and agree on the mergers. This left them little time or means to oppose the reform.
- *Use of both stick and carrot*: Municipalities that did not reach the population targets could be forced to merge by the parliament, thus creating an incentive to enter into voluntary mergers. An opt-out clause allowed municipalities to refuse to merge under some conditions, but they would not receive the new tasks transferred to municipalities and would have to conclude compulsory service agreements, buying these services from neighbouring municipalities. This allowed the reform to succeed in the vast majority of cases, reducing the opposition from the fiercest opponents.

Box 6.1. **The Danish Local Government Reform**

The Danish Local Government Reform was implemented in January 2007. This reform consisted of three main elements:

1. **A new map of Denmark:**
   - The number of municipalities was reduced from 270 to 98 by mergers, resulting in an average size of 56 000 inhabitants per municipality. Fourteen counties were eliminated and replaced by five new regions.
2. **A new distribution of tasks between levels of government**
   - A number of tasks were transferred from the counties, leaving the municipalities responsible for handling most welfare tasks. Municipal responsibilities include: social services; child care; compulsory education; special education for adults; rehabilitation and long-term care for the elderly; preventive health care; nature and environmental planning; local business services; promotion of tourism; participation in regional transport companies; maintenance of the local road network; libraries; schools of music; local sports and cultural facilities; and a responsibility for employment, shared with the central government.
   - The new regions took over responsibility for health care from the counties, including hospitals and public health insurance covering general practitioners and specialists, pharmaceuticals, etc. The regions also have a number of tasks involving regional development.
   - The central government was given a clearer role in overseeing efficiency in the provision of municipal and regional services. Employment services became a responsibility shared with municipalities, and responsibility for upper secondary schools was re-allocated to the central government. Tax collection was also transferred to the central government, as well as part of collective transport and road maintenance and it assumed an increased role in nature and environmental planning. Finally, responsibility for culture was transferred to the central government (in practice, subsidising a number of private cultural institutions of national character).
3. **A new financing and equalisation system**
   - The number of taxation levels was reduced from three to two, since the regions, unlike the counties, no longer have the authority to impose taxes. Their revenues consist of block grants and activity-based funding from the central government and the municipalities. In addition, in order to ensure that the local government reform does not result in changes in the distribution of the cost burden between the municipalities, a reform of the grant and equalisation system was carried out, which takes into account the new distribution of tasks.

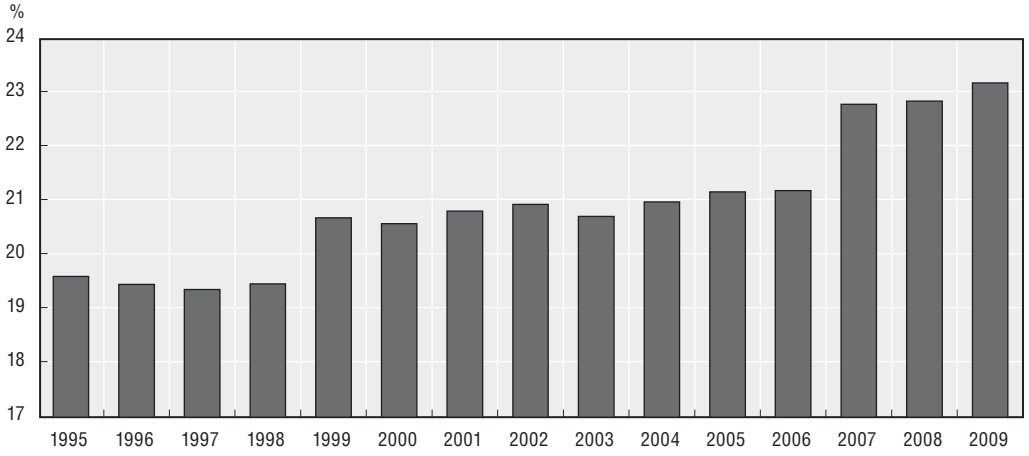
Context of the reform

Institutional framework and issue history

Denmark is traditionally a decentralised country, with a wide consensus on the importance of decentralisation and local democracy. Technological change, the types of public services provided and citizens' demands were a threat to decentralisation, because the existing administrative units were deemed too small to provide effective local services in a decentralised manner, in particular in the health sector (Figure 6.1). As a result, there was a danger that some public services might be centralised, which was contrary to the

Figure 6.1. **In Denmark, local health care spending rose considerably**

Ratio of health care expenditure to overall local government spending



Source: OECD National Accounts.

will of the people. The municipal reform was thus presented by the government as a solution for reinforcing decentralisation. Voluntary horizontal co-operation between municipalities, rather than mergers, could have been an alternative solution for tackling the problem of size. But horizontal voluntary co-operation agreements had existed for decades in Denmark, and were criticised for their lack of transparency and democratic control. Besides, they covered only a few services (mainly garbage collection and treatment) and were not in force in all municipalities. That numerous voluntary co-operation agreements existed was interpreted as a sign that municipalities were too small, and was used as an argument to promote the merging of municipalities. The reform actually reduced the number of collaborative arrangements, and some previous arrangements were even banned, such as in the case of environmental issues.

The 2007 territorial reform followed two failed attempts and some successful experimentation. In 1995, a first commission worked on the structure of metropolitan areas and suggested to merge the municipalities of greater Copenhagen. This project was mainly driven by civil servants and did not gain sufficient political support. It met with fierce resistance and was abandoned. In 1998, a new commission was created to consider the distribution of tasks, but did not have a mandate to propose a change to the administrative structure (its task was to show what could be gained by redistributing responsibilities within the existing structure). This commission showed the limits of the existing structure, and thus the need for change, but did not lead to large-scale reform. Some voluntary mergers were carried out spontaneously, which showed the feasibility and potential benefits from municipal mergers in terms of service delivery. For example, in 2003, the Island of Bornholm (50 000 inhabitants) carried out the amalgamation of its five municipalities on a voluntary basis, after a referendum. This amalgamation allowed the new municipality to implement some structural reforms, such as reforming the school sector. This reform was at first unpopular, but the amalgamation is now considered a success.

In terms of the total cost of public services and their allocation across government levels, the reform was conceived as a zero-sum game, on the principle that "the funds follow the tasks". Apart from one-off transition costs, the reform was neutral with respect to the overall spending of the central and sub-central level. It did, however, result in higher

grants, as on the one hand, municipalities receive new grants from the central government for the services it transferred to them, and on the other hand, the newly created regions have no taxing power and are funded by grants from the central government and the municipalities. Municipalities were exceptionally allowed to borrow in order to finance transition costs (such as renewing and unifying IT systems). In the long run, these costs are supposed to be compensated by the savings generated by the new structure.

An additional driver of the Danish local government reform was solving the problems faced by the health care sector, where new medical technologies increased specialisation and called for larger regions. These problems had already led to a hospital reform in the region of Copenhagen, when several small municipalities merged their hospitals to provide a better service. The funding for this reform came directly from the central government and entailed no territorial reform. The initial plan was to incorporate hospitals from a wider area, but this turned out to be politically unfeasible.

Economic and fiscal context

The period during which the reform was discussed and implemented were years of sustained growth. The reform was not a response to an economic crisis or the need for fiscal consolidation. The comfortable economic environment is considered to have helped in passing the reform, given that less attention was paid to redistribution as the total revenues to be shared were increasing. During the reform process, the public finances were in very good shape, with the general government account consistently in surplus.

Actors and interests

The main stakeholders were the counties and the municipalities, which were to be reformed, the association of counties and the association of municipalities that represented them, and the citizens and special interest groups. Municipalities were not a homogeneous group, since some would benefit from the reform and others would lose. Large municipalities whose population exceeded the threshold were less affected than smaller municipalities, because they were not merged and would only benefit from the new responsibilities. Rural municipalities were generally smaller in population than urban municipalities, and therefore usually opposed the reform. Rich and poor municipalities also differed, with rich municipalities opposing the reform because they feared rising tax rates and/or decreasing service levels, while poorer municipalities stood to benefit from increased equalisation payments. Rich municipalities in the Copenhagen area, which had already opposed the metropolitan reforms proposed at the beginning of the 1990s, put up stronger resistance, but most of them had already reached the threshold of 20 000 inhabitants before the reform and were hence unaffected. The heterogeneity of its members made the position of the Association of Danish Municipalities quite delicate: it supported the reform, because the reform would give its members more responsibilities and power, but it could not express its support clearly from the beginning, since many of its members opposed the reform.

Local politicians were also divided. While the competences of the merged municipalities would be increased, of the 4 500 politicians at the municipal level, only 2 500 would remain after the mergers. In general, they aligned with the position of their political parties, but in some cases, local politicians from the coalition parties strongly opposed the reform. Most citizens were not opposed to the reform, because it was presented as a way of guaranteeing the provision of effective public services in a

decentralised way. Some special interest groups, such as the handicapped, opposed the reform, because they feared that service levels would be reduced when the responsibility was decentralised, and that services would be cut in the more remote areas. The counties had the most to lose from the reform, as they were simply abolished. Still, they did not strongly oppose the reform.

Electoral mandate and political leadership

A key factor in the Danish local government reform was the change of majority in parliament in November 2001, when the centre-right Liberal Party came to power in coalition with the Conservative People's Party, replacing the Social Democratic Party. The strong personal commitment of the new Minister of Interior and Health, who later became prime minister, was crucial in passing the reform. Reforming the health care system was his main priority, so when he took his functions in 2001, he appointed an advisory committee on the health care sector tasked with considering the organisation of the hospital sector by the end of 2002. The conclusion of the commission was that the optimal district size for each hospital network would be close to half a million inhabitants. The existing counties were therefore too small, and larger areas were needed. The Minister of Interior and Health therefore became personally committed to the reform, despite his party's traditional opposition.

There had been no specific debate about public administration reform in the 2001 election campaign, so the new government did not have a clear electoral mandate for reform. This was not an important issue in the 2005 regional elections either, and in general, the reform did not raise strong opposition from the citizens.

The reform process

Policy formulation and timeline

The Local Government Reform was underpinned by a political agreement negotiated directly by the leading parties, which had a majority in parliament, and was not debated in parliament. Traditionally, the Conservative People's Party favoured amalgamation, while the Liberal Party, which mainly represents farmers and small municipalities, tended to oppose amalgamation. The support of the reform by the minister of Interior and Health and by the Liberal Party thus created common cause between the Liberal Party and the Conservative People's Party, which played an important role in the subsequent negotiations.

In April 2004, the government (the Liberal Party and the Conservative People's Party) presented a proposal for reform of the structure of the public sector: *The New Denmark – A Simple Public Sector Close to the Citizen*, based on the analyses and recommendations of the Commission on Administrative Structure, and the results of a public hearing organised after the presentation of the commission's conclusions. This formed the basis for the subsequent negotiations, which were carried out between the Danish government and two opposition parties: the Danish People's Party and the Social Democratic Party. In June 2004, the government and the Danish People's Party signed the "Agreement on a Structural Reform". The Social Democratic Party did not sign. This is not because it disagreed on the principle of a structural reform, but because of a disagreement on the tasks that should be given to the regions. The Liberal Party wanted to give them only health competences, while the Social Democratic Party wanted to give them more tasks and more tax competences,

which the government refused. In the end, the Social Democratic Party voted in favour of the reform, even though it had not signed the agreement. Indeed, the government used the argument that the Social Democratic Party would benefit and gain more power from the reform. This was indeed the case *ex post facto*, as it won more municipalities than it previously had.

After the agreement had been reached, all municipalities had to engage in a "controlled voluntary process" of merging during the second half of 2004. They were forced to merge until they reached a threshold size of 20 000 inhabitants, but were free to choose the neighboring municipalities with which they wanted to merge. Between mid-2004 and the end of the year, municipalities negotiated with potential partner municipalities, and citizens were given the opportunity to articulate their preference through a series of local referenda. The deadline for selecting partner municipalities was 1 January 2005.

The time schedule for implementation was strongly influenced by an external constraint, the local elections in November 2005, and the pressure this created is considered to have played a major role in the adoption of the reform. Indeed, the Agreement on a Structural Reform was signed in June 2004 and included a detailed time schedule for implementation. This schedule was very tight, as the new municipal borders had to be known before the elections took place, and the new division of tasks had to be decided before the merger process could start. The agreement therefore stated that bills regarding the distribution of tasks and division would be submitted to the parliament in January or February 2005 at the latest, and that changes to municipal and regional borders should be determined by 1 July 2005.

This external constraint created a tight schedule and considerable pressure for the municipalities to reach rapid agreement on the mergers, as it only left the municipalities about six months to carry out the negotiations. The government was aware that if the municipalities failed to reach agreement by the time of the elections, the reform would be abandoned. Pressure was therefore put on municipalities to conclude voluntary agreements, and they were told that if they did not, the central government would decide.

Research and external experts

In October 2002, the government appointed a Commission on Administrative Structure. It consisted of representatives of local governments, ministries and experts. The commission's terms of reference were to determine whether a territorial reform was needed, and if so, to assess the "advantages and disadvantages of alternative models for the structure of the public sector, and on this basis to make recommendations for changes that would remain sustainable for a number of years". Its mandate, unlike that of the 1998 commission, allowed it to explore alternative territorial structures (*e.g.,* a two or three-tier system, merging municipalities or reinforcing collaboration mechanisms) and to make specific proposals for reform.

The report was released in January 2004 and recommended a wide-ranging reform of the public sector, including a change of boundaries and a re-allocation of tasks between the central government, the counties and municipalities (Danish Ministry of the Interior and Health, 2005). Indeed, it concluded that the weaknesses of the existing structure were partly due to the size of the municipalities and counties, and partly to the distribution of tasks between the state, counties and municipalities: a major part of the existing administrative units were too small to achieve the standard of performance required by

legislation. In a number of areas, the report found difficulties in co-ordinating tasks, because the responsibility for some tasks was divided between several decentralised administrative structures, resulting in "grey zones" where responsibility was not clearly defined or overlaps existed.

Reports and expert opinions were mustered to counter opponents' arguments. For example, one of the arguments used by opponents of the reform was that it would reduce the democratic link between the politicians and their constituencies. A survey was carried out and showed that smaller size did not imply greater democracy. On the contrary, it was argued that transferring new tasks to municipalities would increase their accountability. Another investigation of the relative costs of small and large municipalities showed that mergers could result in savings. Municipalities would be allowed to keep any savings realised. This was both an incentive to accept the reform, and provides an opportunity to reap efficiency gains. Several surveys were carried out during the reform process, showing that a majority of the citizens was in favour of the reform.

Bundling and compensation

The Danish Local Government Reform bundled three reform elements (Box 6.1): a territorial reform (merging of municipalities), a reallocation of tasks across levels of government, and a financing and equalisation system reform.[1] This allowed compensating costs and benefits to carry over from one reform element to the other. For example, local politicians may be negatively affected by the territorial reform, as some positions would disappear, but those remaining in power would benefit from increased responsibilities. In the same way, a small municipality might have to bear the cost of a merger, but would benefit from increased equalisation payments. Finally, the association of municipalities would represent a smaller number of actors, but these would be more powerful.

The reduction of the number of municipalities implied a reduction of the number of directly elected officials, which could create major opposition. Thus, the reform contained a provision stipulating that no public official would lose his job in the first year of implementation. One of the main elements of the reform was the increase of power and funding for the municipal level. The municipal level acquired more powers both from the dissolved county level and from the central government, while giving up only a few prerogatives.

Safeguards, guarantees and backdoor solutions

It was very clearly stated in the principles of the reform that "the funds follow the tasks", and thus, that the transfer of new tasks would not imply increasing local taxes. This commitment was all the more credible, as local tax increases would have been very difficult under the "tax freeze" implemented in 2002, which aimed at preventing future municipal tax increases (a municipality could only raise its taxes if another municipality lowered its taxes, so that the national average tax rate remained the same).

