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FISCAL DECENTRALISATION IN EUROPE:

A REVIEW OF RECENT EXPERIENCE

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Introduction

In this paper we review countries' diverse experiences to draw conclusions on the pitfalls and opportunities that are open through decentralisation of governments' fiscal responsibilities to sub-central jurisdictions. We begin by reviewing the theoretical arguments for and against the decentralisation of spending responsibilities. We also provide a cross country comparison of the extent to which spending powers have been devolved in a range of European countries, putting each country's position into a wider context. Second, we review some insights from the theory of fiscal federalism on fiscal autonomy and assess the extent of autonomy at sub-central tiers of government in the same set of countries. We discuss the approaches that have been followed, and a number of the difficulties that particular countries have faced, as the fiscal autonomy of sub-central tiers of government has evolved. Our conclusions are set out in the final section.

Decentralisation of Spending Responsibilities:

Motivation

In several cases, decentralisation has initially been motivated by political concerns, for example, in Spain it was seen as an essential part of the democratisation process. Elsewhere too, decentralisation has been a response to pressures from regional groups for more participation and control in the political process. At the extreme, it can represent an attempt to keep a country together in the face of such pressures either by granting greater autonomy to all regions, or, as in Spain, Italy and the UK, by forging asymmetric devolved powers. In these and other cases, important economic objectives include a wish to improve service delivery and to address perceived limitations of centralised administration. A more macroeconomic motivation relates to separation of issues of constraining the size of government, as determined at the centre, from issues of how to allocate a given level of spending, which may be determined at sub-central level.

The economic theory of decentralisation draws on contributions by Tiebout (1956), Musgrave (1959) and Oates (1972), an excellent overview is provided in Oates (1999). While there is broad agreement that central government should have responsibility for macroeconomic stabilisation, overall redistribution, and for functions providing clear collective benefits or spillovers (such as national defence, international relations and R&D), a key presumption made by supporters of decentralisation is that centralised provision in other areas

can be too uniform and relatively inflexible in the face of potentially diverse regional preferences and needs. Decentralisation can aim at increasing the role of those with greater knowledge of local preferences so that fiscal decisions made at the sub-national level better reflect regional diversity.

Given regional diversity, Tiebout's (1956) model of revealed preference predicts that consumers will choose to locate in jurisdictions that provide them with the mix of public services that maximise their welfare. The intention is that citizens who are dissatisfied with the pattern of provision in their area can, if they wish, move to areas where the pattern suits them better. So under certain assumptions, diversity of provision combined with consumer mobility can lead to Pareto optimal provision.

In many respects the notion of 'subsidiarity', as proposed in the Maastricht Treaty and reasserted in the Amsterdam Treaty through the notion of bringing decisions as close as possible to the citizen, relates closely to this concept of efficiency in public service provision. The notion has received further impetus, both within individual EU states and from the EU's Committee of the Regions. An additional benefit of bringing decisions closer to citizens is that this may promote their involvement in the democratic process, see for example, Tanzi (2000).

The greater sensitivity of sub-central governments to local preferences may enhance the ability of the provider to identify both recipients and citizens' willingness to pay. It is argued that people will be more willing to pay for services that they find to be responsive to their priorities, especially if i) they have been involved in the decision making process, and ii) if costs are clearly perceptible in that process. So, in short, decentralisation may result in a closer approximation to the efficient solution of provision to the point at which the marginal costs and benefits of provision are equated.

Theory also has something to say about the optimal size of sub-central governments. Oates' (1972) classic work on fiscal federalism suggests that jurisdictions should be designed, and the assignment of public expenditures should be carried out, in such a way that provision is the responsibility of the jurisdiction representing the smallest possible area over which the benefits are distributed. Complete application of this principle would suggest that different services would be associated with jurisdictions of different optimal sizes. Obviously other inefficiencies would result from a multiplicity of tiers of government, but they key

principle is that the size of the sub-central tiers should be chosen to be suit the broad range of services provided.

Finally, it has been suggested that decentralisation can foster innovation, in so far as diversity may result in greater experimentation and innovation in provision, and provide valuable information about potential improvements in policy design, e.g. through piloting new approaches. Though a necessary feature must then include some mechanism/forum for cross regional sharing of ideas/findings.

Of course, there are arguments that suggest limits should be imposed on the extent of decentralisation of spending decisions. Central government is likely to be concerned about issues of equality of access to public services and uniformity, or at least an acceptable minimum, in standards of provision. These concerns are will be particularly strong in areas such as health and education, not least because electorates tend to perceive the accountability in these areas to lie with central government. Also, to the extent that the economic arguments outlined above motivate shared responsibilities of central and sub-central tiers of government, there may be increased administrative complexity, lack of transparency and potential clashes in competencies. These disadvantages could easily offset potential benefits. Oates' work on optimal size of government suggests that centralised provision is appropriate in areas where economies of scale are pervasive. Areas where there are interregional spillovers also need to be considered carefully; whilst decentralised provision may still be feasible, this is likely to require compensating transfers.

Comparative Evidence

As things stand, there are sharp differences between European economies in the role played by regional and local government in service provision. Tables 1 and 2 provide internationally comparable information from IMF Government Financial Statistics (GFS) on public expenditure by level of government across a number of distinct functions and over time.

[Tables 1 and 2 about here]

The distinction between unitary and federal countries is perhaps more real than apparent. Whilst some federations assign major functions to regional/state jurisdictions, others do not, or retain control over a sub-set

of functions (eg. health in Germany and Switzerland and social security in Austria and Switzerland). In contrast, some unitary countries have engaged in considerable decentralisation.

The figures show that Denmark has the most devolved system among the unitary countries, dating back to progressive reforms that began in 1970 and proceeded through that decade. In 1998, the sub-central tiers, municipalities and counties, accounted for 76% of all public sector staff (European Communities, 2001). The devolved responsibilities extend to the provision of a broad range of services, from primary education to care of the elderly and to the distribution of benefit payments. Daugaard (2002) argues that the pursuit of administrative efficiency, the ability to target services at recipients and political arguments such as the strengthening of local democracy have been important factors motivating this strategy. However, while Denmark is unusual in channelling social transfers through local governments, the central government remains the main payer. Refunds are paid from central to sub-central governments, so in reality the situation is the same as if the state handled benefits through their own local agencies and the incentives for efficiency gains e.g. through better targeting of benefits to recipients are unclear.

Data limitations, Controls, Directives and Shared Competencies

In general some caveats should be borne in mind when looking at GFS data. As noted by Pola (1999) and Ebel and Yilmaz (2002), it is difficult to disentangle the extent to which the raw measures of expenditure decentralisation really reflect local decision-making. First, although GFS provides a breakdown of expenditure by function and economic type, the statistics sometimes include not only expenditure on functions assigned solely to that jurisdiction, but also on those where the local government is simply delivering a service that is effectively controlled by a higher tier of government.

