OECD Experience with Subnational Fiscal Devolution

Sean Dougherty

Head of Secretariat, OECD Network on Fiscal Relations

Role of Parliamentary Scrutiny in the Reconstruction of Ukraine
4 July 2024 (Virtual)

Twitter **@econecho**

OECD
BETTER POLICIES FOR BETTER LIVES

Key points

1. **Fiscal assignment principles**

2. *Fiscal equalisation mechanics*

3. *The Ukraine context*

Key lessons from the Fiscal Network

Based on the new Handbook and Synthesis:

1. *Better <u>align</u> sub-central spending with own-source revenue*

2. *Raise sub-central spending power & tax <u>autonomy</u> to reduce the need for earmarked grants*

3. *Strengthen fiscal <u>equalisation</u> systems*

4. *<u>Delineate</u> responsibilities and functions clearly*

5. *Improve transparency, data collection & performance <u>monitoring</u> to enhance co-ordination*

Source: OECD (2021), *Fiscal Federalism 2022*

SNGs play a key role in providing public services

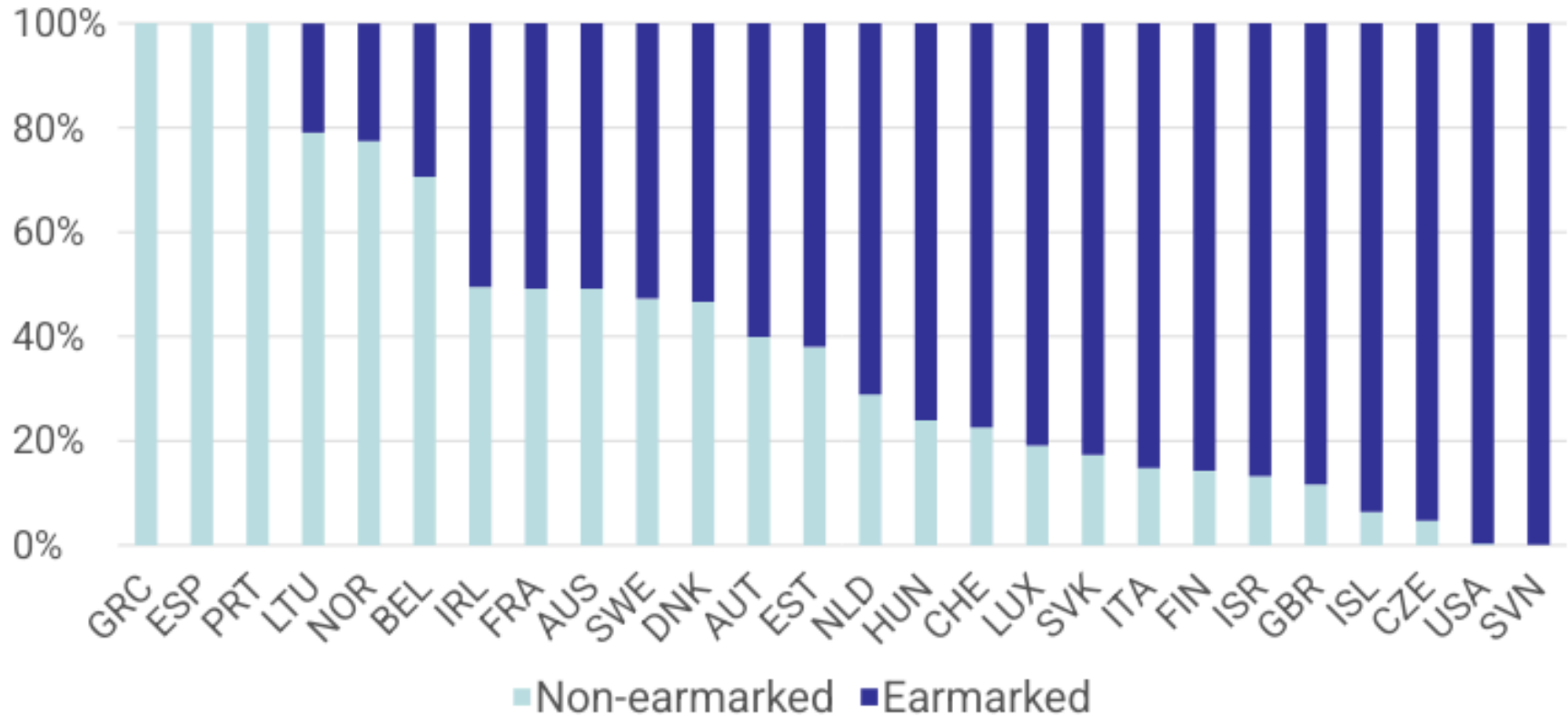OECD subnational governments (SNGs) share as % of general government
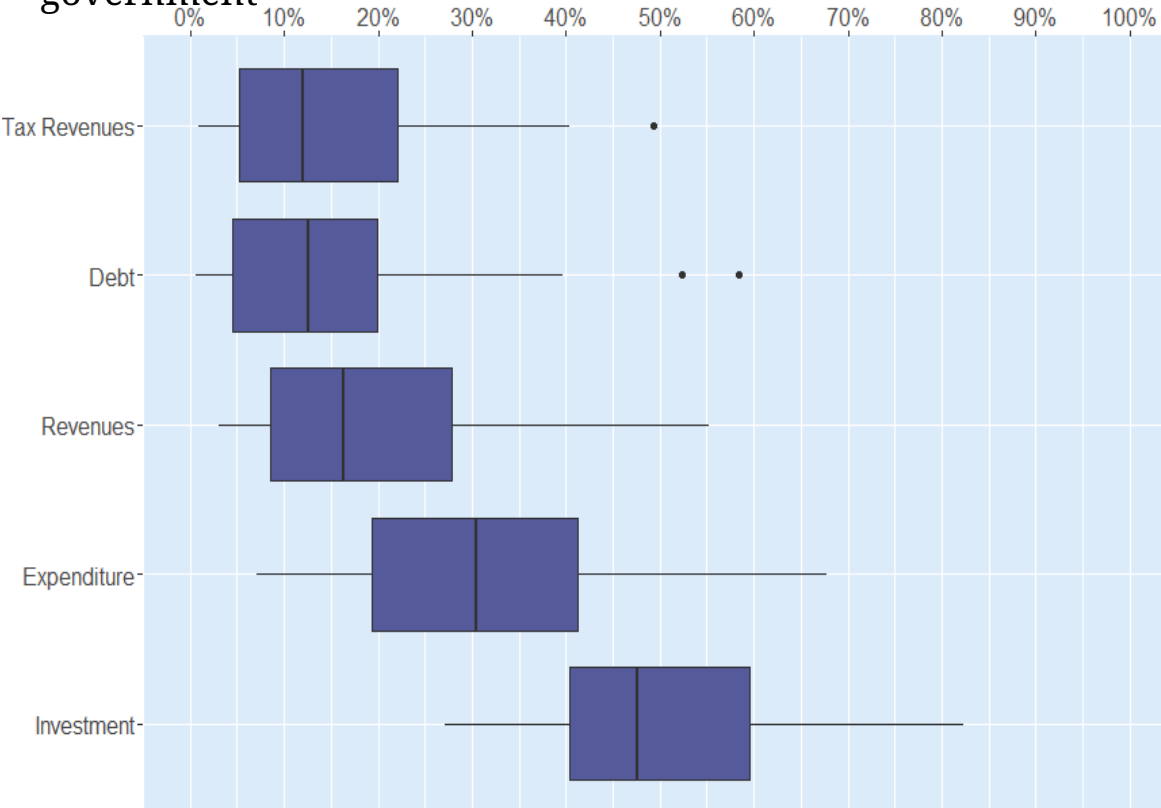
- *SNGs are, on average (unweighted), responsible for:*
  - o *50% of public investment,*
  - o *31% of public expenditure*
  - o *19% of government revenue,*
  - o *15% of government debt and*
  - o *15% of tax revenue*

- *There is substantial dispersion, and in some countries SNGs are liable for the bulk of these assignments*

Source: OECD Fiscal Decentralisation database

Many governments earmark expenditures

Transfers paid/received by general government

% of total transfers

Legend: Non-earmarked, Earmarked

Countries (left to right): GRC, ESP, PRT, LTU, NOR, BEL, IRL, FRA, AUS, SWE, DNK, AUT, EST, NLD, HUN, CHE, LUX, SVK, ITA, FIN, ISR, GBR, ISL, CZE, USA, SVN

Source: OECD Fiscal Decentralisation database

Decentralisation can improve outcomes, only to a certain extent (e.g. healthcare)