Despite these compensations, a small number of municipalities that did not reach the threshold of 20 000 inhabitants and categorically refused to merge. A backdoor solution ("cat flap") was offered to them: municipalities could refuse to merge, but they would not receive the new tasks transferred to municipalities and would have to conclude compulsory service agreements, buying these services from neighbouring municipalities. This solution softened resistance to some extent. In the end, only two municipalities, in the Copenhagen area, refused to merge and chose the service agreement solution.

Although municipal amalgamations were voluntary in the sense that the municipalities were able to choose their partners, parliamentary intervention was threatened in cases where voluntary agreements could not be reached. The central government intervened in two cases.

Ownership of the reform

One way of reducing opposition was to include as many stakeholders as possible in the design and negotiation process of the reform, so as to give the different parties the feeling that their interests had been taken into account. Stakeholders represented in the negotiation process could not easily vote against or oppose the reform subsequently. A public hearing was organised after the publication of the conclusions of the Commission on Administrative Structure. This public hearing gathered almost 500 organisations, counties, municipalities, associations and individuals, which were invited to express their opinion on the commission's conclusions. This public hearing was considered a turning point: before the meeting, nobody believed any concrete action would follow the report's publication. After the meeting, it was clear to all participants that the question was not whether something would happen, but what and when it would happen.

Communication

Communication was used as a tool to garner the support of the public for the reform. The Local Government Reform was never presented as a cost saving tool, but the objective was to improve public services delivered, while preventing recentralisation of these services. The rhetoric used, "from cold hands (bureaucrats) to warm hands (social workers, etc.)" reflects the idea that public funds would be used to fund the provision of services rather than administrative costs. Usually, public administration reforms do not attract much public attention. Communication therefore centred on the improvement of health care services, which do concern citizens, in order to create citizen awareness and support for the reform.

Adoption and implementation

The Local Government Reform was considered a success from the beginning. On 1 January 2007, the new system was implemented, and no disruption in public services was felt. Few citizens saw the change in their everyday life, and few were negatively affected by a reduction in public service levels. Following the reform, some municipalities have started to implement structural reforms, such as reforming the school structure, but this is still very limited. Hospital reform, which was already under way, gained some momentum thanks to the new regions and equalisation payments increased, with more money flowing from richer to poorer municipalities.

In a geographic and economic view, most mergers made sense. The new municipalities consisted of a core and a periphery and corresponded to functional areas. There was only one exception: the Copenhagen metropolitan area, where almost no mergers took place is still considered rather fragmented. There were some one-off costs of the reform, and it is still too early to evaluate whether costs have decreased or service levels increased.

Conclusion

The Local Government Reform was the culmination of a four-year reform process. The primary goal of the merger process was to improve the quality of municipal services by transferring new responsibilities from the county level to municipalities and increasing their size to ensure that they can assume these new responsibilities. Concerns for efficiency were also among the reasons that municipalities were merged. It was assumed, for example, that the new municipalities would benefit from economies of scale. However, this consideration was generally secondary to the larger concern regarding the quality of service provision.

Increasing public sector effectiveness and efficiency by inter-municipal cooperation and mergers is on the agenda of many countries and is often a controversial issue. Diverse strategies to manage the effects of municipal fragmentation have been developed in different countries, and municipal consolidation is often at the heart of the debate. The reduction in the number of municipalities has often been viewed as essential for the reform of decentralised institutions. Thus, some countries have made severe cuts in the number of municipalities. This usually goes hand in hand with the introduction or strengthening of a regional tier of government. Still, implementing such reforms cause particular problems, due both to strong local resistance because of the fear of loss of local identity, and due to technical considerations such as the definition of the "optimal" size of the new units.

Note

1. Indeed, several countries combined cuts in the number of local municipalities with the introduction or strengthening of a regional tier of government (OECD, 2006).

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Chapter 7

Finland: Restructuring local government and services

Summary

In 2007, Finland started implementing the act on restructuring local government and services (also known under its acronym "PARAS reform"), which aims at creating economies of scale by encouraging voluntary municipal mergers and municipal co-operation areas for public service delivery. Given the high degree of municipal autonomy in Finland and the country's tradition of consensual decision-making, it was not possible to use threats or sanctions to force municipalities into implementing the reform (as was the case in Denmark, where municipalities were given one year to merge voluntarily, and if they did not comply, the central government could impose the merger). Municipalities could therefore choose between merging and joining larger co-operation areas, but financial incentives were used to encourage municipalities to merge. Municipal mergers were already on the agenda before this reform, and in 2002, a substantial increase in merger subsidies was granted to municipalities wishing to merge. This led to a reduction of the number of municipalities from 452 in 2001, to 432 in 2005. The PARAS reform (Box 7.1) further reduced the number of municipalities to 348 in 2009, and municipalities have until 2013 to benefit from financial incentives under the current framework.

The main factors driving the success of the reform were:

- *Consensus on the need to reform and a shared diagnostic*: There was consensus that provision of public services should be carried out by local governments, and an awareness that the existing system was unsustainable. This included a shared diagnosis that the main problem was linked to the size of municipalities, and that reforming the existing system was necessary to guarantee local provision of public services.
- *The negotiation process took place during a period of strong economic growth (2005-07)*: There is a wide-spread view that the reform would have been more difficult to achieve after the global financial and economic crisis hit, as municipalities facing financial difficulties would have been more reluctant to merge with others facing even greater hardship.
- *Use of time-varying financial incentives*: The earlier the merger takes place, the greater the financial reward to merging municipalities. The financial reward also depends positively on the total number of municipalities merging, as well as the population of the merged municipality.
- *Strong leadership and personal commitment from the minister of Regional and Municipal Affairs (Ministry of the Interior)*: This commitment was all the more important, as the minister was from a party that traditionally opposed municipal mergers.
- *Broad composition of the working groups in charge of making proposals to reform the system*: These working groups were comprised of members from the two coalition government parties, as well as from opposition parties, and members from the Finnish Association of Local and Regional Governments. This allowed the reform to succeed despite a change of government during the reform process.

Box 7.1. **Restructuring local government and services: the reform agenda**

The PARAS reform consists of two main elements: the payment of grants for voluntary mergers of municipalities, and the restructuring of public service delivery. These incentives will last until 2013.

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

Context of the reform

Institutional framework

Finland is one of the most decentralised countries in the OECD. Sub-central governments represent 40% of public spending and 30% of public revenues, well above the OECD average of 26% and 16%, respectively. The municipalities are responsible for providing essential public services, such as primary and specialised health care, social services and education. Apart from giving them wide-ranging responsibilities, the constitution grants municipalities a high degree of autonomy, which is further reinforced by a large reliance on own revenues (central government transfers represent only about 20% of their revenue). For this reason, it is very difficult for the central government to influence municipal behaviour except through dialogue, setting standards or incentives. Besides, Finland is usually governed by coalition governments, which means that a consensus on reforms needs to be reached.

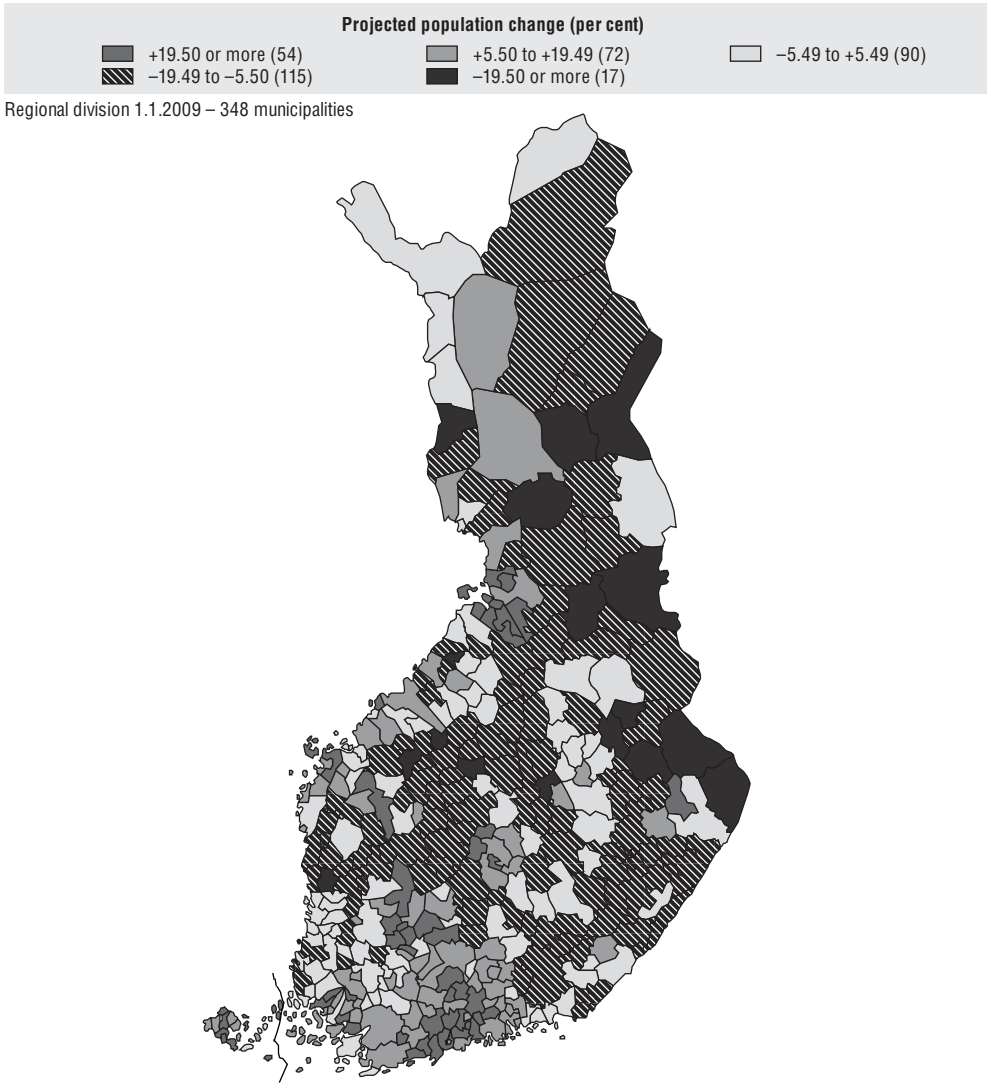
Demographic trends

Today's socio-economic forces are challenging the capacity of Finland's central and sub-central governments to deliver high-quality public services. This is due to two main demographic factors: municipalities in the northern and eastern regions are losing population as younger people move to urban centres, and the older generation that remains requires specialised services. Secondly, an ageing population is putting a strain on

the delivery of services and pushing up spending on pensions and health care. Since the migrating population tends to be young, the pool of human capital available to provide services in the northern and eastern regions is shrinking. Together, these phenomena result in two problems: *i)* there will be fewer workers to deliver public services and pay taxes, and *ii)* there are many retirees demanding services of high quality (Figure 7.1). Given that municipal governments are the main providers of health and elderly care services, these trends seriously threaten municipal financial sustainability, as well as the capacity of municipalities to provide adequate basic public services.

Figure 7.1. **Finland's population is leaving the North**

Projected population change in Finland's municipalities, 2009-2030



Source: Statistics Finland 2009: Official Population Structure, 2030; Population Projection 2009-2060.

Economic and fiscal context

Most of the reform negotiations took place during a period of strong growth (2005-07), and only its final stage and the implementation phase unfolded during the global financial

and economic crisis. It is generally considered that this reform would have been more difficult to adopt in harder economic times. Indeed, municipal mergers have become more difficult during and after the crisis, because many municipalities are facing financial difficulties, and neighbouring municipalities refuse to merge with those in greater difficulty, as this would imply sharing part of the financial burden. For example, large towns favoured mergers during the negotiation process but are now reluctant to merge with surrounding municipalities that face financial difficulties.

Actors and interests

Broad consensus was achieved that reforms were necessary to secure the provision of public services by municipalities, and transferring responsibilities back to the central government was not seen as an option. The diagnosis was that larger units were required to provide public services in a more efficient way, and that these could be created either by merging existing municipalities, or by increasing municipal co-operation for the provision of public services. The main dividing line was therefore between mergers or co-operation areas, and in the case of mergers, whether these should be voluntary or compulsory.

The Association of Finnish Local and Regional Authorities was in favour of creating stronger and larger municipalities to improve self-governance and thus backed mergers. However, given the diversity of its members, it opposed any reform that would entail an obligation to merge, and favoured the voluntary merger approach. Indeed, large towns often favoured mergers because they already fulfilled the different population requirements, but wanted to merge with smaller neighbouring municipalities that benefit from externalities generated by the urban centre. Smaller municipalities, on the other hand, were usually afraid of losing their identity by merging with larger ones, and tended to prefer co-operation rather than a merger. Civil servants were usually in favour of the reform, but pressed the government to include more elements that would make it possible to enforce it, such as the possibility of imposing a merger when municipalities did not reach the population requirements, when co-operation areas did not match functional areas, or when individual municipalities could not find a merger partner because of their financial difficulties. Although there is no explicit party position concerning mergers, the Centre Party has traditionally favoured co-operation areas, while the Social Democratic Party and National Coalition Party tend to prefer mergers. Some municipal politicians and civil servants feared losing their positions and were opposed to the reform. Citizens showed little interest in the PARAS reform, but those who followed the process usually approved the decisions made by their municipalities.

Electoral mandate and political leadership

The PARAS reform was launched after a mid-term government review in 2005, *i.e.* without a clear electoral mandate, and benefited from the strong leadership and personal commitment of the Minister of Regional and Municipal Affairs (Ministry of the Interior). After the mid-term review of 2005, this minister felt that, given the current trends and long-term projections (Figure 7.1), something radical had to be done to secure the adequate provision of basic public services by municipal governments. This commitment was all the more important because the minister was a member of the Centre Party, which had traditionally opposed municipal mergers. The 2007 elections led to a change in government, and the Minister of Regional and Municipal Affairs was replaced. In 2008, the responsibility for regional and municipal affairs was transferred from the Ministry of the

Interior to the Ministry of Finance (with the exception of the Regional Development Affairs Department, which was transferred to the Ministry of Employment and Economy). Despite these changes, the reform process continued smoothly.

The reform process

Policy formulation and implementation

This diagnosis of the problem was widely shared, as was the conclusion that something had to be done to secure the provision of public services by sub-central governments. In 2005, the government started discussions in parliament and with the Finnish Association of Local and Regional Authorities on how to reform the municipal administrative structure to increase the efficiency of local basic services. In January 2007, a framework law for the implementation of a five-year municipal administrative reform (PARAS reform) was voted in parliament. This framework aimed at creating economies of scale by encouraging voluntary municipal mergers and municipal co-operation for public service delivery (creating larger catchment areas).

Three possible models were proposed: a district model (proposed by the Ministry of Social Affairs and Health),[1] a regional model (proposed by the Ministry of Finance),[2] and a model of vital basic local authorities (proposed by the Association of Local and Regional Governments).[3] Several hearings were organised in the autumn of 2005 in all the counties, which provided a statement detailing which model they favored. The report was presented to parliament in early 2006. After a long political dialogue, the government opted for the vital basic local authority model in spring 2006. In September 2006, the government submitted a proposal for a framework act to parliament. The law was enacted in January 2007 to take effect as of February 2007. Municipalities then had a bit more than a year, until the end of August 2008, to report to the government on how they were going to implement the reform (by merging or as co-operation partners). By late 2009, the number of municipalities had declined by 67, bringing the total number down from 415 to 348. Fourteen further mergers are expected before the end of 2012.