To the extent that central governments continue to be seen, or see themselves, as accountable to their electorate they may fear the consequences of deterioration in standards of provision following decentralisation and may respond by using explicit directives. Common examples of areas in which central government direction goes beyond simple guidance are health and education. In such circumstances sub-national governments should be seen not as independent providers of public services, but as local agencies

implementing central government policies, Tanzi (2001). Unfortunately, where directives are used, the GFS data will overestimate the true extent of fiscal decentralisation.

Controls imposed by central government are also frequently motivated by concerns over equality of access. For example, in Germany fiscal relations predominantly reflect the desire to create broadly equal living conditions across the Federation. Here areas of competencies tend to be shared among tiers of government. For example, on health care, the Federal government sets legal conditions, and provides the funds to finance operating costs for hospitals, while the Länder finance hospital investment and regulate capacity; and the Communities are responsible for delivery of local health care services, Wurzel (1999). There may be a trade-off if shared competencies obscure the accountability of local administrations to citizens.

In France too, shared responsibilities are an important characteristic of provision. For example, in education, the central government determines school curricula, certifies university degrees, administers personnel and makes overall plans for the location of educational establishments; the 22 Régions are responsible for the construction and maintenance of primary schools and lycées (which provide the last three years of secondary education), and for vocational training; whilst 96 Départements are responsible for the creation and maintenance of colleges that provide the first four years of secondary education. Likewise, policing is a shared responsibility of Municipalities (through mayors and gendarmes) and the centre (national police). In general, it is difficult to summarise simply, clearly and precisely how responsibilities are divided among tiers of government in France, but it is fair to say that the allocation across Régions is symmetric and their autonomy is limited. In Switzerland some two-thirds of tasks are shared between the centre, the federal states and the cantons, OECD (1997).

In Germany, Austria and France, the precedence of the equalisation of provision over public choice and economic incentives may leave open the likelihood that resource allocation will remain inefficient and lack discretionary flexibility. In Norway too, whilst provision is on the face of it relatively decentralised, a proliferation of directives, norms and standards reflect concern over equality of access and limit the scope for local governments to adjust to local preferences. It is generally agreed that decentralisation should be carefully designed to be transparent, with clearly defined competencies for different jurisdictions. In areas

where the central government wants to retain a major role in setting standards of provision we would argue it should take back financing responsibility accordingly, and elsewhere it should abstain from detailed regulation. If necessary, setting defined minimum standards should replace notions of standard entitlements and autonomy should be addressed in both spending and financing decisions if potential benefits are to be realised.

Economies of Scale and Cross Regional Collaboration

In general, inappropriate or poorly designed incentives for cooperation could work against any advantages of devolution. Indeed, the OECD has criticised some countries for offering insufficient incentives for cross regional collaboration, leaving scale economies in provision unexploited, see, for example Journard and Suyker (2002a and 2002b). However, in areas with low population density the potential gains from regional collaboration in the provision of services such as primary education and care of the elderly are likely to be negligible, while in more densely populated regions, and more generally in the provision of some other services eg. roads and water supply, cross regional provision is prevalent. In some countries, eg. Finland, voluntary associations result in close co-operation on a regional basis, elsewhere formal cross-payment systems may exist to compensate jurisdictions for providing services to out-of-area recipients.

The Decentralisation Process and Asymmetries

Table 2 shows that across most countries, decentralisation has been stable over time. However, there are some notable exceptions. In Italy, regions were given greater powers in the 1970s and early1980s [1], during which time sub-central government spending doubled from 7 to 14 per cent of GDP (Bibbee and Goglio, 2002). Italian regional governments now have primary responsibility over matters such as health, vocational education and training, economic development, public works and the environment. However, the process has not been smooth. Particular challenges have arisen in the area of regional development, where central authorities have doubted the ability of lower tier administrations to manage investment projects properly, Giarda (2000). In addition, as we shall discuss later, devolution of spending preceded any significant increase in financial autonomy of the regions creating other problems.

[1] Unfortunately GFS data for Italy is not available for this period.

In Spain, as noted earlier, decentralisation became an important component of the transition to democracy embodied in the 1978 constitution and has been progressive. Regional governments' share in general government expenditure rose from 11 per cent in 1980 to 32 per cent (close to the OECD average) in 1997, see Table 2 (and Figure 4b). The progressive transfer of primary and secondary education to Autonomous Communities (ACs) was completed in 2001 and a similar process is set to see the transition of health spending and non-university education to all ACs by 2004. However, many competencies again remain shared between the four tiers of government (State, ACs, Provinces and Municipalities). There is additional complexity in so far as asymmetries remain between the functions assimilated by the "fast track decentralisation" ACs (the Basque country, Navarra, Andalucia, the Canaries and Valencia) and those available to the 10 "slow track" ACs and asymmetries across the "slow track" ACs, which have been given the option to assimilate fewer devolved powers over a more protracted period, see Joumard and Varoudakis (2000). However, it is fair to say that progress is being made on a framework to extend and standardise powers.

In general the UK has imposed considerable consistency on the shape of its local government by explicitly allocating functions to different tiers and generally avoiding clashes of competencies. More recently, the creation devolved administrations for Wales, Scotland and Northern Ireland in 1999 has changed the nature of sub-central government but has not so far had a major impact on the degree to which expenditure is assigned to sub-national jurisdictions. The remits of the UK's devolved administrations are clearly defined, though for historical reasons, the devolved territories have been granted different political and economic powers. For example, Scotland has much more exclusive control of functions such as education and health even when compared to many more devolved unitary states. Whilst the blueprints for English regional government are not yet entirely clear, it is already apparent that the ultimate pattern of devolution in the UK will not be symmetric. This is explicitly recognised in Russell Barter (2000), which in fact exalts asymmetry as a virtue, in so far as regions are not forced to take on responsibilities they are not yet ready to bear.

However, political scientists, for example, Le Galès and John (1997), argue that incrementalism carries considerable costs in terms of loss of momentum for reform, while asymmetries across regions may result in

to the opposite problem by giving rise to arguments for further change. In Italy, five special status regions (Regioni a Statuto Speciale) have traditionally had greater devolved powers, but the federalist movement has been pushing for similar autonomies to be granted to all regions to bring the asymmetric treatment of regions to an end.

Fiscal Autonomy

Theory

Having looked at how expenditure responsibilities are allocated, it is natural to consider how these should be financed. The theory of fiscal federalism provides a number of arguments for sub-central fiscal autonomy (see, for example, Gramlich, 1984).

First, it is argued that heavy reliance on grants and other centrally distributed revenues places too little pressure on local administrators and politicians to manage spending efficiently. Devolving fiscal authority is seen as important to ensure that financing and expenditure responsibilities are linked at the margin, so that local politicians can bear the costs of their decisions. Second, it is important that the costs of services are perceptible to the electorate so that they can make meaningful decisions on alternatives.