Better health outcomes are associated with moderate decentralisation
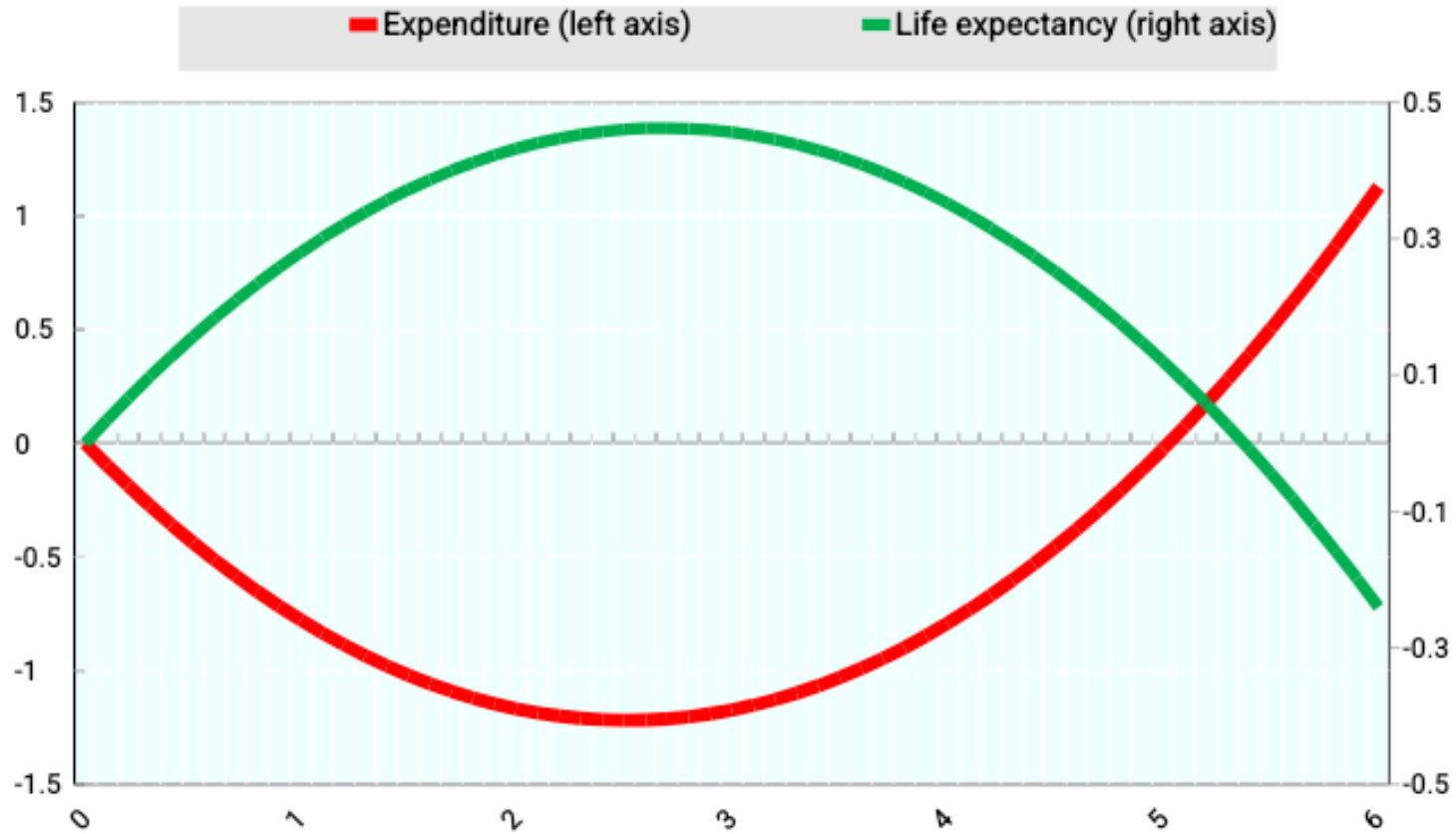
Decentralisation index (0 = fully centralised; 6 = fully decentralised)

Source: *Fiscal Federalism 2022*

Key points

1. *Fiscal assignment principles*

2. ***Fiscal equalisation mechanics***

3. *The Ukraine context*

Highlights of past FE work

Key challenges identified:

