Summary

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The OECD Network on Fiscal Relations across Levels of Government has made significant progress in creating international statistics on regional and local government finances and the OECD staff has produced a number of thoughtful papers offering interpretations of what can be revealed by these data.[1]

To identify what issues deserve the attention of the Network, the OECD, with the support of the Korean Institute of Public Finance arranged an expert meeting in Paris on 10-11 March 2011. This volume contains the papers presented at the meeting.

The invitations to the meeting laid out two specific issues for the workshop. The first was the taxonomy of intergovernmental grants. In the literature a consensus has not yet been reached on the taxonomy of intergovernmental grants. The participants in the workshop were expected to identify the shortcomings of the existing classifications and discuss ways on how this situation can be improved so that an internationally shared terminology could be agreed upon.

The second and related issue was on measuring fiscal decentralisation. International statistics on local finances would be useless, if they did not measure the degree of decentralisation that could be tested against presumed advantages of decentralisation such as enhancing economic growth, public sector efficiency, or citizens' satisfaction. In this regard, the data produced by the OECD, especially the measure of taxing power and the beginning of a measure of spending power of sub-national governments, has made contributions.[2] However, the current measurement of fiscal decentralisation, especially on expenditure decentralisation and intergovernmental grants, are not yet very satisfactory, as discussed in Rodriguez-Pose and Ezcurra (2010) and Baskaran (2010).[3] The lack of consensus on a taxonomy of intergovernmental grants surely compounds this problem. Methodologically, there has been some effort to improve the accuracy of measuring fiscal decentralisation (see, *e.g.* Martinez and Timofeev, 2010). However, as an original source of useful international data, the OECD Fiscal Network faces challenges and opportunities to improve the situation.

In summary, the workshop was expected to discuss two topics: *i)* internationally accepted and understood definitions like the distinction between grants and tax sharing, or the distinction between general grants, block grants, and non-conditional earmarked grants; and *ii)* the issues related to measuring and comparing indicators of fiscal decentralisation.

Hansjörg Blöchliger of the OECD reviews in his paper the Network's statistical work which he sees as serving the objective of comparing sub-central governments' power to shape their own budget across countries. He presents 2005 data on local tax revenues for 30 OECD countries, describing both the types of taxes used by sub-central governments

(SCG) and the composition of tax sources entering tax sharing arrangements.[4] He identifies problems of comparability that are not easily resolved in two cases. In some countries, SCGs have the right to vary tax rates but actually set the same rate (see also *Borge* in this volume). On tax sharing revenues, he concludes that institutional arrangements that are country-specific have made it difficult to agree on a definition as to whether an arrangement is tax sharing or a grant (see also *Spahn* in this volume).

He then turns to the "flowering garden" of intergovernmental grants that has evolved. He first presents 2006 National Accounts data for grants by sector and recipient sub-sector for 30 countries. He then presents 2006 Fiscal Network data for 19 OECD countries that are supplemented with information on the government functions for the grants. He proceeds by summarising the many Network discussions on the dividing line between tax sharing and grants. He concludes that the issue has not yet been resolved and "what counts as tax sharing in one country may count as intergovernmental grant in another". *Blöchliger* also refers to a recent study on sub-dividing tax sharing revenues – "strict tax sharing" and "redistributive tax sharing" – the former being the case when the revenue is strictly proportional to what is generated in sub-national jurisdictions, while the latter involves redistributive elements. The empirical estimates show that more tax sharing arrangements pass under "redistributive tax sharing" than under "strict tax sharing."

Finally *Blöchliger* describes a pilot study by the Network on local spending power from 2009. He first observes that the local share of general government spending does not reflect differences in the degree of local governments' decision-making power on local expenditure. He identifies five categories that affect local spending power such as policy autonomy, budget autonomy, etc., and measures the degree of autonomy in each category based on survey results provided by five countries. The results "support the view that simple expenditure ratios often poorly reflect effective sub-central spending power".

All taxonomies for grants to sub-central governments are structured around the distinction between earmarked and general grants. The purpose is to distinguish grants according to the freedom they allow SCGs in shaping their budgets. But though it is generally accepted that local freedom is to be preferred, available data suggest that earmarking is – if anything – on the increase. Why is that? *Jorgen Lotz* in his paper identifies the drivers for policies of earmarking, and the strongest driver he finds is the desire for "marginal equalisation", *i.e.* the desire to compensate SCGs for the costs of new competences in such a way that the compensation is allocated to those suffering the largest costs from the new competence.