However, the literature on fiscal federalism also provides clear guidance on the limits that should be imposed on fiscal autonomy. Four arguments can be highlighted here. First, the usual argument against complete fiscal autonomy is one of equity. Jurisdictions with different levels of income and wealth will have very different tax resources at their disposal, and the need to ensure that citizens have access to a roughly equal level of public services will imply some degree of redistribution between sub-central governments. For this reason no industrialised countries, not even federal states, have opted for complete fiscal autonomy. A number of approaches to redistribution are feasible, through the use of vertical transfers funded from general taxation, 'pooling' arrangements between sub-central governments, or tax-sharing arrangements designed to benefit poorer jurisdictions. It is certainly important that sub-central governments have access to sufficient funds to adequately cover their spending responsibilities. Clearly there is a trade-off between equity and accountability: if resources are shared equally between sub-central governments, the incentive effects from

fiscal autonomy disappear. This has become one of the key issues that countries have to face in deciding the appropriate level of fiscal autonomy for sub-central tiers of government.

The second argument against complete fiscal autonomy is that one has to avoid tax externalities, in the interests of economic efficiency. 'Tax exportation', McLure (1967), is one such problem. If taxation decisions by sub-central governments impinge on non-residents, then local residents and politicians will not internalise the costs of public services and there is likely to be a degree of over-provision. Of course, insofar as non-residents benefit from service provision, then there could be under-provision, a problem that often arises with large metropolitan areas and satellite towns. The way to deal with this problem is to ensure that different types of taxes are assigned to different levels of government so as to avoid tax exportation between sub-national jurisdictions.

A third limit on fiscal autonomy is a consequence of the potential migration of factors of production. Tax competition is a fact of life in most systems, and the mobility of capital and labour imposes natural limits on fiscal autonomy. This is why most decentralised taxation systems still assign the majority of ability-to-pay or redistributive taxes to central government, especially corporate taxes, which fall on the most mobile factor, capital. Most countries that have opted for a substantial degree of fiscal autonomy have tended to rely on benefit taxes or user charges (based on the benefit consumers derive from local services) and taxes on immobile factors such as property, or small changes in ability-to-pay taxes (such as local income tax), where limits may be applied to prevent tax-induced migration flows across regions.

Finally, the fourth argument against fiscal decentralisation is that it can generate administrative complexity. In essence, it is argued that managing a national tax system is feasible at lower cost and this implies that financing systems based on grants or tax-sharing arrangements are optimal. In fact, in the case of any modern developed economy, this is a spurious argument. There is no reason why one needs to decentralise the tax collection system, as evidenced by a number of OECD countries which manage the collection of taxes shared by different jurisdictions through a single national tax collection system. However, clearly if a national collection system had to cope with a plethora of shared taxes between jurisdictions, this would increase administrative costs.

A subtler version of this argument relates to the problem of transparency and complexity in decentralised tax systems. A complex tax system, where various jurisdictions share the same tax base, and where sub-central governments have important fiscal powers, may lead to a less transparency in the fiscal system, unless attention is devoted to carefully construction and presentation of the chosen system. It is important that voters understand the operations of the different levels of government if accountability is to be achieved (Tanzi, 2001).

To sum up, economic theory suggests that some degree of fiscal autonomy can render policy-makers more accountable, and may improve economic efficiency.

Various commentators have also suggested that part of the crisis in democratic participation in local government elections in the several countries, including France and the UK, is attributable to the lack of fiscal powers available to sub-central governments. For example, The Economist (2002) argues that the problem of democratic participation in local and devolved government will not be solved if the proposed English regional assemblies are granted few economic powers. It has been suggested that voter interest will dwindle in devolved government in Scotland and Wales in the absence of further devolution of fiscal powers, and whether further decentralisation of powers in the UK and France will rekindle participation of the electorate in local elections remains to be seen.

Fiscal autonomy in practice

Once again, internationally comparable data are available from GFS which separate sub-central governments' sources of revenues into grants, taxes and 'other' sources, predominantly user charges and fees. This information is summarised in Figure 1.

[Figure 1 about here]

Grants

As noted above, the potential benefits of decentralisation may cease to exist if local governments suffer from a poor capacity to implement spending. Redistribution via transfers of nationally collected tax across local jurisdictions is generally used to ensure that an adequate level of provision can be achieved no matter how strong or weak the taxing capacity of the sub-central jurisdiction.

In addition, if regions are subject to different cyclical developments the pooling of risks can raise welfare. Pooling may be achieved more easily through vertical transfers from the centre to the regions rather than through horizontal transfers between independent localities, see Oates (1972) and Musgrave and Musgrave (1976). In general, transfers can take three forms i) a grant from a higher tier of government or ii) an allocation of a share in nationally collected or pooled taxes.

A further attraction of block grants relates to macroeconomic control. Central government may try to guard against growth of the public sector by limiting or cutting block grants. To the extent that it is block grants and rather than ear marked grants that are reduced, the sub-central tier is responsible for distributing the restricted or declining resources between individual services.

It is immediately clear that the UK has traditionally financed most of the spending of its sub-national jurisdictions through grants. This heavy reliance on grant funding presents a striking contrast with most European countries (with the exceptions of Ireland and the Netherlands, which are geographically much smaller)[2].

Most countries operate some kind of agreed and transparent formulae-based allocation of transfers, in part to eliminate costs of frequent negotiations. Equalisation schemes have the advantage of discouraging competition between authorities to attract higher-than-average earners with low needs, though at the same time overly generous equalisation formulae can weaken the incentives to attract residents by improving the quality of services or being more efficient. Furthermore, if tax collection is the responsibility of regions prior to central pooling and redistribution then it is also possible that richer regions will put less effort in the task. These concerns have led some countries to cap the extent of revenue equalisation.

Spain has taken a different approach in allowing ACs to retain a proportion of any positive deviation from the budgeted increase in receipts (tied to the growth of a basket of taxes including personal and corporate income taxes and VAT) Joumard and Varoudakis (2002). In the Scandinavian countries equalisation schemes are based upon the tax base and potential revenues based on the average tax rate, rather than actual revenues, see

[2] Note that in line with the earlier discussion, the relatively high dependence on grants in Denmark in part reflects 100% transfer refunding.

Mønnesland (2002). Many countries leave the responsibility for tax collection with central government, which can ensure equal effort in put into collection across the country and can be administratively easier, even if there is a system of local tax surcharges.

In many cases equalisation schemes are self financing. In Sweden one such scheme has covered all the Municipalities and Counties since 1996; it aims to offset 95% of the differences in taxable income per capita between local governments and allows for major differences in service delivery costs. In Denmark a grant is payable to local authorities with a tax base per capita below90% of the national average. Again, the size of the grant paid is based on expenditure need and is evaluated using a range of demographic and social indicators, see OECD (1997).

In Spain a variety of grant formulae have been put in place, the most important of which is redistributes pooled tax revenues based on expenditure need as measured by population size, personal income and tax capacity. Additional criteria at the provincial and municipal levels include surface area and school-age population. The slow delegation of revenue raising powers in Spain has in part reflected the need to collect relevant information on costs of provision as well as differing needs and preferences, most of which was unavailable before, so Spain's sub-central fiscal autonomy and the formulae employed are continuing to evolve.