- Revenue equalisation may reduce tax effort and slow convergence
- Cost equalisation may be prone to rent seeking.
- Equalisation can pose a problem for budget stability.
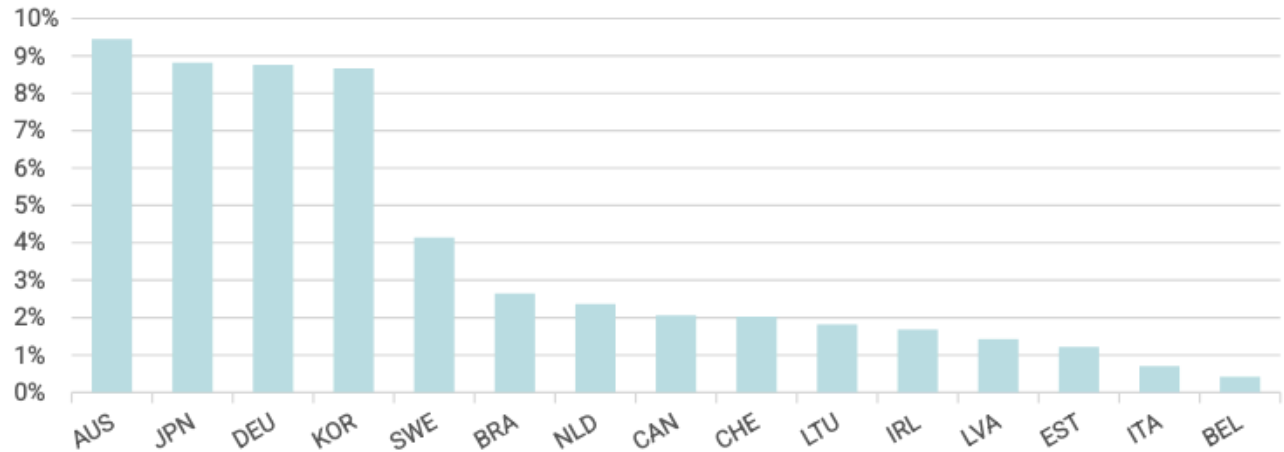
Main policy messages:

- Use core, difficult-to-manipulate measures to determine equalising transfers
- Representative Tax Systems (RTS) can mitigate perverse incentives
- Separate equalising transfers from other transfers
- Monitor impacts on inequality and other economic outcomes

New equalisation findings

- The scale of equalisation varies considerably across countries.

- In federal countries, the scale of equalisation is often related to fiscal autonomy.

Equalising transfers as a percentage of total government expenditure, selected countries

Equalising transfers and tax autonomy, selected federal countries

Legend: SCG (TL2) revenue % total government revenue ■ Equalising transfers % total government expenditure
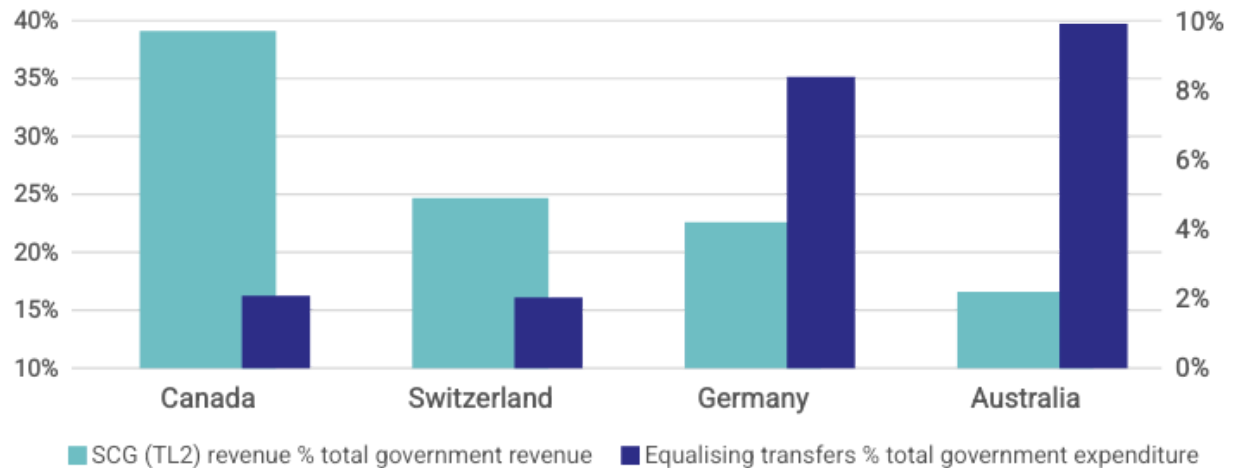
Emerging equalisation challenges