Lotz next asks: How good is the Network's taxonomy of grants to measure the degree of local freedom? He lists five problems with the grants taxonomy used by the Fiscal Network. First, the distinction between own tax revenues and tax sharing depends not only on the power of SCGs to set local taxes but also on whether the SCGs utilise the freedom they have to set tax rates (*Borge* and *Blom-Hansen* in this volume). Second, if there is a correlation between reforms to replace earmarked with general grants and a tendency to increase the stringency of regulations, the shift to general grants does not necessarily result in more local freedom. Third, the imprecise definition of "block grants" means that it is interpreted differently by different respondents to the OECD questionnaire.[5] Fourth, results-based matching grants that give incentives to a more efficient local allocation of spending need to be distinguished from matching grants that lead to inefficiency. Fifth, agent functions delivered by SCGs with no local discretion and financed by 100% matching grants are better classified as expenditure at the central level:

when agent functions are described as a local expenditure financed by matching grants, it paints a picture of a very different policy (see also *Spahn* in this volume). After identifying these problems of the OECD's current grants classification, he discusses ways to overcome these problems.

Junghun Kim, stresses in his paper the importance of measurement of fiscal decentralisation with consistent criteria across countries. Understanding the effect of fiscal decentralisation is very important since it is one of the most important fiscal institutions and affects economic performance and welfare of the citizens. In particular he emphasises the need to describe more appropriately the differences between the many different models of tax sharing. Tax sharing is one of the largest local revenue sources in many countries. A discussion of the merits of tax sharing must take into account that tax sharing in China has been held to serve as an effective fiscal incentive for local economic growth, and the general grants in Japan and Korea are – according to the OECD classification – tax sharing revenues. A discussion of tax sharing, *Kim* adds, also needs to include the more fundamental question regarding its role as a local tax. Tax sharing does not provide any price signals for the delivery of public services to the local population (*Longobardi* in this volume). Recognising the work already done by the Network (*Blöchliger* in this volume), he observes that the different tax sharing practices leave many unanswered questions that require more research.

Nobuo Akai focuses on the problems of creating an index of fiscal decentralisation that can be used to test the relationship between the degree of decentralisation and economic growth or other effects. He presents a brief survey of the problems in using the revenue share, the expenditure share or combinations of these as indices of decentralisation. He describes how, in the Network taxonomy of grants, the effects on local incentives depend on whether the grant is classified as earmarked or general. The latter do not affect local decisions since they do not change relative prices. *Akai* points out that this is not always correct since general grants may result in incentive effects when they are designed in such a way as to result in soft budget constraints. If the transfer is designed and allocated *ex post*, after local governments have undertaken specific actions, the *ex post* lump sum transfer may be regarded as a conditional transfer and result in a soft budget constraint. He gives two examples of this. One is the problem created by adverse selection based on hidden information: if the higher level of government has the authority to start the project and an incentive to bail out the local government *ex post* because of the importance of continuity of local services, the local government may have an incentive to misrepresent the costs of the project. His other example is the problem created by moral hazard: If the higher level of government has an incentive to rescue a relatively poor local government in order to reduce regional disparity, the poor local government may have an incentive to decrease its efforts to provide local services *ex ante*. He concludes that a taxonomy of transfers is complicated and indices of fiscal decentralisation should be designed taking into account how the transfers are designed from the *ex ante* or the *ex post* points of view.

Liu Yongzheng, *Jorge Martinez-Vazquez* and *Andrey Timofeev* develop the discussion further and survey a number of cross-country studies from the literature. Their survey concludes that aggregating many dimensions of decentralisation leads to a loss of information in the form of lower explanatory power. Empirical studies show that the introduction of more variables like the importance of grant financing, fragmentation of local government and other non-fiscal variables improves the decentralisation indicator, but the main point is that there is no single best measure of decentralisation. The choice of the indicator of fiscal decentralisation matters. The point is illustrated with an analysis of the US states.

Paul Bernd Spahn illustrates the inadequacy of simple indicators of fiscal decentralisation by comparing the local revenue shares of Germany and Uzbekistan. While the revenue ratio is higher in Uzbekistan, the country has a strict vertical command structure from top to bottom and no local discretion, while in Germany local authorities are self-governing and strong. A comparison based on simple ratios therefore is deficient. There is a need to include also local democracy and citizens' participation, regulatory powers, and the like. One way to improve the simple ratios would be, he proposes, to give weights to the individual items in the OECD classification of taxes: 1 for pure own taxes and 0 for pure tax sharing arrangements. He argues, referring to the ample discussions in the Network, that the definition of taxes versus grants "cannot simply reflect an idiosyncratic legal interpretation by one country's lawyers". The answers must depend on what we want to measure, and the rationale of the revenue-oriented index is to indicate the degree of local tax autonomy while the expenditure related index should take account of whether local expenditure are autonomous or mandated. All spending mandated by the central government should therefore be excluded from the local budgets (*Lotz* in this volume). He expresses the view that a more comprehensive approach is needed, and points at the need to draw in policy outcomes, institutional aspects, and macro-fiscal indicators together with weighted fiscal measures.