Administrative set-up of the reform and reform process

After the 2005 mid-term review, the Minister of Regional and Municipal Affairs launched discussions within the government coalition (the Social Democrats and Centre Party) about what should be done to secure the provision of public services. In May 2005, he presented a project at the government's mid-term meeting to restructure municipalities and services, and set up a committee, which he headed, to make proposals on how a "sound structural and financial basis can be created for the services that municipalities are currently responsible for, in order to secure the organisation and provision of such services in the future, with regard to the required standard of quality, effectiveness, availability, efficiency and technological advancement". This committee comprised several working groups that analysed the different service areas (social and health care services; educational, cultural, recreational and sports services; technical and other services; and another working group focused on the regional implementation of the project). These different working groups consisted of members from the two coalition government parties, as well as from opposition parties, and members of the Finnish Association of Local and Regional Governments. Including members of the opposition parties proved to be a crucial element, as it allowed the reform to go ahead despite the change of government in 2007.

Experimentation

Since 2005, the "regional model" has been implemented in the Kainuu region, assigning the Regional Council responsibility for about 60% of the municipal services, including those previously under the regional central government administration. The Kainuu model was already under way in 2001, before the PARAS reform, to increase regional democracy: together with the autonomous Åland Islands, Kainuu is the only region with a directly elected regional assembly. This experiment is due to last until 2012. This model has been evaluated, and the results are considered mostly positive. Still, opinion is divided on the effects of the experiment, and the regional model has not been chosen in the PARAS reform. It was argued that this was a very specific case intended to secure the provision of public services in this remote area, and that it should not be generalised. Moreover, municipalities were reluctant to embrace the idea of creating stronger regional councils.

Creating consensus

The high degree of municipal autonomy and Finland's tradition of striving for consensus does not allow the use of threats or sanctions to force municipalities into implementing a reform. The original framework stated that from 2009, the central government could impose compulsory mergers, but this was withdrawn (except in the case of municipalities facing serious financial problems). Given the need to create consensus, it was necessary to find a compromise. This was done by giving municipalities a choice of how to achieve the population requirement: either by merger or by participating in a co-operation area. Still, financial incentives were used to encourage municipalities to merge rather than join a co-operation area. These financial incentives were a function of three factors: the timing of the merger (the earlier the merger, the greater the amount received), the number of municipalities involved (the greater the number, the higher the amount), and the size of the population covered (higher rewards are given to merged municipalities that reach the threshold of 20 000 inhabitants, and the amounts are greater the smaller the initial population of the municipalities that merge).

The PARAS reform guaranteed that there would be no lay-offs in the merged municipalities in the five years following a municipal merger. This clause was popular amongst local civil servants, and helped reduce opposition. A possible, albeit provocative, interpretation of the reform process would be that it was an attempt to carry out "coercive voluntary mergers" as in Denmark (see the Danish case study). But given the Finnish culture of consensus and the coalition parties that did not agree on this issue, an opt-out clause was included, allowing municipalities that did not wish to merge the option to form co-operation areas, which existed in many cases prior to the reform. In practice, the reform actually created few binding obligations for municipalities.

Many countries have bundled several reforms together in order to cross-compensate losses from one reform with the potential benefits of another. In particular, administrative restructuring has often been bundled with a redefinition of the financing system and of the roles and responsibilities (as in Denmark, for instance), with the benefits granted only to the municipalities that agreed to restructure. In Finland, a grant reform was being carried out simultaneously with the PARAS reform, but these were not bundled (Box 7.2).[4]

Box 7.2. **The Finnish grant system reform: work in progress**

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

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

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

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

The role of research and external experts

Considerable research had been carried out prior to the reform, in particular by the Government Institute for Economic Research (VATT), showing the unsustainability of public finances, including projections of the rise in municipal expenditure and deficits due

to the ageing of the population. This helped create broad consensus on the need for reform and on the view that the municipalities were too small to provide the required public services effectively and on a sustainable basis.

Evaluation of the reform and the way forward

The reform framework stipulated that the government must submit a report on the project to parliament in 2009. This report found that so far, the reform had not resulted in savings. On the contrary, since wage levels trended upwards towards the municipality with the highest wages, costs actually increased, which is a common feature of municipal merger reforms.[5] Also, the lack of cost savings may be due to the concessions granted to create consensus for the reform, which proved to increase its costs while reducing its potential benefits. As an example, as there are no sanctions in cases of non-compliance, municipalities cannot be forced to merge or their choices of merger partners influenced. This may leave financially weak municipalities without merger partners (because no other municipality wants to assume their liabilities), and leads to smaller municipalities around urban centres to merge or form co-operation areas amongst themselves, instead of forming a more rational functional area by increasing their ties with the urban centre. The guarantee clause that there will be no lay-offs prevents the merged municipalities from benefiting immediately from potential efficiency gains, while having to bear the transition costs. As the framework did not specify how co-operation areas should be implemented, it results in municipalities participating in different co-operation areas for different services, thus reducing transparency and accountability, and risking an increase in administrative costs. Finally, no clear timetable or deadline was given to municipalities for implementing the reform, and no consensus was found on the specific services that would have to be transferred to the co-operation areas, leading to a multitude of different types of co-operation areas, which are responsible for a different mix of services.

In addition, despite the one-off payments given to municipalities to merge, it is not obvious that municipalities have strong incentives to merge. The process of merging is costly and may absorb at least part of the financial benefits. Moreover, given the equalisation structure, small municipalities that face higher costs of providing public services are compensated through higher grants received from the central government, and can thus provide the same level and quality of public services as larger municipalities. The incentives embedded in the equalisation mechanism should therefore be modified so that smaller municipalities have an incentive to improve their cost efficiency, for example by merging or joining co-operation areas.

The present government has recently taken a series of measures to address these issues. Notably, the central government will have the authority to force municipalities into co-operation areas (about ten municipalities have not yet reached the population targets). The present framework agreement only runs until 2012, and no decision has yet been made as to what will happen after this date. The government will have to decide whether to continue within the same framework or whether to change it. Some stakeholders are pushing for more radical changes, with larger population requirements and devolution of all social services.

Conclusions

Demographic trends and the impact of the economic crisis are challenging the capacity of Finland's central and sub-central governments to deliver quality public

services. This has increased the urgency of implementing reforms that lead to efficiency gains. Like other OECD countries, Finland is searching for ways to secure the sustainability of its local government finances and the decentralised provision of basic public services by implementing reforms that reshape the territorial organisation of its municipalities. In 2007, Finland started implementing the PARAS reform, which aims at creating economies of scale by encouraging voluntary municipal mergers and municipal co-operation in public service delivery. Still, despite financial incentives for mergers, it is not obvious that municipalities have strong incentives to merge, as the process of merging is costly (reducing the net benefits of the reform), and the existing equalisation system compensates municipalities for higher public service delivery costs, thus reducing their incentives to search for efficiency gains. The PARAS reform would therefore benefit from setting clear targets for the mergers (population of the new municipality, total number of municipalities to be reached, a clear deadline for carrying out the mergers, etc.), and clear guidelines for the co-operation areas (which services should be transferred, to which institution, etc.). Also, bundling the unfinished grant reform and further local government reforms, by changing the incentives embedded in the equalisation system, would increase the incentives for municipalities to implement efficiency-enhancing reforms.

Notes

1. Districts would have a population base of 100 000 to 200 000, would be controlled by a convention of municipal councils, and would be financed partly by local authorities and partly by the central government.
2. This model foresaw the creation of 20 to 25 regional municipalities with their own powers of taxation and directly elected councils.
3. This model foresaw an increase in the financial resources and of the population of the local authorities. The target population of these local authorities would be 20 000 to 30 000 inhabitants.
4. This grant reform ended up being much more modest than initially planned. It may also have benefited from a bundling with the structural reform.
5. For a discussion of the possible economies of scale resulting from municipal mergers, see OECD (2006).

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Chapter 8

Italy: Law 42 on fiscal federalism

Summary

In 2009, the Italian parliament endorsed Law 42 on fiscal federalism, setting a milestone for Italy's gradual move towards decentralisation and federal institutions. The law, which is based on a constitutional amendment passed in 2001, increased tax and spending autonomy of the regions, provinces and municipalities and overhauled the equalisation system, tackling the wide fiscal interregional differences in a consistent and efficient fashion (Box 8.1). A set of legislative decrees, some of which have not yet been implemented, determines intergovernmental tax arrangements, equalisation, fiscal rules and accounting harmonisation. The cost of the reform to both the central and sub-central governments is not yet known, but there is strong pressure for the reform to remain "fiscally neutral".

The main factors driving the success of the reform were:

- *The electoral mandate and political pressure were strong*: Law 42 was adopted by a coalition composed of a centre-right party (*Popolo Della Libertà*) and a regionalist party (*Lega Nord*). The electoral campaign focused on federalism issues, with several regions pressing for more autonomy. The constitutional reform of 2001 had instead been adopted by a coalition government composed of a centre-left party.
- *The reform was ripe:* The period after 2001 saw a number of failed attempts to implement the constitutional amendment. Despite mounting pressure, particularly from the northern regions, various governments failed to push a reform agenda. In the meantime, fiscal relations had become ever more inefficient and prone to deficit bias. Experts had repeatedly criticised the shortcomings of the system. The economic crisis of 2008 exacerbated the risk that fiscal federalism will become unsustainable.
- *Reform steps were sequenced:* The reform was pursued in several stages. The constitutional reform of 2001 was followed by a framework law, which itself was followed by a set of legislative decrees. Sequencing could create a "veil of ignorance", forcing all the actors involved to agree on reform principles (lock-in) without knowing their individual and short-term consequences. Sequencing could also allow for agreement on the less problematic aspects of the reform before the more contentious ones were tackled.
- *Several reform elements were bundled:* The reform consisted of various elements that, once bundled, could satisfy a majority of actors and interests. The link between "taxing power" and "equalisation" held the reform together: an extension of taxing power appealed to the wealthier regions and the regions in the north, while equalisation was attractive to the poorer regions. In parallel and by amending the Internal Stability Pact, the central government succeeded in imposing stricter fiscal rules while allowing the regions more flexibility in implementing them.
- *Expert advice was consistent and unbiased:* The reform process was underpinned by extensive and consistent expert advice. The "High Commission for the study of the general principle of public finance and tax system", established in 2003, comprised

many external and independent experts. At the current stage, the public administration has been much more involved. The Bank of Italy, together with other institutions and research centres, prepared several reports pointing at the flaws of the old system.

Box 8.1. **The Italian Law 42 on fiscal federalism**

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

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

Law 42 is a framework law that sets down the principles for reform but leaves their implementation to a set of legislative decrees. These decrees also have to be passed by parliament, and only five of them are in force as of mid-2011. Pending issues include the functioning of the equalisation scheme and the tax shares allocated to each government level. There is some uncertainty whether the reform will be fiscally neutral for the central government. Parallel to adopting Law 42, the central government tightened fiscal rules in the Internal Stability Pact, and non-complying SCGs are sanctioned. To moderate the strictness of the rules, regions are given some flexibility in dividing up overall deficits and debt among their provinces and municipalities.

Context of the reform

Institutional framework

Italy is on a slow but steady path towards political and fiscal decentralisation. As a result of the fiscal federalism reforms during the 1990s, the spending share of the regions rose to around 30% and those of the provinces and municipalities to around 21% of total government spending, net of interest and social security payments (Buglione and Marè, 2007). All sub-central levels – regions, provinces and municipalities – have spending as well as taxing powers, making Italy unique among federal and quasi-federal countries. Health care makes up the bulk of regional expenditure, while education, transport and territorial development are main spending items of the provinces and municipalities. With SCG tax revenues hovering around 20% of total tax revenue, taxing power is low, resulting in a large vertical fiscal imbalance, with around 50% of total SCG revenue provided by transfers from the central government. The main autonomous taxes at the regional level are the regional tax on productive activities (a business-*cum*-value added tax) and a regional surcharge on the personal income tax, both introduced in 1997. Local governments rely essentially on the property tax. To contain overall tax pressure, regional and local power has often been curtailed by the central government. A number of special statute regions – *i.e.* islands and border regions – have wider spending prerogatives and benefit of special tax sharing programs, triggering a "multi-speed" federalism in the country.

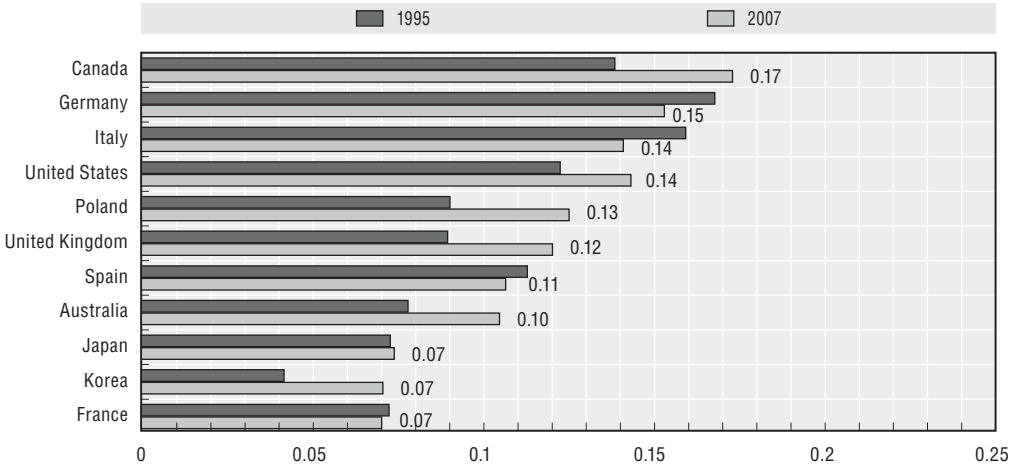
Economic and fiscal conditions

With average annual growth rates below 1.5% during much of the reform period, Italy's GDP growth was weak and clearly below the OECD average, except for a short period of stronger growth after 2006. Structural reforms, deemed necessary to boost productivity, were repeatedly postponed or watered down, contributing to low growth.[1] Structural government balances were negative throughout the entire reform period, although the internal stability pact, enacted in the wake of Italy's accession to the euro area, had reduced deficits from the high levels of the 1990s; and the primary balance was always positive between 2000 and 2007. Deficits as a percentage of total spending were higher at the regional and local than at the central level during much of the reform period. While the reform is seen by most interview partners as structural and driven by political demands, the crisis of 2008 and its aftermath and the resulting revenue shortfalls put new pressure on all government levels to curb spending.

Strong interregional disparities, especially between the north and the south, are an important issue in Italy. Among the high-income OECD countries, Italy has one of the largest regional GDP per capita disparities, except for Germany, which is adjusting to reunification, and Canada (Figure 8.1). In the southern part of the country, per capita GDP is around a third lower than in the north, reflecting a wide productivity gap; while unemployment is triple that of the northern regions. The southern regions have lagged behind the national average since the 1950s, despite a set of regional development policies.[2] Economic differences impinge on fiscal positions: tax-raising capacity is lower, and deficits and debt are higher in the south, despite a comprehensive transfer system. The unequal economic and fiscal situation was one of the main drivers in the debate on decentralisation, with the north asking for a "territorialised" fiscal system, *i.e.* one that left revenues where they were generated. The constitutional reform of 2001 that set the stage

Figure 8.1. **Italy suffers from significant interregional disparities**

Gini index of GDP inequality in selected high-income OECD countries



Note: Gini coefficients for GDP per capita are measured at the level of regions, *i.e.* territorial level TL2.
Source: OECD Regional Statistics.

for the fiscal federalism reform was meant to be a compromise between northern demands for more autonomy and southern demands for lower economic and fiscal disparities.