- **Several emerging challenges were identified in this round of analysis:**
  - System complexity, policy neutrality and interaction with incentives
  - Balancing transparency and mechanism design
  - Which factors to equalise, including revenue base and revenues excluded
  - Scale and extent of equalisation
- **Some challenges apply to gap-filling systems in particular:**
  - Quantifying outcomes (e.g. revenue equality vs service provision)

Equalisation does not always reduce revenue inequality, and can increase it

Inter-regional Gini coefficient before and after equalisation
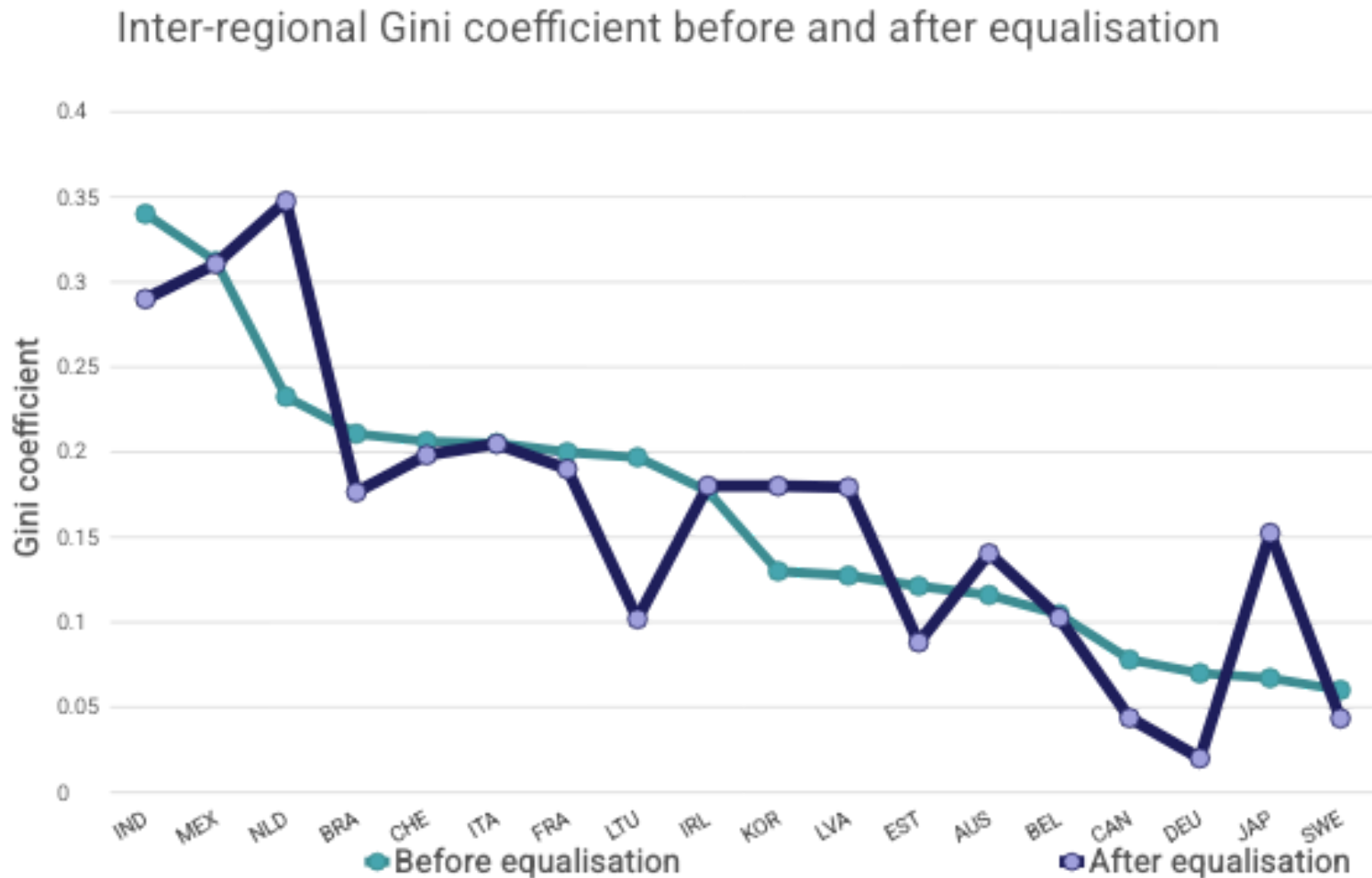
Country approaches to equalisation