Lars Erik Borge discusses some shortcomings of the Network revenue classification seen from the Norwegian perspective. Here the rate of the local income tax is free but subject to an upper limit, and since 1979, all municipalities have applied the maximum rate. Should the classification, as done by the OECD, follow the formal rule that there is local autonomy or follow the practical interpretation that there is no variation? *Borge* argues that it should be classified as a tax sharing arrangement to distinguish from the data for the other Nordic countries, but he declines to classify it as a general grant because it is allocated according to origin and hence leaves incentives for municipalities for the development of their local tax base. A particular point he raises is the Network classification of VAT-compensation as an earmarked grant, which he argues convincingly it is not. And finally *Borge* argues that, when an indicator is used to test the effects of fiscal decentralisation on economic growth, the index should reflect the local incentives for improving their own tax base.

Jens Blom-Hansen applauds in his paper the focus of the Network statistics on the degree of local autonomy. But he warns that the concept that the local authorities have the right to set their own tax rates is more complicated than generally believed. He describes the efforts of the Danish government to limit local taxation freedom gradually without changing the income tax law that stipulates such a freedom for the local authorities. He concludes that "taxation rights of Danish local governments today are effectively controlled by the central government and only marginal adjustments are possible". He concludes that "as the Danish case shows, the effective central regulation of local taxation rights can be quite complex". So it is not, he argues, enough to focus on official rules in national tax codes. Referring to a recent study on the political autonomy of regions, he adds that a valid measure of local taxation power has been shown to be "intimately connected to local autonomy in general".

Ernesto Longobardi provides analytical insights into the status of the ongoing reform of intergovernmental fiscal relations in Italy. The reform is mainly characterised by the movement from grants towards tax financing intended to improve accountability. When applied to the Network taxonomy on taxing power, he shows that the effective increase in infra-marginal tax autonomy due to the reform will be quite modest, but at the margin, where autonomy really matters, there will be enough room for accountability to improve. The main problem in Italy is that both the centre and the local governments fear the introduction of local tax autonomy: the former out of fear that the electorate will fail to properly distinguish the different fiscal responsibilities and the latter because they would prefer not to have to tax their inhabitants.

Altogether the papers in this volume recognise the merits of classifying grants and producing fiscal decentralisation indices currently used, but also indicate the limits of their applicability. In particular, country-specific variables such as hidden regulations of the central government, the inefficient design of general grants, and the degree of autonomy in general seem to make cross-country comparisons of grants and the degree of fiscal decentralisation quite challenging and often bring about misleading interpretations. Future challenges therefore lie in incorporating diverse dimensions of fiscal decentralisation such as the legal, political and regulatory structure into grants classifications and measures of fiscal decentralisation.

Notes

1. Recent examples of such papers are: Blöchliger and King (2007); Bergvall *et al.* (2006); Charbit (2010); and Blöchliger and Petzold (2009).
2. See Blöchliger in this volume and, for example, Stegarescu (2005) and Thornton (2007).
3. It is worth noting that, in a recent study on the effect of fiscal decentralisation on economic growth, Rodriguez-Pose and Ezcurra uses Government Finance Statistics of the IMF since there is "no reliable alternative".
4. The classification of local tax revenues basically conforms to the definitions of OECD (1999).
5. The definition of block grants in Bergvall *et al.* (2006) was "mandatory and non-earmarked grants" with the additional explanation that it is given for a specific purpose (or purposes), but its actual use is not controlled. The OECD Network tried to reduce the confusion involved in the definition and in 2011 changed it to "earmarked, mandatory, non-matching grants". But, since there are so many different types of "block grants", the issue of uncertainty still remains (see Kim, Lotz and Mau, 2010).

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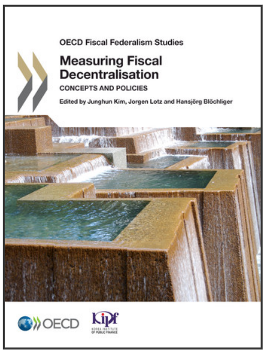

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