Issue history

The decentralisation process can be traced back to the constitution of 1948, which included several federalist elements, and to the creation in 1970 of a fully fledged regional level above the provinces and municipalities. In 1997, in the wake of an economic crisis and Italy's bid to join the euro area, the country passed the "Bassanini reforms", which devolved a set of spending and regulatory powers to sub-central governments. A system of "negotiated planning" was devised, with more involvement of SCGs in local and regional development. Although some taxing power was delegated to the regions, in line with new spending responsibilities, the revenue side remained much more centralised than the spending side. This institutional set-up required sizeable intergovernmental transfers, which were mainly determined by negotiations between the central government and individual regions, but was based on historical cost and lacked objective allocation criteria. In the second half of the 1990s, the northern regionalist movement started to claim that the generous transfer system was straining the resources of the economically rich north and discouraging economic development in the south, and it began to seek more autonomy. A reform of equalisation was passed in 2000 but was not implemented, because the poorer regions feared a reduction in transfers. In 2001, the constitutional reform was finally adopted, preparing a thorough revamp of fiscal relations. One of the main achievements of the constitutional amendment was that it clarified spending roles, the principle of fiscal autonomy and, in more general terms, how the transfer system and equalisation should work.

After the passage of the constitutional amendment, however, the path to reform was intricate. In 2003 the Berlusconi 2 government set up a High Commission on Fiscal Federalism to draft reform proposals, but when the commission presented its report, there was no legislative follow-up by the new Prodi government elected in 2006, and the commission was dissolved in 2007. Legislation passed in 2006, which aimed at clarifying

spending assignments, failed in a referendum, although the government had made implementing the constitutional amendment one of its priorities. Fiscal federalism became the "unfinished agenda". In view of the shortcomings of the legislation, the Constitutional Court had to step in frequently to rule on contentious cases, often in favor of the central rather than the regional level. In the meantime, the transfer system had become more and more opaque, cumbersome and prone to spending excesses. Problems were especially acute in health care, where costs rose by 10% or more annually, probably because regions could extract additional transfers if they ran deficits (soft budget constraint). When a new centre-right government (Berlusconi 3) was elected in September 2008, a thorough reform of fiscal federal institutions and a rapid implementation of the constitutional amendment were ripe.

Actors and interests

The main actors in the reform process were the three government levels, in particular central government and the regions. The core objective for the central government was to make sub-central governments accountable, *i.e.* to establish an intergovernmental fiscal framework that supported fiscal discipline. Central government wanted *i*) SCG spending to be largely covered by own tax revenue, as stipulated by the constitutional amendment, *ii*) a set of tighter fiscal rules within the internal stability pact including sanctions for non-compliance and *iii*) a transparent and formula-based equalisation system for SCGs whose tax-raising capacity or needs were below a fixed standard. Transfers were to be eliminated except for equalisation and for "special purposes". Given the dissatisfaction with the regional business-*cum*-value added tax, central government also wanted to broaden the regional tax base. The regions as a whole were basically happy with these demands. Most preferred the steadier stream of own tax revenues to the volatility of intergovernmental grants, whose opaque political determination was a permanent source of uncertainty as far as revenues were concerned. The regions also wanted a broader tax base and at least some rate-setting autonomy for the taxes assigned to them. Regions broadly agreed that the transfer system was highly ineffective; both in terms of efficiency and interregional equity, and that it should be overhauled. Regions and municipalities were hesitant to embrace tighter fiscal rules, fearing that they would have to shoulder the brunt of consolidation.[3] Municipalities, especially the cities, wanted to maintain their direct links with the central government and avoid too much dependence on the regions, a reflection of the historic importance of city-states.

The fault lines ran across the regions rather than between the regions and central government. The most contentious issues were tax autonomy and the extent of equalisation. While the wealthier regions favoured "territoriality", *i.e.* a system whereby taxes accrued to the region where they were collected, the poorer regions demanded strong equalisation that accounted for lower tax-raising capacity and a lower capacity to provide essential services. The wealthier regions also wanted more autonomy over the devolved taxes, while the poorer regions – especially those in the south – feared that tax competition and the ensuing mobility of households and firms would put them at a disadvantage. Some debates revolved around how the evidence should be interpreted: while some regions claimed that transfers should be reduced because they had failed to reduce the north-south gap, the poorer regions noted the ineffectiveness of the system and the need to strengthen it.[4] The municipalities disagreed on their capacity to shoulder the cost of additional services: while the large cities were ready to take over responsibility for a large

array of services, the smaller ones feared being overwhelmed by spending obligations. In general, the demands from the northern regions were stronger and more consistent, and they were backed by the *Lega Nord* party, which had joined the coalition government. Several observers remarked that the south lacked the political equivalent of the *Lega* to bundle and streamline its demands. It was important that during the reform process a few regions – both in the north and the south – emerged as "bridge regions" able to mediate between opposing positions. The fact that these regions had no strong individual stakes in their reform proposals helped them to act as honest brokers and increased their trustworthiness.

Electoral mandate

The drive for reform of fiscal federalism in Italy comes from the entire political spectrum and is endorsed by a majority of the population. However, the wishes of the electorate are not always clear or consistent, and competing interpretations of how to approach reform may at times leave reforms unfinished. The interests of jurisdictions sometimes supersede party discipline, with members of parliament voting along regional rather than party lines. On the other hand, the potential threat of a no-confidence vote can undermine a federalist consensus across political parties, since it tends to enforce voting along party lines.

The 2001 constitutional reform was prepared by a centre-left government, and the reform was adopted just before regional elections that revealed strong demands for regional empowerment. The centre-right government elected in 2001 interpreted the constitutional reform as a mandate for strong reform but finally over-reached with its proposals. The centre-left that came back in 2006 made an attempt to link decentralisation to the liberalisation of local and regional public service markets, but the implementing law was not enacted. When the centre-right government again came to power in 2008, it had a clear mandate: the government was a coalition of a centre-right party (*Popolo della Libertà*) and a regionalist party (*Lega Nord*) that claimed more autonomy for the regional level. The government had focused its election campaign on the federalism issue, arguing that the constitutional reform of 2001 had still not been implemented and that it was time "to live up to fiscal federalism". Within a few months of the election, the government prepared the framework law.

The reform process

Policy formulation: sequencing

The Italian fiscal federalism reform extended over a long period and was sequenced into distinct steps. Each step made the reform more concrete and visible, while obscuring for as long as possible the more contentious elements. The constitutional reform of 2001 laid down the principle that sub-central spending responsibilities should be covered by own resources and that adequate equalisation should ensure a comparable level of public services across the country. Law 42 of 2009 took up these principles and cast them into operational policy objectives. The law stipulated that regions were entitled to the tax on productive activities, and to a share in both the value-added tax and the personal income tax. Tax revenues should suffice to cover spending levels for an average region. The local level was entitled to the property tax and some other minor taxes.[5] Equalisation was divided between an allocation for delegated services (health and education) with full equalisation based on standard cost, and an allocation for non-essential services with only

partial equalisation, based on tax-raising capacity. The legislative decrees – of which only five have been adopted so far – finally define the tax sharing system for the regional and local level, the allowed minimum and maximum tax rates, the degree of partial equalisation and the procedures for defining standard cost, especially in the health care sector.

Sequencing had the advantage of ensuring that governments acted under a veil of ignorance, which forced them to concentrate on long-term effects and to adopt a broader view. Specific numbers for revenue shares or equalisation formulas were not available, which made the assessment of short-term effects virtually impossible. The actors involved were obliged to consider the underlying principles rather than bargain for specific advantages, which in turn facilitated reaching a consensus. Some southern regions acknowledged the long-term advantages of stronger fiscal autonomy and of a more rational equalisation scheme, thereby mitigating the sometimes sterile north-south confrontation.[6] Several interview partners said they were convinced that sequencing produced a lock-in effect: once the different actors had agreed on the framework of Law 42, they could not retreat from the consensus once the numerical cornerstones of the legislative decrees became apparent. Others were more skeptical, pointing out that winners and losers of the more contentious consequences of reform are still widely unknown. They argued that once the additional calculations became available, distributional effects would become visible, and resistance to reform would increase, unless the central government put additional resources on the table. As a precautionary move, the central government agreed early on to a set of transitional arrangements in order to cushion negative short-term impacts of the reform.

Policy formulation: bundling

The reform consisted of several elements that could be bundled to satisfy the various interests. The principle of fiscal autonomy, *i.e.* that spending should be covered by own tax revenue, and the principle of "territoriality", *i.e.* that tax revenues should remain where they were generated, pleased the wealthier regions. Tax autonomy – the right to set and vary tax rates – pleased regions that boasted efficient public services and/or stood to benefit from inter-jurisdictional tax competition. Tighter fiscal rules were adopted mainly at the demand of the central government. However, the central government brought the regions on board by allowing them greater flexibility in dividing up the total sub-central deficit between the regional, provincial and municipal level, and a few regions made already use of this possibility.[7] The reform of the fiscal equalisation system satisfied two types of regions, those with low tax-raising capacity and those where the cost of providing services was above the national average. Although the correlation between low tax-raising capacity and high service costs is relatively high, the two equalisation systems do not always benefit the same regions.[8] The harmonisation of accounting rules was a strong priority of the central government, which was eager to compile comparable and reliable data on sub-central public finances, and was also intent on ensuring that SCGs did not circumvent tighter fiscal rules through creative accounting. The municipal level finally got more own revenues, less earmarked grants and a better functioning equalisation system.

The deal "more tax revenue "*versus*" better equalisation" was the lynchpin holding the reform together. The constitutional reform of 2001 explicitly called for an equalisation fund to balance the principle of sub-central self-funding. While early reform proposals focussed on decentralisation, autonomy and "territoriality", demands for equalisation

grew during the negotiations. The wealthier regions accepted the definition of "essential services" and minimum standards and accepted that their cost had to be fully equalised. Health care, now recognised as an essential service, became a central issue for the south. And, while the wealthier regions were inclined to a "horizontal" – *i.e.* between regions – equalisation model with limited equalisation, poorer regions preferred a vertical or gap-filling equalisation system, which puts the burden of equalisation on the central government rather than the wealthier regions. Finally, the regions accepted centrally determined minimum and maximum tax rates instead of full tax autonomy, as fully fledged tax competition was seen as benefitting the wealthier regions only.[9]

Experimentation

Several Italian regions – the islands and some border regions – have a special statute with extended spending and taxation powers. These regions have long acted as a laboratory for fiscal decentralisation experiments which, if successful, were transferred to or adopted by the other regions. For example, the value-added tax regime in force in some special statute regions inspired the tax-sharing system established by the reform. The experiments carried out in the special statute regions provided evidence that wide-ranging decentralisation of fiscal power could have beneficial effects at both the central and the sub-central level. While the demarcation of special and ordinary statute regions created an inherent "multi-speed federalism", the 2009 reforms were intended to reduce the institutional gap and to assign to the ordinary regions some prerogatives that special statue regions already enjoyed. The idea of experimentation was also carried forward once the framework law was adopted: in advance of the implementation of Law 42 for major metropolitan cities, a legislative decree from 2010 specifies a set of concrete rules and regulations for Rome.

Administrative setup

Once framework Law 42 had been elaborated, the subsequent implementation of the legislative decrees involved more actors and a heavier administrative structure. In 2010, an Intergovernmental Committee on Fiscal Federalism was created with equal representation for the central government, the regions, the provinces and the municipalities. The committee was divided into seven working groups, each treating one aspect of the reform, and steered by the Ministry of Economy and Finance. Each working group was composed of delegates of the Ministry of Economy and Finance, delegates from line ministries, each government level and external experts. The structure was chosen to concatenate leadership by the Ministry of Economy and Finance, with adequate representation of the relevant actors and interests. One of the main activities of the committee was to define the relevant information needed to establish the financing framework, as well as to collect data, to allow for informed decisions on reform needs and outcomes. The regional level co-ordinated its position through the Conference of the Regions, where all regional presidents meet and the reform was regularly on the agenda. Since the decisions of the Conference of the Regions have to be reached by consensus, this implied extensive interregional consultations but meant – although they are not legally binding – that the regions had a strong negotiation position.

The role of experts

Fiscal federalism is a widely discussed topic in Italian academic circles, so the government could rely on a large number of experts. While the elaboration of the framework law benefited from the input of *ad hoc* experts, the subsequent formulation of the legislative decrees was done by systematically involving experts as members of the working groups and for drafting reports. A major role of experts was to provide relevant information and data. Some interview partners argued that the lack of appropriate fiscal data could have resulted in misinterpretations of reform needs, slowing down the reform process.

The Bank of Italy, together with other prominent institutions and research centres, prepared several reports pointing out the flaws of the old system. Between 2004 and 2010 the Bank's study branch, in particular, prepared more than ten reports on topics such as economic and fiscal disparities, sub-central tax raising capacity, sub-central spending, and sub-central debt and debt management, pointing early to the need for reform and setting up a reform agenda.[10] The main conclusion of the reports was that there was ample room for more fiscal autonomy at the sub-central level and that the equalisation system had to be thoroughly overhauled.

Adoption, implementation and unfinished elements

Framework Law 42 was adopted by both parliamentary chambers in May 2009, with the abstention of the opposition parties. Several legislative decrees – each requiring an act of parliament – detailing the framework law were passed in 2010: the devolution of state-owned property to regional and local government; the new legislative framework for the capital city; the definition of expenditure needs for municipalities; municipal funding and the taxes allocated to the municipal level; the funding and tax system for ordinary regions; the definition of standard cost for the health care sector; and the harmonisation of sub-central accounting principles. In parallel, stricter fiscal rules were inserted into the Internal Stability Pact, though providing the regions also with some leeway in allocating debt between the municipal, provincial and regional level.

Several decrees that will spell out numerical cornerstones – such as the tax shares allocated to the sub-central level or the size of the equalisation fund – are still being drafted, although framework Law 42 was due to have been fully implemented by May 2011. Also, the calculation of standard cost across regions, which is essential for determining equalisation payments, has been delayed, due both to a debate on which indicators to take into account and to the lack of appropriate data. This is likely to give rise to potentially enduring conflicts between the central and sub-central government levels. Finally, although the central government aims at "fiscal neutrality" (meaning that the reform does not require additional central government resources), it is uncertain whether it can stick to this aim, especially if reform losers start to show signs of opposition.

Conclusions

The Law 42 of 2009 on fiscal federalism, based on the constitutional reform of 2001, was one of the farthest-reaching reforms of Italy's fiscal framework. Its success built on a set of abandoned or failed reform attempts. For years, experts had argued that a reform of fiscal relations was inevitable for reasons both of efficiency and of equity. The reform was pursued by a government that had a clear mandate for more regional autonomy and for an

overhaul of an excessive and inefficient transfer system. The sequencing of various reform steps – a constitutional reform followed by a framework law, followed by legislative decrees that set out numerical values for the various reform elements – made sure that actors had to agree on reform principles without knowing how they would be affected individually. Sequencing also made it possible to adopt the less contentious elements of the reform and to use the momentum generated to address the more difficult issues. The bundling of autonomy, efficiency and equity issues pleased both the wealthier and the poorer regions.

The reform also showed the formidable constraints for fiscal federalism reformers. Several key numerical cornerstones (such as the tax share allocated to the regions, tax autonomy, the size of the equalisation system and the way standard cost is calculated) are still lacking. While all actors agreed on the principles of the reform, it is not certain whether this consensus will persist once the outcomes for individual governments become available and distributional conflicts apparent. The public still has no clear appreciation of the nature and the consequences of the reform. Based on other countries' experience, specific equalisation formulae are often a particularly contentious issue, requiring a strong consensus on the underlying principles before the discussions on the numbers begin. Some parts of the reform have already been delayed, *e.g.* in the area of standard cost calculation. The coming phase, with more legislative decrees to be presented to parliament, will reveal whether the consensus can hold once concrete numbers are presented.