- **Several key mechanism design approaches have been identified to help equalisation policy be more neutral from the perspective of the SCG:**
    - Use of a representative tax system (e.g. Canada, Australia, Germany)
    - Use of standardized costs (e.g. Japan, Korea)
    - Incomplete equalisation (e.g. Germany, Lithuania, Estonia)
    - Separating equalising transfers from other transfers (e.g. Canada)
    - Arms-length commissions (e.g. India, Australia)
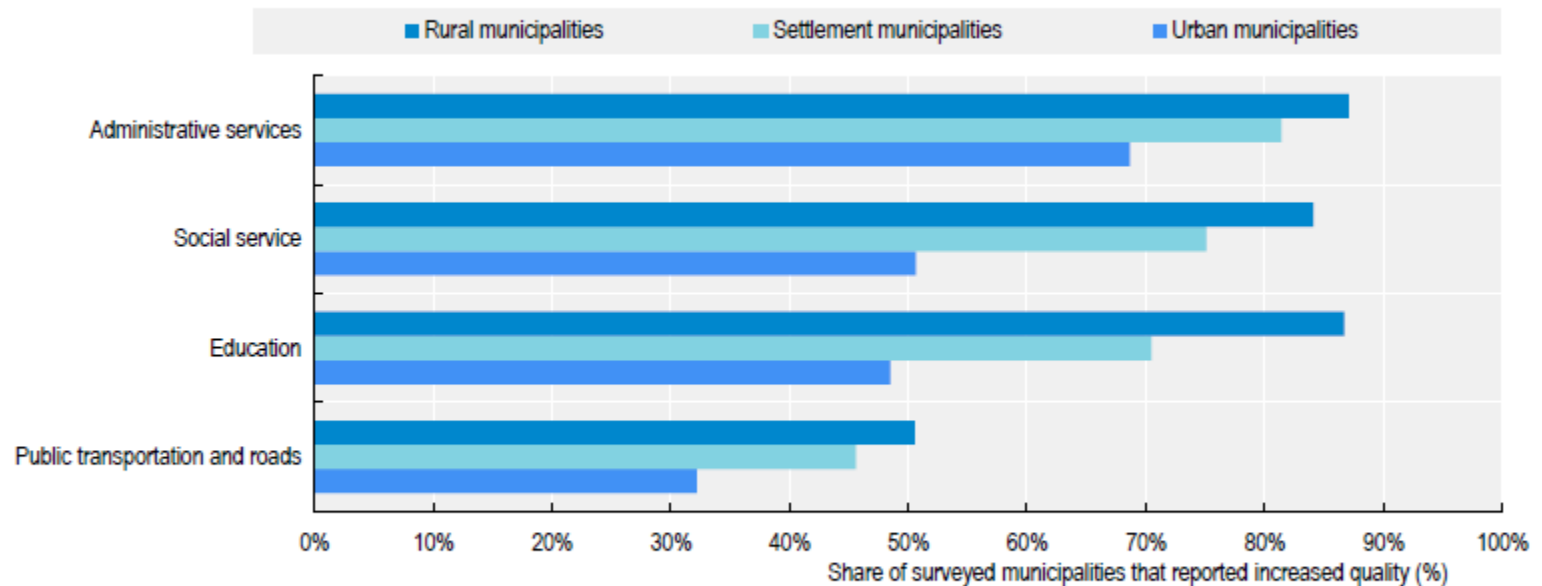   - Linking equalisation to sub-national performance (Italy)

OECD

Key points

1. *Fiscal assignment principles*

2. *Fiscal equalisation mechanics*

3. ***The Ukraine context***

Ukraine's decentralisation reforms have had positive effects already

Positive effect of the decentralisation reforms on the quality of local service delivery

Note: The survey was filled out by 741 municipalities (51% of all Ukrainian municipalities in 2021).
Source: Author's elaboration, based on the OECD online survey.

Source: OECD (2022), "Turning to Regions and Local Governments to Rebuild Ukraine", *Policy Responses: Ukraine*.

OECD Network on Fiscal Relations across Levels of Government

Objectives:

- *Share experiences on all aspects of fiscal federalism and sub-national public finance, on both the revenue and spending sides of the budget*

- *Annual Network meetings, as well as workshops and expert seminars*

- *Unique policy analysis, database and reports*

Web: **http://oe.cd/fiscalnetwork**

Twitter @econecho