In France, where autonomy is more limited, a third of the funds available to sub-central government are in the form of grants. The main grant, the *Dotation Globale de Fonctionnement* uses objective factors based on need (population, school population, tourist numbers, and fiscal capacity). Separate allocations are made for capital grants, *Dotation Globale d'Equipement*, which tend to support local initiatives by matching investments by Communes and Départments,

Post-war Germany has operated a system of horizontal equalisation aimed at equalising revenues between poorer and richer Länder. This system, the *Finanzausgleich*, has been very successful in maintaining a high degree of uniformity in public services throughout Germany. In 1997, following the incorporation of the East German Länder into the system, €6.1 bn was transferred from the richer to the poorer Länder, compared to only €1.5 bn in 1994. In addition to these horizontal transfers, a number of federal grants were made to

fiscally weaker Länder (€7.2 bn in 1997), see OECD (1998). Overall, 20% of Länder revenues came from grants, including transfer payments from the equalisation system. In 2001, a new agreement was reached for the period 2005-19 which maintains a federal contribution of about €10 bn per year, OECD (2002). Some observers have argued that this extent of equalisation has led to a lack of accountability, see Spahn and Franz, (2000). Whilst the reforms have attempted to addressed a perceived need to incentivise the Länders' performance and efficiency, equity remains a guiding principle of the new system.

A different set of difficulties arise when allocations are closely linked to historical shares. This is likely to place too little emphasis on efficiency and the containment of spending. For this reason, with very few exceptions, European countries have moved away from allocation formulae based on historic shares, such as the UK's Barnett formulae, towards formulae that use objective parameters that measure fiscal need and tax-raising capacity.

Whilst the UK has always had a system of grant allocation based on fiscal need for local government, it has resisted any reform of the Barnett formulae for the allocation of block grants to its main devolved regions (see Twigger (1998) for an explanation of the formulae). In doing this, the UK remains, with Italy, one of the few countries that has resisted the trend towards needs-based formulae and stuck with history and political expediency. However, there is growing recognition that any further move towards financial autonomy for the UK's main devolved units will bring with it a need to address the issue of horizontal equalisation and will require some reform of the grant system, see for example, Muscatelli (2001) and Cuthbert (2001). Further progress on the devolution agenda, such as the creation of regional assemblies in England, will also bring the issue of needs assessments to the fore.

In many countries, both equity considerations and electoral concerns strongly influence central governments' funding of sub-central tiers. We have already discussed the use of central government directives to influence spending decisions, but constraints attached to funding may also be used to exercise control on local provision. The use of earmarked, conditional or matching grants may be more easily justified if there is evidence of strong inter-regional spill-over effects from the provision of particular services though it's also arguable that, where these effects are perv asive, the provision and funding of such services might be more

appropriately retained by central government. This was certainly a key factor motivating the recent shift of the responsibility for hospitals back to central government in Norway[3].

The form of the restrictions imposed obviously affects the nature of the budget constraints facing the sub-central tiers of government and this can give rise to the so called 'fly paper effect' - that is that grants "stick where they hit", resulting in a different allocation than would arise from the same marginal change in own tax revenues, see for example, Courant et al. (1981).

Given the distortions involved, the heavy use of earmarked grants has been criticised on efficiency grounds and recent reforms in Norway and elsewhere have resulted in the greater use of transfers through the income system, with the objective of increasing local government freedom to decide how to use the money, responding to citizens' preferences and increasing cost efficiency, whilst also continuing to place strong emphasis on equalisation of resources across the country.

Specifically, in 1986 the Norwegian central government introduced the General Purpose Grant Scheme which replaced a system of about 50 earmarked grants. However, even after this reform, the share of funds tied to specific uses remains high by international standards; in 2001 conditional grants accounted for some 16% of local governments' total financial resources, b and Suyker (2002b)[4]. Newer earmarked grants influence the supply of childcare, services for care of the elderly and the renovation of school buildings. Their continued use appears to reflect the central government's perceptions of problems relating to weak service levels in priority sectors. In Sweden, some 90% of grants were earmarked until 1992, with extensive regulations on provision imposed. But there too, reforms aimed at improving the efficient use of local resources and encouraging innovation have now reduced that figure to around 25%, see Roseveare (2002).

[3] This transfer was accompanied by a reduction in the block grant and the upper limit on local tax rates, matching the reduced county expenditure level. The transfer of capital equipment was compensated via ear-marked grants.

[4] This figure will reflect shifts in finances following the transfer of hospital finances but may be distorted by the presence of ad hoc ear marked grants compensating for the transfer of capital equipment. Unfortunately intertemporal and cross country comparisons are not feasible since, to the best of our knowledge, there is no comprehensive source of internationally comparable data on proportion of intergovernmental transfers that are earmarked or conditional as opposed to general purpose.

In general the use of earmarked grants erodes local accountability and the remaining benefits from sub-central provision are then less clear. Only block or untied grants are consistent with autonomy of local decisions. A further problem with grants is that costs of provision are less likely to be perceptible to citizens. If sub-central governments have access to their own taxes, this particular problem may be solved.

Taxes

GFS provides a single figure for sub-central tax revenues and does not distinguish between revenues collected through shared taxes, piggybacked taxes, or taxes that are completely locally determined. As noted above, shared taxes can be an attractive source of revenues given the potential benefits of pooling risk and the relatively low administrative costs involved. Many countries, including Norway, Germany and Austria make extensive use of such arrangements.

In discussing fiscal autonomy it is relevant to consider the extent to which to which sub-central governments control their own tax base or tax rates. Using the classifications provided in OECD (1999) combined with the GFS data we are able to generate a weighted index of fiscal control that addresses this point. Specifically, the OECD use a classification of sub-central tax revenues ranging from (a) where the sub-central government can set both the tax rate and tax base, to (e), where central government sets both the base and the rate of taxation[5]. Tax sharing schemes (d) are divided into four categories from (d.1) where the sub-central government can determine the revenue split, to the other extreme (d.4) where the national government can unilaterally decide the revenue split.

In Figure 2 we summarise this evidence. The vertical axis shows the tax revenues received by sub-central governments as a percentage of total tax revenues, so provides a measure of the importance of sub-central financing of public services. The horizontal axis plots a constructed index of 'fiscal control'[6], reflecting the extent to which tax revenues can be considered to be controlled at sub-central level. It follows that the

[5] Although these data still neglect some important issues. For instance, comparative data have not so far been collected on the extent to which sub-central governments face limits on change tax rates and the tax base (e.g. expenditure or revenue capping).

[6] The construction of this index of fiscal control, based on the OECD data, is explained in Darby, Muscatelli and Roy (2002).

countries closest to the north-east corner of the graph are those in which the sub-central governments have the greatest degree of fiscal autonomy: that is they have a large share of total taxation and have greater control of taxation receipts.

