

# eJournal of Tax Research

Volume 10, Number 1

February 2012

**Special Edition: State Funding Reform in the Australian Federation**

## CONTENTS

- 5 Fiscal Federalism under Review (*at Speed*)  
**Neil Warren**
- 12 The character of Australian federalism  
**Alan Fenna**
- 21 International lessons in fiscal federalism design  
**Robin Boadway**
- 49 Going beyond a zero-sum game: reforming fiscal relations  
**Hansjörg Blöchliger and Camila Vammalle**
- 65 Own revenues in federations: tax powers, tax bases, tax rates and collection arrangements in five federal countries  
**François Vaillancourt**
- 88 Sharing taxes and sharing the deficit in Spanish fiscal federalism  
**Violeta Ruiz Almendral**
- 126 The way forward on state tax reform: an AFTSR perspective  
**Greg Smith**
- 138 Solidarity and the design of equalization: setting out the issues  
**Bernard Dafflon**
- 165 Fiscal equalisation and State incentive for policy reform  
**Neil Warren**

# Going beyond a zero-sum game: reforming fiscal relations

Hansjörg Blöchliger and Camila Vammalle<sup>1</sup>

## 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 changes, and to how policy design and the reform process are intertwined. Given the idiosyncrasies of fiscal federal institutions, such reforms appear very country-specific, with little scope for cross-country comparison, as exemplified by the wide variation of sub-central tax autonomy across OECD countries (Fig. 1). But within this context of diversity, policy makers face similar challenges and opportunities to make fiscal relations more efficient, more equitable and more stable. They may be able to influence the timing, the scope and the sequencing of the reform process and thereby change the balance between winners and losers or between short- and long-term effects. By adapting the

---

<sup>1</sup> Hansjörg Blöchliger is Senior Economist at the OECD Economics Department and the OECD Center for Tax Policy and Administration. Camila Vammalle is Economist at the OECD Public Governance and Territorial Development Directorate. This article is an amended version of the summary chapter published in Blöchliger and Vammalle (2012).

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 local and regional empowerment.

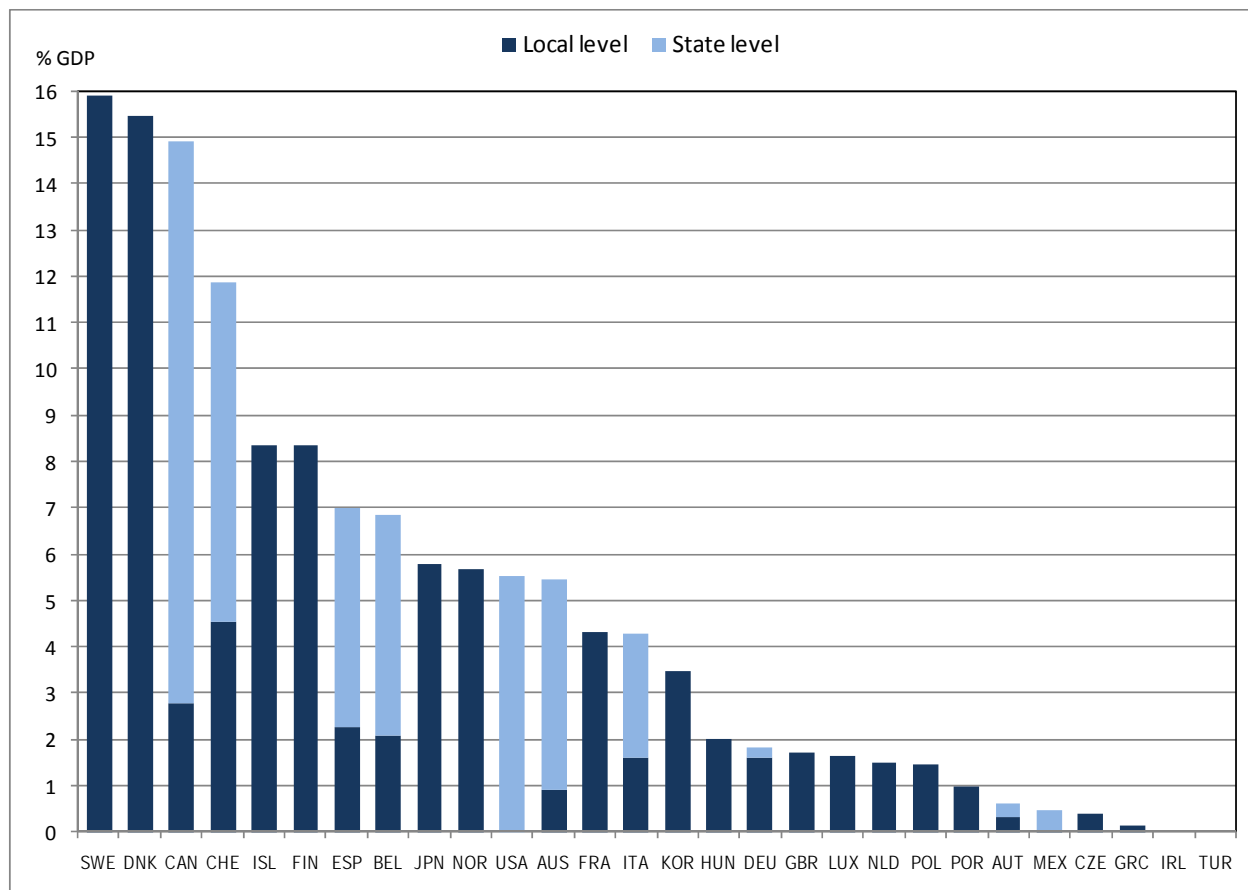
## **1.2 The stakes in fiscal relations reforms**