Notes

1. An overview of Italy's economic and fiscal development in the decade following the adoption of the reform can be found in OECD (2007).
2. OECD (2001) traces the various regional development approaches between 1950 and 2000.
3. To meet deficit objectives, the central government cut transfers to regions and municipalities, and regions are requested to cut their expenditure by a given percentage every year (5% in 2009 and 2010, 13% in 2011).
4. Spending data from the Ministry of Finance suggest that while transfers to and public spending in the south tended to increase until 1992, they subsequently tended to decline with respect to general government spending.
5. The 2009 property tax reform that abolished the tax on owner-occupied houses compromised the federalism reform, since municipal tax revenues declined considerably thereafter. After the reform, municipalities still rely strongly on transfers making up for the lost property tax revenues.
6. In recent years, the productivity gap between the south and the north had been closing, suggesting that the south is catching up (OECD, 2007). This can partly be ascribed to the economic slowdown in the centre-north regions.
7. Provinces and municipalities were not happy with this. They claimed that the new rules would have a cascading effect, and that regions would simply download deficits and debt to the lowest government level. A few regions have established an "intra-regional stability pact" with their provinces and municipalities.
8. In general, the north has a higher fiscal capacity and lower cost per capita to produce a given set of services than the south, but a few regions do not conform to this pattern (Matteis and Messina, 2010 and Bripi, Carmignani and Giordano, 2010).
9. However, tacitly and unofficially, some southern regions did not have such a negative view of tax autonomy, seeing it as a boon to attract new businesses and to compete with more industrialised and agglomerated regions.
10. As an example, see Franco, Massina and Zotteri (2004).

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Chapter 9

Portugal: The reform of the Local Finance Law

Summary

In January 2007, a new Local Finance Law came into force, whose objective was to increase the equity and efficiency of sub-central public finances, while being financially neutral for the central government (Box 9.1). One of the main aims of this reform was to tighten the budget constraint and to reduce the revenue dependence of municipalities on immoveable property. In particular, municipalities relied heavily on housing transaction fees as a revenue source, which gave local governments an incentive to grant building licenses that led to urban sprawl. Another objective was to reduce corruption and other illegal practices at the local level. Finally, the reform aimed at increasing equity by correcting flaws in the previous 1998 Local Finance Law, which were seen as favouring small municipalities over larger ones.

The main factors driving the success of the reform were:

- *The party in power had an absolute majority in parliament:* The reformers seized a particularly favourable political moment, and implemented the reform soon after general elections, to benefit from the legitimacy of a newly elected government.
- *Strong leadership:* The prime minister, the finance and the interior minister were personally committed to the success of the reform.
- *Relatively good economic conditions in the reform period:* In the years after 2000 Portugal experienced weak growth and weak fiscal positions, with demands for tighter budget rules rising. However, growth picked up during the reform period, and fiscal positions improved considerably. Municipal property tax revenues were increasing strongly after the 2003 reform, and growth prospects during the reform period reduced opposition from potential losers.
- *Guarantees were introduced to cap the potential losses due to the reform:* A "maximum variation clause" was introduced to mitigate the effects of the change in the redistribution criteria, and to guarantee that no municipality would face destabilising revenue losses. This clause stipulated that central government transfers flowing to any municipality would be reduced by no more than 5% as compared with the previous year.

Box 9.1. **The reform of the Portuguese Local Finance Law**

The reform consisted of four elements:

1. **A reform of the revenue mix of municipalities**
   - *An increased municipal share in the personal income tax and more tax autonomy*. Five per cent of the personal income tax revenues collected is ceded to the municipalities. The municipalities are free to reimburse all or a part of this 5% to their residents, on the condition that they maintain the constitutional principle of uniformity and progressivity of the tax.

Box 9.1. **The reform of the Portuguese Local Finance Law** *(cont.)*

- *A reform of the general-purpose grant system*. The reform reinforced equalisation and created a component of horizontal equalisation that did not exist previously. The allocation criteria were changed by increasing the weight of population and environmentally protected areas, reducing the lump sum transfer to municipalities and reducing the weight of the number of parishes in the allocation formula, thus penalising municipal fragmentation. A new "Social Municipal Fund" was created, disbursing earmarked grants to compensate for the cost of the responsibilities transferred to municipal governments in the areas of education, health care and social assistance. The "minimum guaranteed growth" clause was abolished, under which municipalities were guaranteed that they would not receive less than in the previous year in real terms. Finally, the tax-sharing apportionment was reduced to compensate for the increase of the share of the municipalities in the personal income tax, to ensure fiscal neutrality for the central government.

2. **New fiscal rules**

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

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

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

4. **Two institutional reforms**

- *Harmonising the rules on fees and prices for local public services*. This regulates the imposition of fees by municipalities and parishes, establishing the criteria under which they can be charged, and the principle that the fees should cover the costs of providing the services.
- *A reform of the law governing municipal-owned companies*. A broad definition of local government businesses was adopted, covering municipal, inter-municipal and metropolitan companies. The aim of the law is to better regulate their activity and increase transparency.

Context of the reform

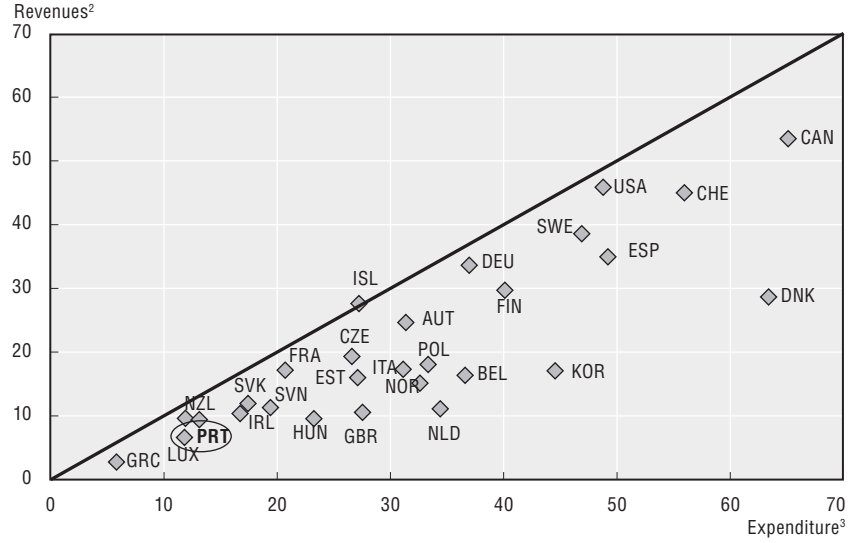
Institutional framework

Portugal is a small and historically centralised country, with a population of around 10 million inhabitants and a territory of 92 000 square kilometres. Decentralisation began after the advent of a new democratic regime in 1974 and the adoption of a new constitution in 1976, which established Portugal as a unitary country, with municipalities (308 at present) and parishes (communal entities) providing local services. Two islands (Madeira and the Açores) have a special status as autonomous regions. Despite a gradual process of decentralisation, the share of sub-central governments in public spending and revenues is still very low, at 13% and 9% respectively, with the OECD average respectively at 32%, and 22%) (Figure 9.1). The revenue mix of municipal governments is quite balanced, with own

taxes representing 51% of total municipal revenues, and transfers from the central government representing 42%. These averages mask considerable heterogeneity. In small municipalities, transfers in 2008 represented about 66% of total revenues, while in large municipalities, they represented only 25%. A reform of central government transfers therefore affects a larger share of revenues in small municipalities than in larger ones. The passage of the reform was facilitated by the fact that it required only a majority in the national parliament and no change in the constitution or adaptation of local laws was necessary.

Figure 9.1. **Portugal is one of the most centralised conutries in the OECD**

Share of sub-central governments in general government revenues and expenditure, 2009[1]



1. Or latest year available: 2008 for Canada, Hungary, New Zealand, Switzerland and the United States; 2007 for Korea.
2. Excluding transfers received from other levels of government.
3. Excluding transfers paid to other levels of government.

Source: OECD National Accounts.

Economic and fiscal context

Over the past two decades, after becoming a member of the European Union, Portugal has undertaken a wide range of reforms to liberalise its economy and open it up to foreign trade and investment. These reforms paid off in terms of GDP growth, and until the early 2000s, Portugal was catching up towards the living standards of more affluent OECD economies. Thereafter, growth stalled, unemployment increased substantially, and the convergence process suffered a reversal. It was not until 2005 that economic growth picked up again, thanks in part to a renewed effort at macroeconomic and structural reforms. Fiscal consolidation brought the government deficit down from more than 6% of GDP in 2005 to 2.6% in 2007, and inflation moderated to about 2.5%, just above the euro area average. The negotiation process (2005-07) therefore took place in a period when growth was picking up and deficits were being reduced. Meanwhile, municipalities were benefiting from strong growth of property tax revenues following the 2003 reform, which had broadened the tax base through more regular updates of property values (OECD, 2010). These favourable economic and fiscal conditions facilitated the reform negotiations, since

all municipalities counted on rapidly raising own and transferred revenues, while central government hoped to keep the reform financially neutral.

Electoral mandate and political leadership

The Local Finance Law reform benefited from a particularly favourable political moment. The Socialist Party had won an absolute majority in parliament after the 2005 elections. Portugal has a tradition of minority governments, having experienced only four legislative periods with an absolute majority government since the constitution was adopted in 1976. This was cited as one of the major reasons for the success of the reform by all interview partners. Given the scope of the reform, which changes the distribution criteria for funding and creates net losers, they contend that it could not have been carried out by a minority government. The reform also benefited from strong political leadership by the prime minister and strong support of the two ministers that were most concerned: the Minister of the Interior, and the Minister of Finance. Besides, the Socialist Party members noted that they had been the architects of the previous 1998 reform of the Local Finance Law, and argued that while in power, the opposition Social Democrats had not made progress on this issue.

Actors and interests

The two main stakeholders are the central government and the municipalities. Public interest in the reform was high, particularly as regards the practical implications of the proposed municipal share in the personal income tax. Because the law authorises municipalities to grant a tax rebate of up to 5% on the personal income tax, there could be differences in the effective tax rates for residents of different municipalities. This was seen by some as contrary to the principle of equity, and by others as an interesting and novel tax competition instrument.

The municipalities had often dissenting and sometimes contrasting views on certain reform elements. Most municipalities, especially those that were already close to the debt ceiling, opposed the tighter fiscal rules, particularly because the new law establishes sanctions to enforce them. Municipalities were also united in lobbying against the consolidation of accounts with local public enterprises, as these were often used to circumvent fiscal rules. But municipalities were split into different interest groups concerning the reform of the grant system, and the degree of opposition to the reform depended on how these issues affected each municipality. In particular, the Local Finance Law changed the distribution formula of the grants, and because it had to be neutral for the central government's finances, it created net losers. Municipalities were therefore divided according to whether they stood to lose or gain from the reform. In general, large, dynamic municipalities with a growing population and education needs, and extended protected areas (*pro natura* municipalities) gained from the new distribution criteria that took these factors into account. Benefits were somewhat attenuated by the fact that after the reform, richer municipalities had to contribute to the Social Cohesion Fund. Small municipalities, especially those losing population and those that had previously benefited from the automatic increases in transfers, were against the reform, as the new formula no longer guaranteed an increase in their revenues independently of how their population or their spending needs evolved.

The specific political configuration during the reform period also created some tensions. While the central government was socialist, most municipal mayors belonged to

the opposition (the Social Democrats). To some extent, the reform laid open the different ideological views on decentralisation of the two main parties. However, since municipalities of the same party stood to lose from the reform and some to gain from it, interests of individual governments often superseded party ideology. The central government could use divisions among municipal leaders to bring certain groups on board or to sideline reform losers, but in general tried to find a consensus with the opposition. Interest groups outside government were little interested in the reform, apart from the education sector, which lobbied for continued earmarking of intergovernmental grants and was strongly opposed to decentralising curricula and wage bargaining.

The reform process

Administrative setup and timing

The government was conscious that it faced a window of opportunity to reform the Local Finance Law, as it had a clear majority in parliament, and the legitimacy of a newly elected government. It therefore acted swiftly, and shortly after the election, the Ministry of the Interior and the Ministry of Finance released a joint ministerial order to create a working group to review the Local Finance Law of 1998. This working group was comprised of five experts, including well-known and respected academics and public servants, and was co-ordinated by the secretary of State for Local Government (representing the minister of State of the Interior), and the secretaries of State for the Budget and for Fiscal Affairs (representing the minister of State for Finance). The National Association of Portuguese Municipalities also participated in the working group as an observer.

The working group was given six months to come up with a proposal to reform the Local Finance Law. This proposal had to facilitate the implementation of the principles of decentralisation, which had been voted in 1999 but which had resulted in a very limited transfer of responsibilities. This was due in part to the fact that this law did not establish a framework for increasing local resources in tandem with local responsibilities. It also had to design a new framework for own municipal revenues, to reduce the municipalities' dependence on revenues from the building industry. Besides, the working group was also charged with ensuring that the reform was financially neutral for the central government.

Bundling

The 2007 reform contained several elements helping central government to forge a majority across municipalities. The increase in the personal income tax share and the newly acquired autonomy over this share pleased the wealthy municipalities or those that were growing rapidly. The reform of equalisation satisfied essentially the poorer municipalities and made up – at least partially – for losing the "minimum-guaranteed growth" clause or the lump-sum grants not connected to the number of inhabitants. With respect to the new fiscal rules, the central government put the ceilings in a way that only a small minority of municipalities was affected in the short run, and the government made sure to have the tacit agreement to strengthen the rules from all municipalities with sound fiscal positions. Given that reform speed was high and that several numerical cornerstones were modified during the reform process, the different stakeholders were never quite sure on how they were affected individually. In the end, the central government's bundling strategy was successful with regards to its own fiscal position: Portugal was the only country under scrutiny where the reform was "fiscally neutral", *i.e.* where central government did not provide additional resources in order to rein in affected stakeholders.

Safeguards and guarantees

Despite the careful design of the reform, it was necessary to introduce some safeguards and guarantees. To mitigate the effects of the change in redistribution criteria, and in particular, to guarantee that no municipality would face destabilising revenue losses, a "maximum variation clause" was proposed by the working group as a transition measure: No municipality's transfers would be reduced by more than 5% as compared with the previous year. But as the reform had to be financially neutral for the central government, this clause implied capping the overall increase in transfers to municipalities, and using the excess funds to increase the transfers to losing municipalities. Transfers were therefore capped at 5% annual growth. Initially this was conceived by the working group as a temporary measure that would expire in five years (2007-11), but as the final law passed by parliament does not mention this sunset clause, the measure is permanent.

A Social Municipal Fund was created to compensate for the responsibilities that were transferred to the municipalities. This fund is earmarked for education, health and social services. Municipalities complained about this reduction in their spending autonomy, but the central government considered it a way to guarantee the constitutional right of citizens to obtain the same level of public services throughout the territory.

Experts and academia

The role of academics and experts was crucial in this reform. The fact that the working group was composed of well-known and respected experts gave its recommendations credibility and an impression of neutrality. Moreover, these experts were very active in defending the proposal in the media and in academic circles. The Court of Accounts also played an important role, by publishing reports demonstrating the inefficiencies of the previous system, and justifying the need to reform it.

Communication

Municipalities were always informed of the progress of the working group, because a representative of the National Association of Portuguese Municipalities acted as an observer in the group. They could therefore not argue that the reform was prepared without consultation with them. The media were also very interested in the reform. The main newspapers dedicated several articles to the topic and interviewed members of the working group, and a major TV show organised a confrontation between those in favour and those against, where both the Minister of the Interior and the president of the National Association of Portuguese Municipalities participated. It seems that the public was more convinced by the arguments in favour of the reform than by those against.