[*Figure 2 about here]*

The UK the figures reflect local authorities' relatively high control over a very small proportion of total taxation (council tax)[7]. Contrasts between federal states are also apparent: Switzerland grants its sub-central governments the greatest control over taxation in our sample, whilst the German and Austrian Länder have far less independent control.

The Scandinavian countries warrant further investigation; their right to set local income tax rates is seen as the cornerstone of their local government autonomy, but in reality the systems are fairly restrictive. In Norway, local governments can set a local income tax within a range set by the central government. However, in practice, all the regions apply the maximum rate. Similarly, Municipalities are able to levy a tax on net wealth, within a centrally determined band, but again all set the same maximum permitted rate. Property taxes, commercial rates and energy taxes are also effectively constrained by Nordic and international standards, and whilst the imposition of user fees is permitted, these are required to be set below costs. Overall, sub-central fiscal autonomy is severely constrained.

The Danish central government has in principle abstained from direct intervention to set constraints on local taxes. However, the system of formalised budget co-operation between central government and local government associations links the size of central transfers to local tax setting decisions and in reality appears to have a similarly restrictive effect on tax rates, Mønnesland (2002). Furthermore, it has been argued that the form of the negotiation process, with its frequent last minute changes to agreed budgets, hampers transparency and does not facilitate multi-year planning, see Daugaard (2002). In Sweden the central governments' commitment to fiscal consolidation in the 1990s gave rise to various *ad hoc* regulations that

[7] Note that since the UK figures relate to 1998 they pre-date the introduction of the Scottish tax varying powers (the Tartan tax). However since the Scottish right to vary the rate of income tax has not yet be

have at least temporarily limited local autonomy, these include the imposition of a cap on tax rates between 1991-93 and the central government taking a 50% share of any increase in tax revenue from 1997. As in a number of other countries, excessive fiscal autonomy has been considered to be a contributory factor in overall budgetary control and the sub-central tier has been forced to play a part in the fiscal consolidation effort.

If devolved government and fiscal autonomy is designed with the objective of increasing accountability, a complex system, where various jurisdictions compete for the same tax base is may lead to a lack of transparency (Tanzi, 2001). As noted above, the choice of appropriate tax instruments for sub-central governments presents some problems in the light of issues such as: the mobility of factors of production across jurisdictions; the need to balance fiscal autonomy with some degree of revenue distribution between richer and poorer regions; and the need to avoid complexity.

While some countries have devolved business taxes, including Austria, Belgium, Germany, Italy, Spain and Switzerland, these do not constitute a substantial share of regional or local revenues. Instead, attention tends to focus on property taxation and taxes or tax surcharges on labour income. Dependence on business activity also generates incentives to over invest in business infrastructure and services to attract companies to the area. Another factor in choosing which tax to devolve is the predictability of revenues; corporate tax revenues are relatively more volatile, given their dependence on cyclical activity, than property, income, wealth or sales taxes, so undue reliance on corporate taxes could necessitate income guarantee schemes.

Regional sales taxes are common in the US, but are less feasible within European countries where devolved regions are far smaller than US states, and in any case there are EU wide limits on sales taxes. Property taxes have the advantage of immobility of the tax base, but to the extent that some beneficiaries of services are not homeowners, the costs of provision are less perceptible; also the tax base for property taxes generally grows relatively little over time. For these reasons, attention has increasingly turned to taxes or tax surcharges on labour income. To date, what evidence exists suggests that labour migration may be less of a problem than

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exercised, and in any case would have a very small impact on total Scottish tax revenues, it is fair to say that devolution has so far changed the position on financial autonomy very little.

some observers had feared in so far as there is little evidence that small tax differentials have led to major movements in population within EU countries.

User charges and fees

It is also possible to compare the extent to which individual consumers or companies contribute directly to the provision of for services by the public sector, via user charges and fees including collective and co-payment arrangements – the 'other' catergory in Figure 1. By the very nature of public goods it is not surprising that this category makes up the smallest component of total sub-central government revenues. Further, the scope for user charges is likely to remain limited given legitimate concerns over access by low income groups. (Reimbursement of charges via the benefit system can be a necessary though imperfect solution.) Elsewhere, the scope to extend user charges may be limited to the extent that the delivery of key services has already been privatised. However, concern over the distortionary effects of tax financing, fairness and a wish to make costs more perceptible to consumers, are all factors that potentially support increases in the scope of user charges.

The OECD has been critical of low reliance of user charges various countries, e.g. in the areas of child care, care of the elderly and pharmaceuticals. Trends in these areas suggest that take-up of free services is booming and supply-side rationing is considerable, Atkinson and van den Noord. (2001). The provision of services free of charge, or without making costs perceptible, obviously risks prompting excessive demand and hitting supply constraints, since the social costs of supply are largely irrelevant for the individual. User charges offer the potential to gain more information about price sensitivity of demand for services and can potentially render demand pressure directly influential rather than being expressed indirectly and imperfectly through the electoral system. Demand pressures may also be influential on supply side efficiency. However, user charging will be viable only if the costs of collection and of compensation through the benefit system are low relative to the sums that can be levied and the efficiency gains that can result. Countries that have tried to increase reliance on fees and charges have generally aimed to strike a balance between co-payment and maximum contributions to avoid imposing unduly high expenses on some households.

Borrowing Autonomy

The ability of any level of government to borrow can be helpful in facilitating short-term smoothing and to finance investment projects. However, threats to fiscal sustainability can derive from insufficiently hard budget constraints, and a lack of expenditure restraint. These macroeconomic considerations lead many central governments to place restrictions on the ability of sub-central authorities to borrow, see for example Pisauro (2001) and Rodden (2002) for more detailed discussions of these issues. Figure 3 shows an index of borrowing autonomy from Rodden (*op cit*.).

[Figure 3 about here]

It is interesting to note that there is sometimes very little relation between the degree of decentralisation in spending and borrowing autonomy. For instance, in France regional and local authorities have considerable latitude in deciding how much to borrow for capital expenditure, although borrowing is not allowed to cover current expenditure or to refinance existing loans.

In Germany, the Länder and local authorities can only borrow for investment purposes, in proportion to their financial capacity, and subject to agreement by the Länd's interior ministry. Spain also sets limits to total debt service spending and only allows short-term borrowing to cover cash-flow requirements and long-term borrowing to finance public investment projects. However, Joumard and Varoudakis (2000) argue that in the absence of penalties, these rules are not enforced effectively. They suggest that non-authorisation of access to credit markets has had the result that sub-central authorities make greater use bank loans which are less effectively regulated, but more expensive. Deficit restraint at sub-central level in recent years has been attributed to the annual programmes of deficit reduction that are bilaterally negotiated between the State and each region, rather than controls on borrowing.

