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Going beyond a zero-sum game: reforming fiscal relations

Hansjörg Blöchliger and Camila Vammalle[1]

1. INTRODUCTION

1.1 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). 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 to 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 refers to how political, economic and institutional factors influence the design, adoption and implementation of policy cgc6.6998tG[k on .14o38f)5.6( )]TJ-1 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 episodes of reform in nine OECD countries, 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.

Box 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 globalisation 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

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- 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

Table 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, 2007
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.

Box 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.

2. 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.

2.1 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 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 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, in OECD 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.

2.4 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 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.

3. TIMING AND SCOPE

3.1 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.[7] The experiments showed the feasibility of a new approach and helped to overcome resistance. In Canada, the 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

[7] 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.

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.

3.2 Bundling may be necessary to forge majorities

Most of the ten fiscal federalism reform case studies consisted 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.[8] 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

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 studied 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 reforms 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.

3.4 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 themendrf maintaining a low political profile. Such “depoliticisation”, 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.

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.

4.4 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 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

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