Implementation

In June 2006, the working group finalised its proposals to reform the Local Finance Law. The law was discussed in parliament, and adopted on 15 January 2007. A few minor differences distinguish the draft law from the law that was finally approved, but small changes may have important consequences. The compensation measure, conceived as temporary (2007-11), became permanent, because the reference to a sunset date does not appear in the law. This was a severe disappointment for about 40 municipalities, for whom the application of the new criteria would have led to additional transfers of more than 5% as compared to the ones received before the new law, in some cases, up to 17% higher than the previous allocation. But the 5% growth ceiling for central government transfers means

that these municipalities have to give up large portions of their allocation every year to finance those municipalities favoured by the old system that lost more than 5% of their transfers under the new system.

The reform was quickly implemented. In particular, it was soon evident that the government was ready to apply the sanctions to municipalities that did not comply with the new fiscal rules. Some municipalities lost no time in exercising their option to reduce the personal income tax bill for their citizens. More difficult to implement was the consolidation of accounts. Municipalities used two arguments to delay the implementation: first, that the clause violates the principle of "autonomy of accounts", as only the National Court of Accounts is permitted to audit the municipal accounts, and they may not be submitted to external auditors. Second, some municipalities argued that there are no criteria for consolidating accounts conforming to two different accounting systems. This technical issue is being solved at present with a new rule that establishes criteria for consolidating municipal accounts.

Conclusion

The Portuguese 2007 reform of the Local Finance Law proceeded rapidly and effectively, and it is the only instance among the reforms studied for this report in which the central government did not put extra resources on the table to ensure the passage of the reform. The political leadership and commitment to the reform, as well as the careful design of the reform process, were important elements in achieving this. Still, two exogenous factors greatly facilitated the reform: first, the fact that the government had an absolute majority in parliament, and second, that the reform required the approval of only a single piece of legislation in parliament. Despite the reform and its achievements, Portugal remains one of the most centralised countries in the OECD.

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Chapter 10

Spain: Reforming the funding of Autonomous Communities

Summary

When it was created in the 1980s, the Spanish system of financing Autonomous Communities (AC) provided for a renegotiation every five years. Each round of negotiation raised political tensions and subjected the central government to additional costs for reaching an agreement. The AC finance law (*LOFCA: Ley Orgánica de Financiación de las Comunidades Autónomas*) adopted in 2001 was supposed to remain in force indefinitely and thus to avoid such problems. However, since it did not include mechanisms to adapt to asymmetric shocks (such as uneven population increases across regions), it was criticised for generating inefficiencies and inequities in revenue allocation. After only a couple of years, the need to reform the system became apparent. Preliminary studies were undertaken between 2006 and 2008, negotiations were carried out in 2008 and 2009 between the central government and the ACs, and in December 2009, a new LOFCA was passed by the national parliament and subsequently ratified by all the ACs (Box 10.1).

The main factors driving the success of the reform were:

- *A shared diagnosis of the need for reform:* About seven million migrants entered Spain from 1999 to 2009, which generated asymmetric impacts among ACs. As the 2001 LOFCA was based on a population census taken in 1999, it could not adapt to these changes, and the evolution of transfers was partially decoupled from the evolution of population and costs. It quickly became obvious that some ACs with low population growth were receiving above average per capita revenues, while other ACs with large migrant inflows were being under-financed.
- *Strong leadership by ACs that had modified their statutes increased pressure to reform the LOFCA:* Some ACs complained that the old system was too redistributive, and pushed for increased tax autonomy and reduced redistribution. In 2006, six ACs changed their statutes (constitutions), increasing the need to reform the LOFCA. The leadership of these ACs became particularly important because Spain was governed by a minority government during the negotiation process, which gave the ACs increased leverage.
- *The reform provided a significant increase in the total revenues assigned to the ACs, which was particularly timely in the context of the financial and economic crisis:* The central government made it clear from the beginning that there would be no net losers and no dramatic changes in the relative positions of the ACs. A special fund was created to guarantee that all ACs would be net winners.
- *The multi-polarity of interests among ACs reduced opposition to the reform*. From an economic perspective, strong and dynamic ACs would benefit from the new criteria, and less dynamic ACs with above-average per capita revenues would lose in relative terms. From a political perspective, some ACs were governed by the majority party and some by opposition parties. There were ACs in all four groups. The combination of self-interest and party discipline therefore reduced opposition to the reform.

Box 10.1. **The reform of the funding of the Spanish Autonomous Communities**

The reform consisted of the following elements:

- *A rise of the share in shared taxes*: The shares of the Autonomous Communities in the following taxes were raised: Personal Income Tax (from 33% to 50%), Value-Added Tax (from 35% to 50%), and Excise (from 40% to 58%). Of these taxes, 75% are allocated to the Fund to Guarantee Public Services, which is divided among the ACs according to adjusted population criteria. The remaining 25% are allocated to the AC where they were generated. If an AC increases its tax effort, it can keep the resources that are generated.
- *Creation of several specific funds*: several specific funds were created for different purposes: the Fund to Guarantee Public Services, the Global Sufficiency Fund and two convergence funds (the Competitiveness Fund and the Co-operation Fund).
- *Reform of the equalization system*: the equalisation scheme was reformed. The previous system of total equalisation, based on a static assessment of relative needs, was changed to a system that only equalises partially, but is frequently adjusted. The new system provides partial equalisation (of 80% of needs). These needs are now re-evaluated and adjusted yearly, following the evolution of actual needs (mainly in response to population changes), and thus ultimately adjusting the ACs' relative shares. Under the previous system, needs were calculated based on the 1999 census, not taking into account relative changes in needs between ACs.
- *New criteria for fund allocation*: the criteria for allocating funds to ACs were changed. About 80% of the ACs' revenues (75% of ceded taxes plus about 5% additional transfers from the central government) are allocated to the Fund to Guarantee Public Services, according to an "adjusted population" criterion, *i.e.* population weighted by age group, area of the AC, dispersion of the population in the AC, island status, etc. This fund is adjusted yearly, taking into account the evolution of these variables. Additionally, a Global Sufficiency Fund provides sufficient resources for the rest of the devolved responsibilities, and guarantees that there are no net losers due to the reform.
- *Creation of two new convergence funds*: two new Convergence Funds were created. First, a Competitiveness Fund was created to satisfy the ACs whose financing was clearly below the national average in the previous system (richer ACs with steep population growth). It aims to reduce per capita financing disparities. Second, a Co-operation Fund was created to help the less dynamic ACs (which had fallen behind either economically or in population growth), thus helping to reduce growth discrepancies among ACs.

Reform context and exogenous factors

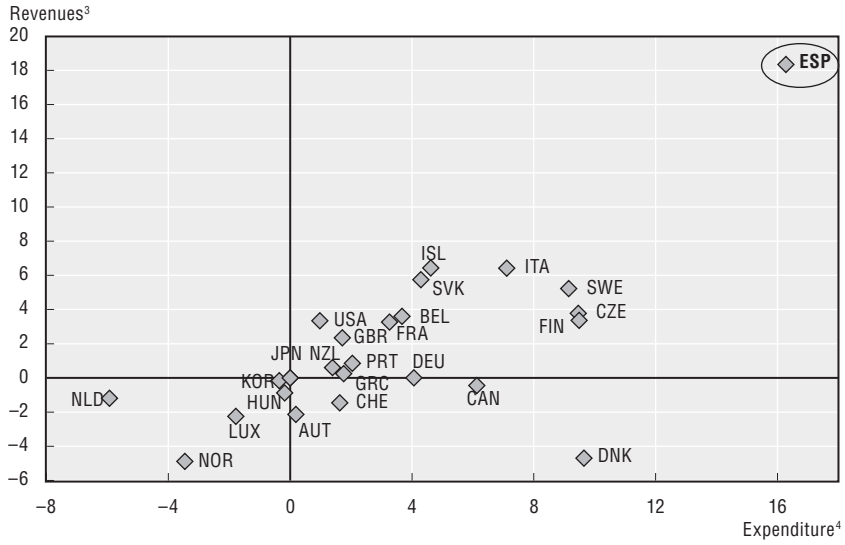
Institutional framework

In the last three decades, Spain has undergone a deep process of political and fiscal decentralisation, shifting from a highly centralised system to a highly decentralised one. This trend is reflected in the change in the share of the ACs in total public spending, which rose from 21.5% in 1995 to 35.6% in 2009, and the share of the ACs in total public revenues, which rose from 6.6% in 1995 to 24.1% in 2009 (Figure 10.1). The Spanish Constitution of 1978 created the Autonomous Communities (ACs) and stipulated that they should have financial autonomy to carry out their competences. This should respect both the constitutional principle of co-ordination with the central government and the principle of solidarity between all Spanish citizens, guaranteed by the central government. More

specifically, the solidarity principle implies the guarantee of access to basic public services in the whole territory and the lowering of income disparities between regions. Each AC established its "Statute of Autonomy", which is equivalent to a regional constitution. Both the central government and the ACs have legislative powers, and their laws have the same status (in the event of a conflict, the central government laws do not prevail over that of the ACs), even though each level of government can only issue laws on matters that are under its competence.

Figure 10.1. **Spain went through a rapid fiscal decentralisation since 1995**

Changes expressed in percentage points, 1995[1]-2009[2]



1. Or earliest available year: 1996 for Norway; 2000 for Korea.
2. Or latest available year: 2008 for Canada, Hungary, New Zealand, Switzerland and the United States; 2007 for Korea.
3. Excluding transfers received from other levels of government.
4. Excluding transfers paid to other levels of government.

Source: OECD National Accounts Database.

Reforming the LOFCA therefore required first, that the law be approved by the national parliament, and second, that a particular agreement be concluded with each AC to specify its application in its territory. This institutional structure makes it desirable to reach unanimity among the ACs.[1] This explains why the central government attempted to make all ACs feel like net winners and had to put money on the table to reach a consensus.

Since 1993, and in particular during the negotiations of the reform, Spain has been governed by minority governments, with the exception of the period from 2000 to 2004. It therefore depended on the support of nationalist parties, giving considerable leverage even to those ACs not governed by nationalist parties, since all ACs would fight to get treated similarly.

Issue history

After the devolution process that increased the ACs' responsibilities, the funding system for ACs (*Sistema de Financiación de las CC.AA*) has also been reformed periodically since its first implementation in the early 1980s. Progressively, the share of taxes in ACs' revenues was increased, with a proportional reduction in the share of transfers. Until 2001,

the financing schemes were established for a period of five years, and therefore had to be renegotiated periodically. This often generated political tension, a considerable amount of energy and increased financial costs for the central government as it sought to obtain agreements from the ACs. By contrast, the 2001 reform was intended to remain in force indefinitely, in order to avoid these problems. However, it soon became subject to criticism, particularly because it could not adapt sufficiently to the unexpected population increase (seven million migrants arrived in Spain between 1999 and 2009). Indeed, in the 2001 model, transfers to the ACs were based on the 1999 census, and there was no direct dynamic element for adjusting the transfers to population changes. It had mistakenly been assumed that a higher population would imply higher taxes. Moreover, changes in population were asymmetric across the ACs. As the 2001 model could not adapt to these changes, the evolution of transfers was partly de-linked from the evolution of population and costs, and it soon became obvious that some ACs with low population growth were receiving above-average per capita transfers, while other ACs with large migrant inflows were under-financed. This resulted in a broad consensus on the need to reform the previous system.

Political influence and leadership

Besides a shared diagnosis of the need to reform the system, one of the main drivers for the reform was pressure from the Catalan AC to reform the 2001 model. Catalonia complained that the old system was too redistributive (*i.e.* that it was contributing too much to the common pool in proportion to what it was receiving as transfers) and argued for increased tax autonomy. In 2004, negotiations began in Catalonia to reform its Autonomous Statute. This reform was achieved in 2006, and ratification of the new AC statutes raised the question of updating the LOFCA. The new statute proposed a higher share in national tax revenues, and partial and dynamic equalisation instead of the complete and static equalisation of the previous system. Five other ACs (including Valencia and Castilla-León) changed their statutes, but not all of them in the same fashion. The need to revise the LOFCA thus became increasingly apparent. Throughout the negotiation process, the Catalan AC played a leadership role in driving the reform forward.

Economic and fiscal context

Most of the reform negotiations occurred in 2008-09, *i.e.* during the economic crisis, at a time when it was not clear that the central government would be able to provide additional revenues to the ACs, as it had in the past. Moreover, the final phase of the negotiations and the vote in parliament took place in late 2009, once it had become clear how serious the impact of the financial and economic crisis was on Spain and on the ACs' finances in particular. The ACs' expenditure are relatively rigid (they comprise mainly spending on education and health care), so that they are not easy to compress, and ACs must comply with relatively strict fiscal rules. Significant changes in the regional funding system were called for to foster efficiency and ensure the sustainability of the allocation of funds, and to fix vertical and horizontal imbalances. The extra funds provided by the reform also acted as a fiscal stimulus, improving the regional financing system, as well as reducing the need for public borrowing or specific *ad hoc* policies to help ACs overcome the global financial crisis. Questions were raised as to whether the reform should be continued given the economic environment, but most stakeholders agreed that this made the reform of the ACs' financing system even more important.

Actors and interests

The main actors in this reform were the central government (in particular the Ministry of Economy and Finance) and the ACs. For the central government, reform was seen as necessary because of the increasing disparities and inefficiencies generated by the previous system. Its main objective was to implement a new system acceptable to all ACs, while ensuring the long-term fiscal sustainability of the central government. As for sub-central governments, as in any reform involving redistribution, some ACs would benefit from the reform and some would lose in relative terms from it. In particular, as one of the objectives of this reform was to correct a situation where some ACs were receiving much more revenues per capita than the national average, these were sure to lose, at least in relative terms, from any change in the system.

One factor that helped the reform succeed was the fact that at the ACs were divided into at least four different interest groups:

- At the economical level, ACs that had experienced sustained population growth in recent years would obviously benefit from a new allocation formula that corrected for this, while less dynamic ACs receiving above-average per capita revenues (in most cases with a significant gap) would lose this status in relative terms.
- At the political level, some ACs were governed by the majority party and some by opposition parties.

The ACs fell into all four possible groups. Those governed by both government and opposition parties which stood to lose, at least in relative terms (since the central government had guaranteed that there would be no net losers), and ACs of all political stripes which would enjoy relative gains. This multi-polarity of interests was very important, as the combination of self-interest and party discipline helped moderate opposition to the reform.

A third dividing line between ACs was their relative wealth and contribution to the equalisation system. Since the 2001 system was deemed to reach complete equalisation, some actors considered that the ACs receiving the most tax revenues were net contributors to horizontal equalisation. Besides, if these ACs also had large population increases (as in the case of the Baleares), they may have received less than their fair share of revenues in per capita terms. This created pressure from the more dynamic ACs, led by Catalonia, to acknowledge this redistribution and reduce it, moving to a partial but dynamic equalisation. The aim was to equalise 80% of total resources, representing basic public services: education, health and social services, which would be revised every year. Of course, the less dynamic ACs resisted this change. Finally, since new criteria would be given more weight in the new redistribution formula, each AC lobbied to attribute greater weight to the criteria that it would benefit from (area, dispersion, insularity, etc.).