Elsewhere too, the Maastricht criteria, and subsequently the Stability and Growth Pact, have forced the imposition of greater controls over borrowing by sub-central governments. For instance, Austria introduced an 'internal' Stability Pact in January 1999 to help ensure that the overall deficit position for all levels of government does not exceed 3%. This is done by allowing very little margin for borrowing by sub-central tiers of government, who are only permitted to run an aggregate deficit of 0.3% of GDP. One possible

justification of the low margin is that temporary deterioration that is best covered by temporary borrowing is likely to be caused by the operation of automatic stabilisers which are largely the concern of central government.

Italy has imposed a similar 'internal pact', but a problem with such *ad hoc* solutions is that they might place too my much of a constraint on public investment. This is a well-known criticism of the EU Stability and Growth Pact in contrast to the 'golden rule' for borrowing adopted in the UK. Presently, within the UK the devolved administrations face the same constraints as a central government department i.e. it is possible to carry over underspending, and limited overspending is allowed via the Reserve, HM Treasury (2002). However, if the UK is to adopt the EU's Stability and Growth pact in the future, this may result in less flexibility for the current three year spending plans.

Imbalances in Expenditure and Financial Autonomy in the Devolution Process

We have noted a number of cases in which movement toward fiscal autonomy has lagged behind the decentralisation of spending; this has particularly been true when political considerations were dominant in motivating the initial change. The experience of Italy offers a clear example of the kind of problems that this mismatch can give rise to, and illustrates how these problems can be exacerbated when central government also imposes standards on local provision.

Specifically, during the 1970s reforms had been aimed at simplification of the tax system and regaining central government control at a time of macroeconomic crisis. These reforms actually reduced the extent of sub-central fiscal autonomy, but at the same time spending responsibilities were progressively devolved. Particular areas of tension emerged in the provision of health and transport services where the regions were given key responsibilities for service delivery. The system of grant finance was based on historical spending shares with insufficient reference to performance or needs, and failed to promote efficiency and weak incentives to contain spending. Conditional grants often took on the character of entitlements, through central government imposition of "essential" standards. As Bordignon (2000) and Bosi and Tabellini (1995) note, this led to a clear problem of 'moral hazard', with regions blissfully running spending overruns in key areas,

knowing that the central government would bail them out[8]. This situation, in which the system of vertical transfers rewarded profligate and inefficient regional governments, obviously worked against fiscal responsibility and accountability of the regions. The Italian case is an extreme example, due to the particular administrative framework that allowed budget overruns and a political situation that encouraged bail-outs. However, similar problems can be identified elsewhere, in relation to specific areas of expenditure.

In Denmark, high growth in expenditure on childcare and care of the elderly since the 1990s reflects central government policy. Fiscal balance has not been a major concern of the local providers since additional spending has typically been funded by higher revenues and higher provision in subsequent years. Local governments have repeatedly blamed overruns on agreed spending on the centrally imposed objectives and regulations, and have resorted to unplanned tax hikes, while parliamentarians have criticised them for not meeting centrally initiated objectives and not complying with negotiated budgetary limits, Dauguaard (2002). However, it is clear that the central government has effectively separated the discretion to decide policy from the responsibility to finance spending. The existence of targets that are regularly not met lack and credibility and raises moral hazard problems. Reforms proposed by the OECD and others include imposing financial penalties on tax increases, and extending local discretion to other forms of taxation, tax allowances and user fees, Bibee and Goglio (2002).

These examples serve to illustrate that if central government is intent on maintaining the level of key public services, sub-central governments can exert real pressures on the central government to increase vertical transfers, unless these are explicitly prohibited by law. Clearly, if budget constraints are to be binding, lower level governments should suffer the consequences of their own mismanagement and should not be able to rely on transfers from above to bail them out of financial difficulties.

Since 1992, the Italian central government has progressively handed over greater fiscal autonomy to sub-central governments, and this has been accompanied by a corresponding reduction in transfers. Between 1993 and 2000 a number of different tax reforms were introduced, involving experimentation with various types of

[8] The constitutional court has sided with the regions and ordered central government to provide additional grants to cover the costs of providing nationally mandated "essential" services.

sub-central taxation; these have ranged from health taxes to a tax on business value added (IRAP) and an income tax (IRPEF) surcharge. However, despite these reforms, vertical transfers through conditional grants remain an important feature of Italian public finances and the central government has found it almost impossible to reform the allocation of central grants to reflect objective factors rather than historic allocations, and to exclude the possibility of bail-out.

The Spanish experience is also of interest. As noted above, devolution of revenue raising powers lagged the rapid decentralisation of spending competencies. So, the process has been characterised by growing imbalances between tax assignments and expenditure functions. Figure 4 puts this experience into context. Specifically, each point shows the share of sub-central tax and non-tax revenues excluding grants plotted against expenditure by sub-central governments, where both are given as percentages of the appropriate general government totals. The vertical distance between each point and the 45-degree line shows the extent to which sub-central jurisdictions are dependent on central government grants.

[Figure 4 about here]

The figure on the left shows the position of each of the European countries using the most recent figures available in the 2001 edition of GFS and the right hand panel shows how the position of Spain has evolved over time.

Initially revenue raising powers of the Spanish regions were confined to the so-called "ceded taxes", mainly on property. As recently as 1994, the ACs relied on government grants or tax-sharing arrangements for up to 96% of their expenditure. Their fiscal discretion was further limited by the fact that they could determine tax base or rates on only 22 per cent of their tax revenues, compared with around 90 per cent for Belgium, Denmark, Japan and Switzerland (OECD, 1999). In the period 1994-96 ACs were allowed to obtain a share of the personal income tax raised in their own territory, and also began to make greater use of fees and user charges. By 1996, the percentage of own revenues in the ACs had risen to 18%. In 1997 a formal agreement progressively increased the range of taxes available to ACs (on wealth and property transfers) as well as allowing them a greater share of their own revenues from personal taxation.

As mentioned earlier, another feature of the Spanish system, both on expenditure and revenue is the asymmetry across regions. Some ACs are able to exercise control over more tax rates and tax credits than others, leaving open a range of distortions. For example, special corporate income tax regimes apply to the three historic Basque Country territories (Alava, Gu ipuzcoa, Vizcaya) and to Navarra and these provide several more generous tax incentives to companies than the general regime. Quite apart from questioning whether the Basque Country's investment tax credits, additional reliefs for business start-ups and companies who locate their headquarters in the region are efficient uses of taxpayers' resources, the fact that other ACs do not have the option to adopt similar schemes is a source of tension that has resulted in challenges in the Spanish and European Court. Arguably, although it is still evolving, the asymmetric and multi-speed nature of the Spanish reforms has resulted in a complex tax system, which achieves greater autonomy at the expense of less transparency.

Even in countries like the Spain and the UK, where asymmetric devolution settlements are justified for historical or cultural reasons (e.g. in the UK, the existence of a separate Scottish education and legal system prior to devolution), unless these exceptions are explicitly costed as part of a comprehensive regional financing system, it is clear that tensions between regional and central governments, across regions, and with European policies on tax harmonization, can create considerable difficulties.