The problem for policy makers aiming to reform fiscal federalism and local government is that benefits do not accrue to all citizens and jurisdictions alike. While reforms are supposed to benefit the economy and the society as a whole, their costs and benefits are unevenly distributed, and some individuals and groups are bound to be net losers, particularly in the short run. These losers, whose numbers may not be large, often have well-identified stakes and interests, which they tend to defend vigorously. The benefits of reform are often thinly spread over a large and dispersed group of beneficiaries that is often unaware about the potential gains of reform. In addition, the cost of the reform tends to become apparent immediately, while the benefits, whose extent is uncertain, tend to emerge later. The asymmetry between winners and losers in the reform process and uncertainty about the size and distribution of the future benefits may weaken the support for reform. A bias toward the status quo, and resistance to reform, may result, even if potential winners are likely to outweigh the losers in the long run. Only under certain circumstances can uncertainty about the outcome of a reform create a “veil of ignorance”, *i.e.* a situation where stakeholders, unaware of how they will be affected individually, may be ready to agree to social contracts that increase the overall effectiveness of fiscal federalism arrangements.<sup>2</sup>

<sup>2</sup> The “veil of ignorance” is a concept originating in political philosophy that explains how productive arrangements and social contracts evolve (Rawls, 2001). The “veil of ignorance” and the “status quo bias” are opposite outcomes of the same underlying fact, namely uncertainty. Somewhat simplified, the

**Figure 1. Taxing power of sub-central governments**

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



**SOURCE:** OECD Fiscal Decentralisation database

Fiscal federalism and local government reforms can be seen as a blend of structural reforms including tax reforms, and public administration reforms, and they can be analysed using the appropriate political economy framework.<sup>3</sup> Fiscal relations reforms have their peculiarities, however:

The main actors and interests in fiscal relations reforms are government levels and individual governments, rather than interest groups outside the public sphere. The fact that governments will be dealing mainly with each other is likely to shape the reform and the reform process.

“veil of ignorance” assumes that overall efficiency gains will help to pass a reform because the average gains are assumed to be positive, while the “status quo bias” assumes that uncertainty about individual outcomes will block the reform because risk aversion puts a negative value on the stakeholders’ expected average outcomes.

<sup>3</sup> Political economy of reform issues in selected areas are reviewed in the OECD publication *Making Reform Happen* (OECD, 2010), with contributions, among others, by Price on fiscal consolidation, by Brys on fundamental tax reform and by Charbit and Vammalle on public administration reform. Tompson (2009) scrutinises pension, product and labour market reforms in ten OECD countries.