The reform process

Organisational and administrative set-up of the reform

The reform process aimed at ensuring a high degree of consensus among the ACs. The first reform phase took place in the Fiscal and Financial Policy Council (*Consejo de Política Fiscal y Financiera*, CPFF), which brings together the Ministers of Finance and Territorial Administration of the central government and the ACs' councillors of finance. This council analysed the problems (specific studies on population growth, health care, etc.), and established proposals. These were initially rather general, and following a multilateral

negotiation process within the CPFF and parallel bilateral negotiations with each of the ACs, they became increasingly concrete. The bilateral negotiations with the ACs were crucial. In principle, a simple majority is necessary at the CPFF to arrive at an agreement, and this is virtually guaranteed since the central government has half the votes. But in practice, the new model must be accepted and signed by each AC. It was therefore essential that the central government verifies the acceptability of the agreement with each AC. This phase ended with a vote on the new system by the central government and all the ACs according to their self-interest, within the CPFF. The text adopted in the CPFF was then submitted to the national parliament, where the vote is along party lines. Finally, each AC must agree to the specific application of the reform in its territory.

Policy formulation

In 2004, the first results of the implementation of the 2001 model became available, and by November, a study conducted by a CPFF working group on the asymmetric impacts of population growth on AC finances made it possible to discuss a possible reform of the 2001 system. From February 2006 to March 2007, a working group was created within the CPFF to diagnose the problem and suggest reform proposals. The CPFF issued two reports, and various ACs also provided input and their own reports. Meanwhile, in June 2006, Valencia and Catalonia each adopted a new Statute of Autonomy, which created strong pressure for reform of the LOFCA. After winning re-election in March 2008, the central government promised that it would reform the law. The negotiations with the ACs and in the CPFF started in May 2008, and in July 2009, the new law was approved in the CPFF, with the vote of the central government, all the ten ACs governed by the party in power and one AC governed by the opposition; the other six ACs abstained. It was then approved by the national parliament in December 2009. As expected, the governing party voted in favour, and the opposition against, and it was subsequently accepted by all the ACs.

The process for reforming the funding of ACs in Spain is complex, calling upon different bodies and institutions. Yet, it may be argued that it is precisely this complexity that helped ensure the reform of the system, as it allows for the opposition to speak out in the political sphere (parliament), for nuanced views to be expressed in more technical bodies, as well as for the final bilateral acceptance of the new system.

Scope of the reform

This reform focused on the revenue side of the ACs. It does not touch the roles and responsibilities of each level of government, which had already been widely decentralised. This reform does not apply to the Basque Country and Navarra, which traditionally benefit from a different treatment: these communities collect all the taxes in their territory, and transfer a negotiated fee (*cupo/aportación*) for the services that the central government provides as a result of its own competences. These two ACs do not participate in the national equalising system. This special statute was not questioned during the reform.

Research and external experts

Research and experts contributed substantially to shaping the reform. In particular, the Institute of Fiscal Studies (*Instituto de Estudios Fiscales*), a think tank attached to the Ministry of Economy and Finance, conducted several studies that showed the

shortcomings of the previous system, and suggested reform options. Each AC also had its "academic referee" and presented studies and reports to support its position.

Communication

The reform was of great interest to Spanish citizens, and generated fierce debates. For the central government, and also for the governments of the ACs that favoured the reform, it was important that these multilateral negotiations, which concerned the positions of all the ACs, were not perceived as being tailored especially for Catalonia, which had been vocal in lobbying for the reform. Getting public opinion to support the reform throughout the ACs was crucial, as each AC needed to accept it. This required extensive communication efforts by AC governments in their constituencies. In the case of Cantabria, for example, the regional government visited the regional parliament six times during the course of the reform to explain its objectives and how it would affect the AC. It also met with unions, associations, citizens and so on.

Dealing with stakeholders

It was important for the central government to reach consensus across the ACs so that the new law could be implemented throughout the national territory. This consensus was achieved through various elements of the reform that ensured that each AC ended up better off than under the previous model.

No losers in absolute terms

The central government made it clear from the outset that there would be no net losers. No AC would get fewer resources than under the previous system, so they all stood to be net winners. The central government announced that it would increase transfers to guarantee this outcome. Furthermore, according to statements of some AC representatives, the central government had guaranteed that there would be no dramatic changes in relative positions, even though some ACs that benefited from the previous system were bound to lose from the reform in relative terms. One AC, for example, had been receiving per capita revenues 26% above the national mean. In exchange for an increase in its absolute level of financing and the consideration of criteria that benefited it in the adjusted population formula, this AC suggested that it would agree to the reform only on the condition that the reform ensured that it would get closer to the national average per capita funding, without significantly changing its relative position. The AC finally accepted being "only" 19% above the national average, while remaining the AC with the highest per capita funding.

To satisfy the ACs that wanted less redistribution and partial equalisation, the Fund to Guarantee Public Services, which represents about 80% of the ACs' resources, was aimed at equalising basic public services (*i.e.* education, health and social services). A Global Sufficiency Fund was created, based not only on the equalisation criteria but also on providing sufficient resources for the responsibilities devolved to the ACs and guaranteeing that all ACs would be net winners. Finally, two more funds, known as the Convergence Funds, were created, which can represent up to 3% of total AC revenues. The first, the Competitiveness Fund, was created to satisfy ACs that were clearly below the national average in the former system (richer ACs with large population growth), with the aim of reducing per capita financing disparities. The second, the Co-operation Fund, was dedicated to the ACs that were less dynamic (whether economically or in population

growth), to help reduce the growth gap among the ACs. It was also intended to avoid excessive "re-ordering" in the short term, *i.e.* that the ACs favoured by the previous system would be better off, even if they were closer to the mean.

In general, as one observer noted, the system is complex, and since an important part of the revenues will change every year, it is difficult to estimate how much a given AC will actually receive. Besides, given the crisis, it is not easy for ACs to estimate how much they would have received in 2009 if the previous system had still been in place, and therefore to estimate the difference due to the change of system. This uncertainty, and the clear difficulties that would have ensued if the new agreement had been rejected, helped the reform succeed, since each AC was assured of being better off.

Conclusions

The acceptance of the reform by all the ACs was secured largely because it was able to address the drawbacks of the previous system (*i.e.* the lack of sufficient dynamic adjustment of resources to the ACs' financing needs) and because it led to a significant increase in the total revenues assigned to the ACs. Given the financial and economic crisis, this increase would have probably been necessary in any case. It thus generated a double dividend, both by supporting ACs during the crisis and facilitating the implementation of the reform and by guaranteeing that all the ACs would receive more revenues in absolute terms. Besides, special care was taken to ensure that there would be no major changes in the ACs' relative positions.

Note

1. In theory, unanimity is not a requirement, and if an AC does not accept the agreement, the central government can decide to impose it or simply not apply it. In practice, this latter option may complicate the administration of the LOFCA, especially for the horizontal equalisation calculations, which is why it is desirable to reach unanimity among the ACs. The central government may impose substantial penalties in the event of an AC rejecting the new agreement.

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Chapter 11

Switzerland: The new fiscal equalisation and responsability assignment framework

Summary

Between 2003 and 2007, Switzerland passed a set of constitutional and legal amendments following a popular vote that substantially changed fiscal relations between the federation and the cantons (states). The reform objectives were to renew Swiss federalism, giving cantons more autonomy over a number of policy areas, while achieving a better balance between rich and poor cantons and better collaboration in service delivery across cantonal borders. The reform had several elements. It aimed at *i)* disentangling a number of policy areas that had been jointly funded and regulated by the federal and cantonal level, *ii)* introducing a horizontal and vertical equalisation fund to equalise tax-raising capacity and public service cost across cantons, *iii)* obliging cantons to collaborate in public service provision, and *iv)* introducing new management techniques in the remaining joint tasks (Box 11.1).

The main factors driving the success of the reform were:

- *Good economic and fiscal conditions during reform adoption*. In the years preceding the reform in the 1990s, Switzerland experienced weak economic growth and increasing fiscal imbalances. Structural reforms that aimed at restoring fiscal sustainability were passed; including saving programmes and tax increases, and a stringent fiscal rule, the "debt brake", was introduced in 2001. However, when the reform was adopted, the economy performed better and budgets returned to surpluses, allowing both the federal government and the wealthier cantons to fund additional spending and to "buy" the reform.
- *Reform ripeness*: The reform was overdue. The former system of fiscal relations, dating from 1959, could neither deal with recurring issues, such as disparities between wealthy and poor cantons, nor with emerging ones, such as the specific needs of urban areas. Cantons repeatedly complained about a reduction in their spending autonomy, but attempts in the late 1980s to change the indicators determining grant allocation, which restrained spending flexibility, led nowhere. In the mid-1990s, several federal-cantonal financial management pilot programmes were set up, showing both the desirability and feasibility of a wide-ranging reform.
- *Bundling*: The reform was strongly shaped by Switzerland's political system, which allows opponents of reform considerable leverage. To secure its success, various elements catering to specific stakeholders had to be bundled to gain support for the reform package. While equalisation was strengthened, stringent caps on total payments from the federal government and net payer cantons were set. With bundling, a majority of cantons were likely to benefit from the reform, both wealthy and poor as well as urban and rural ones.
- *Administrative leadership*: Administration, rather than political, officials instigated the reform, and claimed ownership of it. External experts were asked to report to the administration and were relatively tightly controlled. The government set up a framework that gave federal and cantonal finance ministries strict control over reform

proposals. The reform also resulted in a power shift from the federal line ministries to the Ministry of Finance.

Box 11.1. **The Swiss reform of fiscal equalisation and of task allocation**

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

- *Disentanglement:* Responsibility for a number of tasks in policy areas such as education, social security and transport infrastructure – previously funded and regulated jointly by the federation and the cantons – were allocated either entirely to the federal or to the cantonal level. Since the federal level was funding its share of joint tasks through a set of intergovernmental grants, disentangling resulted in a decrease of grants by about 40% from their pre-reform level.
- *Fiscal equalisation:* A new fiscal equalisation system was introduced, consisting of three elements: *i)* a horizontal equalisation fund financed by cantons with above-average tax raising capacity and granting payments to cantons with below-average tax raising capacity, *ii)* an equalisation fund financed by the federation for cantons with below-average tax-raising capacity, and *iii)* a federal equalisation fund for cantons with high geographic-topographic or socio-demographic spending. To compensate for the additional federal spending linked to the vertical equalisation fund, the federal government reduced the cantons' share in the federal income tax from 30% to 17%.
- *Horizontal collaboration:* The federal level obtained the right to coerce cantons into horizontal collaboration and joint funding in selected policy areas, such as higher education and health care, in order to reduce externalities and free-riding of cantons and to improve collaboration on service provision across cantons. However, the federal level may only intervene if a certain number of cantons call for it.
- *New fiscal management:* A number of public finance and new public management techniques were introduced into the remaining joint policy areas where formal collaboration is still required, such as standard and norm cost accounting or performance contracting. In the latter case, policy objectives (*e.g.* on environmental protection) were established jointly between the federation and the cantons, and implementation was left to the cantons.

In addition, a transitional "cohesion fund", to be phased out over the next 28 years, was created aimed at compensating cantons that were net losers of the reform. Also, a new budget rule stipulated that the size of the horizontal equalisation fund should be between two thirds and 80% of the size of vertical equalisation. Every four years, parliament will have to decide on the size of the three elements of equalisation. While the reform covered the spending side of the federal budget – and grant revenues for the cantons – the federal tax system, tax assignment across government levels and cantonal taxing power remained untouched, except for the lower cantonal share in the federal income tax.

Context of the reform

Framework conditions

The reform and the reform process have to be seen in the light of Switzerland's political system, that is, a coalition government encompassing the main political forces, direct democracy and strong constitutional powers at the cantonal level. The parliament has two chambers, the second of which represents the cantons. Constitutional amendments, like those put in place by the reform, have to be submitted to popular vote, where they require approval both by a majority of voters and by a majority of cantons. This gives the currently 19 fiscally weak cantons particular power. The reform touched at the heart of the Swiss institutional system, since the actors and interest groups most directly affected were the constituent elements of the federation. More than for most other structural reforms, cantonal majority rule was at the centre of attention, since the "new fiscal equalisation" aimed to find a new equilibrium between the cantons and to a lesser extent between the federation and the cantons. It was thus clear from the outset that the reform could only pass the various political hurdles if it offered financial and non-financial benefits to a sufficiently large majority of cantons.

The economic and financial context helped make the reform possible. Globalisation, particularly the emergence of the European single market, exacerbated competition between jurisdictions, for which the intergovernmental institutional and fiscal framework was deemed to be ill prepared. Moreover, throughout the 1990s, Switzerland experienced weak economic growth and increasing fiscal imbalances, which put some pressure on governments to act. Several structural reforms that aimed at restoring fiscal sustainability were passed during this period, including saving programmes and tax increases, and a stringent fiscal rule, the "debt brake", which was introduced in 2001. Although the new fiscal equalisation reform was not seen as a cost-saving device, policy makers often hinted at the long-term efficiency effects of the reform of federal cantonal relations. Views differ on whether weak economic performance made the reform possible and to what extent political approval, at a time when public finances were in good shape, helped pass the reform. Some interview partners argued that the reform passed only because during the adoption period, growth was sustained and both the federal and the cantonal tills were full, thereby weakening opposition from fiscally strong cantons.

Issue history

The system of intergovernmental relations dating from 1959 was considered both inefficient and unbalanced. Fiscal relations and fiscal equalisation consisted of a set of earmarked matching grants in all policy areas with joint federal-cantonal responsibility. To reduce differences between rich and poor cantons, grants were inversely related to fiscal capacity. The grant system – mixing up joint funding and equalisation – had several drawbacks: *i)* matching gave cantons an incentive to increase spending in order to obtain more grants; *ii)* although matching was inversely related to fiscal capacity, the equalisation effect was negligible, since rich cantons spent more on subsidised services than the poor ones; *iii)* the increasing number of policy areas carried out and funded jointly by the federation and the cantons eroded cantonal autonomy; and *iv)* the indicators measuring tax-raising capacity gave an incentive to cantons to raise tax rates. The term "executive federalism" was often used to describe the reduced policy-making power of the cantons. Finally, because the system had become so complex and opaque, no precise information on

the equalisation effect was readily available, and investigations into its efficiency had never been conducted. Initial attempts in the late 1980s to change the indicators determining grant allocation had failed, since they did not address the system's fundamental flaws.

At the beginning of the 1990s and later, during the reform process, several new policy issues had emerged. During the 1990s, transfers had grown more rapidly than total government spending and the cantonal share in federal taxes, putting pressure on the federal budget (Table 11.1). Although the rich-poor divide still ran essentially between rural and urban cantons, the urban cantons increasingly had to cope with the cost of education, unemployment and immigration, and social welfare budgets soared, especially in the crisis years in the first half of the 1990s. While the existing equalisation system took the cost of geography and infrastructure into account – favouring mountainous and rural cantons – it neglected the socio-demographic burden of urbanised jurisdictions. Simultaneously, some urban and agglomerated cantons started to complain about territorial externalities, *i.e.* other cantons free-riding on services without proper compensation. Despite numerous voluntary agreements on inter-cantonal service provision and compensation, some cantons argued that horizontal collaboration had to be backed by federal "soft coercion".

Table 11.1. **In Switzerland, transfers outpaced federal spending**

Transfers and tax sharing as a percentage of federal spending, 1990-99

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
	In billion CHF									
Total federal spending	31.6	35.5	37.8	40.6	41.6	40.9	44.2	44.4	47.0	46.3
Transfers	Per cent of federal spending									
Conditional transfers	18.2	18.9	18.0	17.8	18.5	19.0	20.3	20.8	20.4	21.9
Tax sharing	7.3	7.2	7.6	6.8	7.2	7.0	7.0	7.1	7.2	7.4
Total transfers	**25.5**	**26.0**	**25.6**	**24.6**	**25.7**	**26.0**	**27.3**	**27.9**	**27.6**	**29.3**

Source: Blöchliger and Reschovsky (2002).