Conclusions

While decentralisation is sometimes driven primarily by political considerations, economists have traditionally seen benefits on the grounds that decentralised provision and fiscal autonomy can promote the efficiency and accountability of sub-central governments.

However, overlapping and poorly defined central and local competencies, the use of central government directives, entitlements and conditional grants act to prevent independence and full fiscal responsibility at the sub-central level, and can result in excessive expenditure that is unchecked by limited incentives to raise own revenues. Competition over the tax base can also easily destroy some of the potential benefits of fiscal autonomy.

Equalisation schemes are likely to be required to align sufficient revenue sources with expenditure commitments. However, excessive degrees of fiscal equalisation can work against the gains in accountability that would otherwise derive from fiscal autonomy. The use of grants and transfers in equalisation systems should pay attention to expenditure need, costs of delivery and fiscal capacity. Formula based allocations based on predicted revenues, indicators of needs and costs of provision should increase fiscal transparency and reduce the need for frequent costly negotiations.

So, the decentralisation process should be carefully designed to be transparent, with clearly defined competencies for different jurisdictions. In areas where the central government wants to retain a major role in setting standards of provision it should take back financing responsibility accordingly, and elsewhere it should abstain from detailed regulation. If necessary setting defined minimum standards should replace notions of standard entitlements, allowing fuller autonomy in both spending and financing decisions.

Most countries that have granted a greater degree of fiscal autonomy to their regions have done so through a greater delegation of taxes on immobile factors, or on personal income. Where taxes are devolved to lower tiers, the choice of tax and any limits set should pay heed to tax externalities. Many countries leave the responsibility for tax collection with central government, which can ensure equal effort is put into collection across the country and can be easier administratively, even if there is a system of local tax surcharges.

User charges may be a useful source of revenues and can be helpful in relaxing supply constraints and strengthening the influence of demand. By charging at the point of delivery they are also highly perceptible and relieve pressure on general tax revenues. However, the scope for user charges tends to be limited, either because of relatively high collection costs in comparison to the sums that can be levied, or because of concern over access by low income groups, or because the kind of services best suited to charging have already been privatised.

For budget constraints to be binding, lower level governments should not be able to rely on transfers from above to bail them out of financial difficulties. Hence there is a case for devoting energy to good institutional design, for example by introducing a binding ceiling for transfers and limits on borrowing, probably accompanied by a system of incentives and sanctions.

In a number of countries, asymmetric and multi-speed reforms have resulted in considerable added complexity. Where asymmetric devolution settlements are justified on historical grounds they should be explicitly costed as part of a comprehensive regional financing system, to avoid tensions. In our view, the persistence of asymmetries cannot be justified on economic grounds and is unlikely to be sustainable.

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Table 1: Sub-central Government Expenditure by Function
as a pecentage of General Government totals for each category.

		Education	Health	Social Security and Welfare	Housing and Local Amen-ities	Public Order and Safety	Econ'c Affairs and Services	All Func-tions
FEDERAL COUNTRIES								
Germany	(1996)	96	28	79	93	92	64	38
Switzerland	(1999)	90	31	23	85	93	37	47
Austria	(1998)	72	48	9	25	3	n.a.	31
Spain	(1997)	71	31	6	93	41	60	32
UNITARY COUNTRIES								
Denmark	(2000)	46	95	55	33	13	35	46
Norway	(1998)	63	77	19	87	17	17	34
France	(1993)	37	2	9	82	28	18	17
Netherlands	(1997)	33	5	14	79	25	26	22
UK	(1998)	67	0	20	41	52	29	22
Ireland	(1997)	22	48	6	70	100	70	25

Source: IMF Government Financial Statistics, 2001 edition.

Notes:

1. Figures are given for the most recent year available, as noted in brackets after the country name.
2. For the federal states, the single sub-central government figure combines the totals at federal and local level, this provides a clearer comparison with unitary countries where only a single figure is available (even for countries that have a multi-tier system of regions, and local level government).
3. Spain is included with the federal countries above, although it is not strictly a federation. It is often referred to as 'quasi-federal' or 'regionalised state' since the constitution does not include a federal distribution of powers and the Spanish Parliament can transfer legislative and executive functions without any statutory reform. See Russell Barter (2000) for a more detailed typology of international forms of regional government.
4. Disaggregated data are not available for all European countries in GFS so a number of countries had to be excluded from this table (notably Finland, Italy, Belgium and Portugal).

Table 2: The Evolution of Sub-Central Government Spending since 1970

Figures are given as percentages of General Government totals.

FEDERAL COUNTRIES	1970	1975	1980	1985	1990	1995	latest
Germany	45	44	44	41	41	41	38 (1998)
Switzerland[1]	56	55	53	52	50	48	47 (1999)
Austria	30	32	31	30	30	31	31 (1998)
Spain	-	-	11	21	30	30	32 (1997)
UNITARY COUNTRIES	**1970**	**1975**	**1980**	**1985**	**1990**	**1995**	**latest**
Denmark[1]	44	47	48	43	44	44	46 (2000)
Sweden	45	44	40	37	37	31	34 (1998)
Norway	38	40	33	33	32	32	33 (1997)
Finland	38	38	39	40	41	34	36 (1998)
France	17	17	16	16	18	18	17 (1997)
Italy[2]	-	-	27	27	27	24	28 (1999)
Belgium[3]	-	-	14	12	11	11	11 (1997)
Netherlands	-	27	25	26	23	24	22 (1997)
United Kingdom	30	30	26	24	25	22	22 (1998)
Ireland	27	28	27	25	23	24	25 (1997)
Portugal	-	7	-	-	8	8	10 (1998)

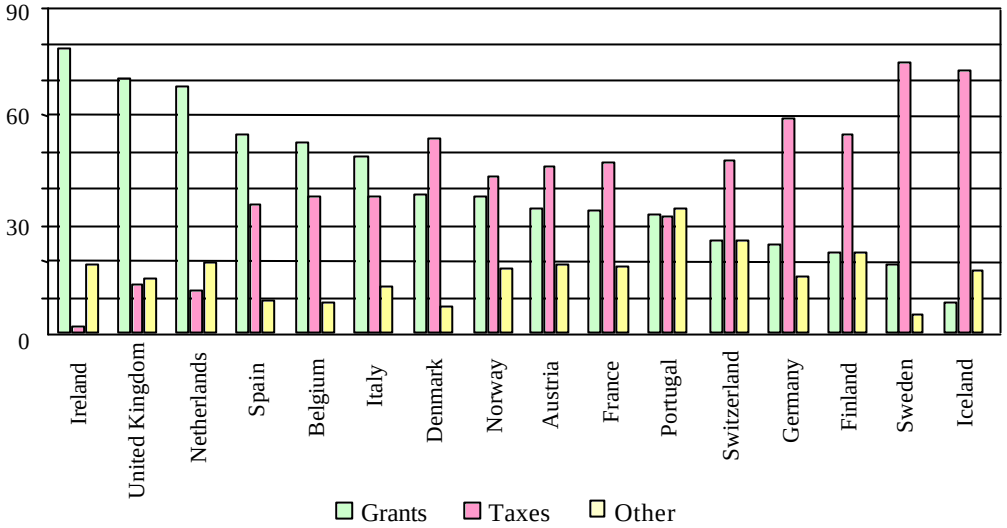
Source: IMF Government Financial Statistics, 2001 edition.

Notes:

1. Figures for Switzerland relate to 1984 and 1991 rather than 1985 and 1990, due to constraints of data availability. Likewise for Denmark a figure for 1972 has had to be substituted for 1970.
2. GFS data for Italy has been supplemented by data provided in Giarda (2001).
3. Belgium has effectively moved from a unitary structure to a federal structure. However, whilst the OECD provides some information for all three levels of sub-central government in Belgium (local government, communities and regional government), to date the GFS has kept its disaggregation to central and local government where it appears that the federal layer has been included with the centre. To this extent, the above figures understate the true extent of devolved spending in Belgium.

Figure 1: Composition of Sub-Central Government Revenues

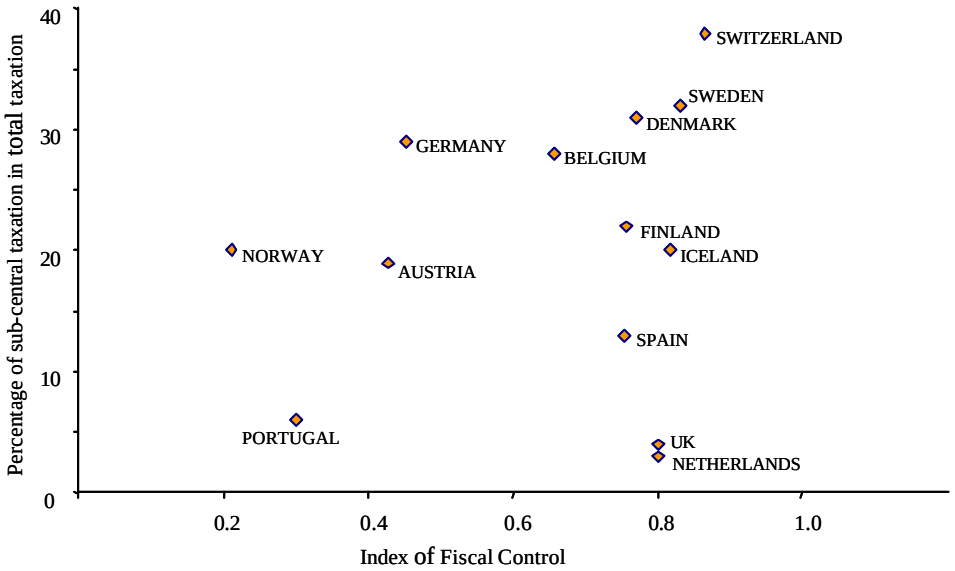
as a percentage of their total revenues



Source: IMF Government Financial Statistics 2001

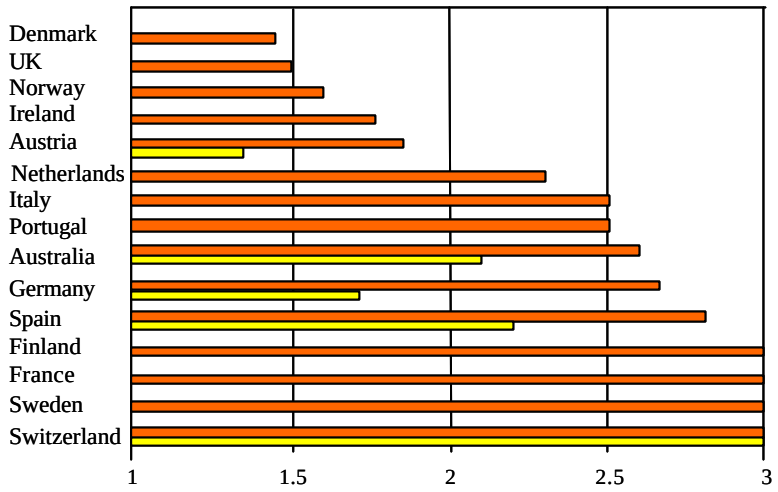
Figures relate to 2000 for Denmark; to 1999 for Austria, Sweden and Switzerland; to 1998 for Belgium, Finland, Germany, Portugal, Norway, UK; and to 1997 for France and the Netherlands.

Figure 2: The Importance of Sub-Central Levels of Government and the Extent of Fiscal Control



Source: IMF Government Financial Statistics 2001, OECD (1999) and own calculations

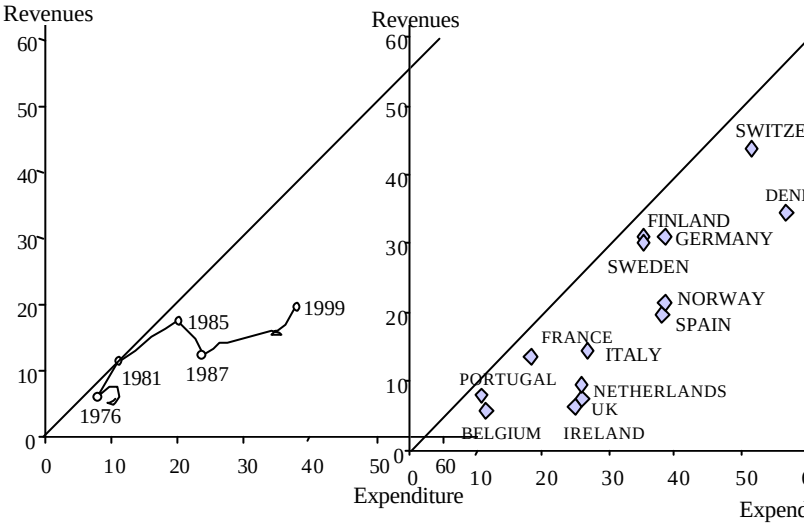
Figure 3: Index of Borrowing Autonomy



Source: Rodden (2002).
Note: The index is bounded between 1 and 5 where 1 = no borrowing autonomy and 5=high borrowing autonomy and the period assessed is 1986-1996 where feasible. The light bar relates to the local level of government where these figures are available. The darker bars relate to state/regional level government.

Figure 4: Fiscal Imbalances: Tax and Non-Tax Revenues and Expenditure of Sub-Central Governments

(a) Cross Country Comparison **(b) Decentralisation in Spain**



Source: IMF Government Financial Statistics

1. Revenues include taxes, fees and other sources of non-tax revenues but exclude grants.
2. The figures are expressed as percentages of general government totals. Transfers from central government to lower tiers of government are excluded from the general government totals. The date for which each country's data is plotted is as given in the notes to Figure 1, note that this means the figures for the UK pre-date devolution.