Actors and interests

The two main actors in the reform process were the cantons, represented by their intergovernmental bodies, the Conference of Cantonal Governments and the Conference of Cantonal Finance Ministers, and the federal Ministry of Finance. The cantons as a whole had a larger stake in the reform, as it was likely to promise them both more spending autonomy and a more balanced distribution of fiscal resources, while the Ministry of Finance saw for quite a while the reform primarily as a cantonal pet project that only required technical assistance. Political support at the federal level was weak for a long time. Since at an early stage of the reform process, the different actors had decided that the reform should not entail a net redistribution of fiscal resources between the federal and the cantonal level – a principle that was disregarded only at the last minute of policy formulation – the two main actors actually never met in a confrontational manner. The local level played a minor role, as it was not directly touched by the reform, but was invited as an observer, and the large cities outlined their position during the reform process. Other interest groups were less affected by the reform, or conflicts were avoided at an early stage. One exception was associations representing the handicapped, which feared that reassignment of the funding for foster homes would entail a reduction in service levels.

The main divide was not between the two government levels but between the cantons themselves. While the reform had to be "fiscally neutral" between the federal level and the cantons *as a whole*, the reform – particularly fiscal equalisation – was certain to have considerable redistributional consequences. The reform would produce winning and losing cantons, and the net fiscal effects for each canton were easy to calculate and hence visible to politicians and the public. Some cantons were not too unhappy with the old system, and for the cantons to find a concerted position in favour of specific reform proposals and reform steps took a relatively long time. While the actual winners of the reform remained relatively silent, the strongest proponents of the reform were cantons with an intermediate fiscal capacity that had stakes neither in the status quo nor in renewed fiscal equalisation but which could benefit from the efficiency gains of the reform. These intermediate cantons acted as the honest brokers of cantonal interests. They overcame reform fatigue within the administration and pushed for a common cantonal stance towards the federal level. The political leadership of cantons, for whom the effect of the reform on their fiscal position was not immediately obvious, is probably one of the factors that helped overcome obstacles to the reform.

The reform process

Policy formulation and administrative set-up

The reform started as an administrative rather than a political endeavour and it did so with modest ambitions. Towards the end of the 1980s, a group of federal and cantonal officials involved in the day-to-day operations of grant allocation to the cantons became increasingly aware of the shortcomings of the grant system, both in terms of efficiency and equity. Their efforts culminated in a first report published in 1992 that set out the framework for a fiscal federalism reform. Based on this report, the administration commissioned a group of academic experts. Their report, published in 1994, showed the old system's weaknesses within the larger context of Swiss federalism: the proliferating grant system and the ensuing loss of autonomy for the cantons; the weak equalisation effect of the grant system; the spending drift due to matching and a costly administration. The report also showed that the persistent shortcomings of the system could not be tackled by a simple reform of intergovernmental grants but required a much broader reform of the federal system. While the experts had delivered a detailed account of the old system, they had to refrain from any proposals for reform, at the explicit demand of the administration. The reform and its elements hence became the intellectual property of federal and cantonal officials rather than of external experts.

The ensuing reform process within the administration relied on consistent and equal representation of both government levels in the reform project group, both at the political and administrative level. In 1996, the federal finance administration jointly with the Conference of Cantonal Governments published the *Lignes directrices*, a report that showed the scope of reforms needed to renew fiscal federalism and to reach the efficiency and equity objectives of intergovernmental fiscal policy. In 1998, a new report was published, again under joint responsibility of the federation and the cantons, articulating the reforms set out in the 1996 report. After that report, the attention turned to the federal level, which was the only authority with the power to legislate the constitutional and legal reforms to amend fiscal relations. All reports were authorised by federal decrees and endorsed at the political level, *i.e.* the federal council of ministers and the Conference of Cantonal Governments, thus providing strong political support.

Within the administration, the reform process was spearheaded by the Ministry of Finance, which chaired the project group dealing with the reform. Since the reform cut across several policy areas, line ministries whose areas were affected by one of the four reform pillars were consulted and collaborated in working groups. However, they were kept away from the conceptual work. The reform process was thus sometimes perceived as a game between the cantons and the Ministry of Finance. The ministry's lead also ensured that economists played an active and pivotal role during the reform process. It was mostly the work of a small group of economists – either within the federal finance administration or external experts – that inspired the various reform steps, preventing specialists in other academic fields from presenting reform alternatives. Academic experts in constitutional law were almost entirely excluded. Despite their sometimes outright hostility to the reform in its final phase, the closed shop helped preserve the project's consistency and its appeal to politicians and the public at large.

Bundling

Bundling was a key element during the negotiations, as it helped reduce distributional conflicts and bring diverging interests on board. The administration presented reform proposals and their variants together with an analysis of the short-term financial impact, known as the "global balance". The global balance became a central tool for reform negotiations. Although the administration often played down the global balance and was quick to show the long-term efficiency benefits of the reform, it had to address the highly visible short-term distributional issue and to offer selected advantages to as many stakeholders as possible. Bundling hence reflected both the need to tackle unwarranted distributional conflicts as well as the desire to offer clearly visible long-term benefits to selected jurisdictions. As such, the reform package comprised the following elements:

- Fiscal equalisation appealed to the cantons with low tax-raising capacity. To bring the richer and more urbanised cantons on board, an equalisation fund for specific socio-demographic burdens was added towards the end of the reform process. This fund eased budget pressures associated with high social welfare spending.
- To tackle fears of ever-growing demands for fiscal equalisation, upper and lower limits on the size of the horizontal equalisation fund were set. Horizontal equalisation, to be paid by the cantons with above-average tax-raising capacity, should be within two-thirds and 80% of the amount of vertical equalisation. This constitutional rule is supposed to forge a link between the federal level and rich cantons against strong demands for equalisation from poorer cantons.
- Disentangling competences brought on board fiscally strong cantons interested in more spending autonomy. The federal level was also interested in disentanglement and grant reduction, as it reduces the administrative burden.
- The rule on horizontal collaboration offered a net gain to the urbanised cantons, because it would ensure that at least part of their territorial spill-overs (services provided across jurisdictional borders) would be funded by adjacent cantons.
- In sum, many reform elements were taken up explicitly to reduce opposition from richer and more urbanised cantons to the additional burden of fiscal equalisation. The reform was encompassing and wide-ranging, not least because widely divergent stakes and positions had to be balanced against each other. Once the four pillars had been accepted, the necessary popular and cantonal majority was not yet assured: towards the end of the

reform process, the federal government had to introduce a transitional cohesion fund (*fond de rigueur*) in partial compensation to all cantons whose fiscal balance would be negatively affected by the reform. While the cohesion fund ensured that almost all cantons would be net winners for an extended period of time, and thereby reduced cantonal opposition considerably, it violated the principle of fiscal neutrality between the federal and cantonal level. This made the federal level, *i.e.* all Swiss taxpayers and hence the least organised and weakest interest group, the principal underwriter of the reform. Still, as some interview partners observed, the cohesion fund, a political compromise, which was intended to be in place only for a limited period, helped to preserve the reform's long-term integrity.

Finally, some opposition ensued from interest groups other than cantons, mainly on the disentanglement and grant reduction issue. The proponents of reform eschewed conflicts with some well-organised groups and agreed to maintain joint federal-cantonal funding in areas such as natural and cultural amenities, social security and housing. Some demands were not honoured, however: the demand of associations of the handicapped for continuing federal involvement in the funding of homes and special educational institutions was rejected. The federal level was only prepared to set minimum standards for cantonal homes – akin to an unfunded mandate – and opposition from the handicapped remained fierce until the vote had passed. In general, disentanglement and grant reduction was the most problematic reform aspect, because many actors and interest groups, occasionally including the two government levels, had no obvious interest in increasing fiscal transparency and accountability.

Political leadership

The push for reform was driven by a few political leaders both at the federal and the cantonal level. At the beginning, political support was stronger at the cantonal than at the federal level, reflecting the stronger interest of the cantons in the reform. Several cantonal finance ministers supported the reform publicly over longer periods and pushed for continuation at critical junctures when the project ran out of steam. The fact that the ministers came from different types of cantons (large/small, etc.) and that none had a strong personal stake in the reform increased their credibility among other cantons and the public at large. Political support from the federal level grew towards the end of the 1990s. Two finance ministers in succession made strenuous efforts to finalise the project and to prepare the various bills, and defended the project publicly.

Party politics played a minor role, since the reform did not translate into the usual left-right polarisation. Party leaders barely spoke about the reform, whether pro or con, before and during the voting campaign. All the same, the reform was more closely affiliated with the centrist and right-wing parties, which were more interested in reviving federalism and cantonal fiscal autonomy. Interest groups such as employers' associations and trade unions were virtually unaffected, and played a secondary role. The only interest groups vigorously opposing the reform were the associations of the handicapped, which objected to the cut in federal subsidies for social assistance.

Adoption and implementation

Given the importance of the reform, the federal government decided to pass it in stages. In 2001, the government presented the 27 constitutional amendments needed to obtain the green light in parliament for the four main reform elements, and the popular

vote was held in 2003. Simultaneously, the federal government presented the new fiscal equalisation law, which was also passed by parliament in 2004. The constitutional vote passed with a majority of 65% of the population, and only three cantons objected. In 2005, the government presented parliament with a set of 37 laws, which had to be adapted following adoption of the constitutional amendments, and the parliamentary vote was held in 2006. Finally, in 2006, the government presented the size of the horizontal and vertical equalisation funds, for which the parliamentary vote was held in 2007. At each stage, the federal government aimed for maximum transparency. For instance, when voting on the constitutional reforms in 2003, the electorate had already been informed about the consequences of the various laws, and when voting on the laws, information on the subsequent steps was made available.

The constitutional and legal reforms, including executive decrees, were implemented from 2007 onwards, most without particular delays. Minor technical problems arose with the collection of data for determining the cantons' tax-raising capacity. An amendment to the fiscal equalisation law is now under discussion in order to set rules on how to deal with data errors. In addition, one of the four reform pillars, coerced horizontal collaboration, came under attack from parliamentary commissions, partly as a result of its own success (many horizontal agreements had been concluded in the previous few years), but was finally turned down by parliament in 2010. As predicted, the cantons have reacted to the new institutional framework and the new autonomy in various ways, such as by changing tax rates, by changing spending levels or by paying back debt. Several cantons started to reform fiscal and institutional relations with their municipalities, including territorial reorganisation like municipal mergers and the establishment of jurisdictions covering urban agglomerations.

Communication

Communication was an important strategic consideration in bringing the reform to the public. Communications experts helped to elucidate the policy behind the technicalities. Catchwords such as "strengthening federalism", "increasing autonomy" and "more equity among cantons" were frequently invoked. The complexity of the issues also made it easier to influence opinion makers. Journalists were invited to seminars where details of the reform were laid out by experts and officials from the various ministries involved. Since opinion leaders and the public at large generally favoured federalism, it was possible to build trust around the project. As a result, the media overwhelmingly backed the reform. Arguably, without the personal commitment of communications experts within and outside the administration, and their collaboration with political leaders, the reform would have gone unnoticed and probably failed in the popular vote.

Conclusions

The new fiscal equalisation and responsability assignment framework was one of the farthest-reaching institutional and fiscal reforms since the creation of the federation. More than 15 years passed between the first steps of the federal and cantonal administrations and the point at which one-eighth of the Swiss constitution was amended. The lengthy reform process made it possible to integrate all relevant stakeholders and was flexible enough to respond to new policy challenges, like the crisis of over-spending in large cities. Rather than create sustained opposition, bundling the reform offered several win-win situations and weakened or split potential veto candidates by limiting the number of well-

identified losers. Favourable economic and fiscal conditions allowed the federal government to provide higher transfer to the cantons, which reduced opposition. The support of a few political leaders, both at the federal and the cantonal level, and the strategic leadership of the finance ministry and a few associated economists helped to keep the reform process on track. Sequencing and transitional compensation made the reform easier to digest for voters, although the course of reform was basically set at the first vote on the constitutional amendments. Since the reform passed, its various elements have been implemented without encountering much resistance, apart from some minor technical problems related to the determination of cantonal tax-raising capacity. Finally, the reform encouraged several cantons to reform their own cantonal-municipal fiscal relations and to increase the efficiency of local public finance.

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Australia

Commonwealth Central Agencies

- Commonwealth Department of the Treasury: Commonwealth-State Relations Division
- Department of the Prime Minister and Cabinet: COAG Unit
- Department of Finance and Deregulation: Deregulation Group

Commonwealth Portfolio Agencies

- Department of Education, Employment and Workplace Relations
- Department of Families, Housing, Community Services and Indigenous Affairs: Strategic Policy Branch
- Department of Health and Ageing: Portfolio Strategies Division

State First Ministers' Agencies (New South Wales, Queensland, South Australia, Victoria, Western Australia)

- Department of the Premier and Cabinet: Policy and Strategy Division; National Reform Unit; Intergovernmental Relations Unit

State Treasuries (New South Wales, Queensland, Victoria, Western Australia)

- Department of the Treasury and Finance: National Reform Branch; Statistics Unit; Tax and Intergovernmental Relations Division; Economic and Financial Policy Division; Revenue and Intergovernmental Relations

State Portfolio Agencies (New South Wales)

- Department of Education and Training: External Relations Policy

Academics

- University of Canberra: National Institute for Governance
- University of Sydney: Constitutional and Public Law
- Griffith University: Center for Governance and Public Policy

COAG Reform Council

Business Council of Australia

Austria

- Federal Ministry of Finance, fiscal constitution and equalisation division
- Statistik Austria

- State governments of *Vienna* and *Niederösterreich*
- WIFO Austrian Institute for Economic Research
- Cities' association (Österreichischer Städtebund), municipal association (Österreichischer Gemeindebund)

Belgium

- National Bank of Belgium
- Private office of the Minister of Budget
- Private office of the Minister of Finance
- Ministry of Finance
- Secretariat General of the Catholic Education
- Academics: Facultés Universitaires Notre-Dame de la Paix, Université de Mons-Hainaut, Katholieke Universiteit Leuven, Vrije Universiteit Brussels

Canada

- Canadian Delegation to the OECD
- Finance Canada: Tax policy branch; Federal-Provincial Relations and Social Policy Branch;
- Chair of the Expert Panel on Equalization and Territorial Formula Financing

Denmark

- Ministry of the Interior and Social Affairs
- Experts

Finland

- Ministry of Finance: Economics Department; Budget Department; Department for Municipal Affairs
- Association of Finnish Local and Regional Authorities
- Academics: VATT (Finnish Institute for Public Finances); University of Tampere

Italy

- Department for Development and Cohesion Policies, Ministry of Economic Development
- Bank of Italy: Structural Studies Department, Public Finance Division
- Institute for Regional Studies, National Research Council
- Association for the Development of Southern Italy
- National Association of Italian Local Government
- State General Accounting Department
- Regional Governments of Basilicata and Emiglia Romagna

Portugal

- National Court of Accounts
- Secretary of State of Tax Affairs

- Ministry of Finance: Center for Tax Studies
- Members of the LFL Working Group
- Academics: University of Lisbon; Economic and Business School of Lisbon
- Municipal administration (Municipality of Sintra): Finance directorate

Spain

- Ministry of Finance: Territorial Financing
- Regional ministry of finance (Cantabria Autonomous Community)
- Council for Fiscal and Financial Policy
- Academics: Rey Juan Carlos University; Universidad Nacional de Educación a Distancia; University of Barcelona
- Autonomous Communities Financial Studies

Switzerland

- Federal Finance Administration
- Presidency and Ministry of Finance of the Canton de Vaud
- Academics and members of a former expert group
- Conference of Cantonal Governments

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