- The impact of fiscal relations reforms is highly visible, especially in the short run. Governments and administrations are often obliged to quantify short-term effects with great accuracy, leaving both winners and losers with a precise idea of how reforms to the tax system, intergovernmental grants or fiscal rules affect them individually.
- Fiscal federalism reforms tend to be a zero-sum game in the short run, where one government level or group of sub-central governments (SCGs) is going to lose what the other government level or other SCGs will win. As a result, such reforms are plagued by a strong bias towards the status quo. The political discussion revolves around short-term distributional effects, and stakeholders will concentrate their efforts on ending up on the “right” side.

### **1.3 Methodology**

This paper is based on ten country case studies and applies the method of “focused comparison” (Table 1 and Box 2). In order to make reform experiences comparable, case studies follow the same structure and methodological framework. They describe and discuss issues such as reform outcomes, the reform context and the issue history, the actors and interests involved, the reform process, the design of the reform, and finally the adoption and implementation of the reform. The reforms studied were adopted between 2001 and 2009, although some reforms were initiated many years earlier. They include the introduction or amendment of fiscal equalisation programmes; the upgrading of (non-equalising) intergovernmental grant systems, particularly a move from earmarked to non-earmarked grants; the introduction or tightening of sub-central fiscal rules; a sub-central sales tax reform; the territorial restructuring of public service delivery, including the merger of municipalities; enhanced inter-jurisdictional co-operation and the introduction of a new regional layer; and the reorganisation of power and competencies across ministries with respect to fiscal relations. In most cases, a reform covers more than one of the topics mentioned.

While the summary might give a comprehensive picture of the reforms recently on the agenda in member countries, the case studies could be said to suffer from selection bias, in the sense that all reforms under scrutiny were adopted and can hence be considered “successful”. Moreover, all reforms, except for the Canadian equalisation reform, some of whose elements became fiscally untenable after the 2008 crisis, were implemented in a sustained way. Once adopted, the reforms were not reversed or watered down. The ten country case studies do not cover reforms that eventually stalled, and they do not analyse the factors that lie behind aborted reforms, nor do they cover situations where the government considers reforms urgent but has so far made no serious attempts to carry them out. Given this selection bias, it is clear that this study has more to say on the factors that promote comprehensive fiscal federal reforms than on the obstacles that impede them.

**Table 1. The ten case studies**

<b>Country</b>	<b>Name of the reform, year of adoption</b>
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 to consolidate, implementation of literally all reforms took place when central and, to a lesser extent, sub-central public finances were in good shape. Good economic conditions and sound fiscal positions help central governments to “buy” reforms and to grant a reform dividend on the spot. The role of a sound fiscal position is most obvious in equalisation reforms, whose explicit distributional objectives inevitably create short-term winners and losers among SCGs (a zero-sum game). In most reform cases the central government provided additional transfers to the sub-central level so as to make almost every SCG a net reform winner. Even territorial reorganisation and tax reforms, whose distributional impacts are weaker, are often bankrolled with additional resources from the central government. Finally, some reforms were implemented as part of a fiscal stimulus programme, as in the case of Australia. Without considerable financial help from the central government, resistance to reform tends to be much stiffer and failure is more likely.<sup>4</sup>

The recent economic and financial market crisis and its dire fiscal implications are likely to change for some time the economic and fiscal environment for reform. Most of the reforms studied were adopted before central governments had embarked on fiscal consolidation. Few reforms have been adopted during the crisis, although Canada’s sales tax harmonisation, which had been delayed for years, was prompted by the crisis and by the need to help the economy out of recession. Portugal’s local government reform, part of a strategy of fiscal retrenchment, was the only reform studied that was fiscally “neutral”, *i.e.* where the central government did not put additional resources on the table. Weak growth and a lack of financial resources will now limit the prospects for reform and the central government’s role as paymaster. Fiscal positions will shape reform outcomes: while good economic and fiscal conditions appear to favour reforms that increase equalisation and more generous handouts to SCGs, economic and fiscal crises will likely trigger reforms that increase sub-central government efficiency and tighten fiscal discipline. The coming years will show what type of reform can be initiated, adopted and sustained under conditions where central governments can no longer afford to pay.

### 2.2 Electoral mandates are useful but not crucial for success

Electoral mandates are an important driver in fiscal federalism reforms, although intergovernmental fiscal relations rarely feature as a high priority in election campaigns. Once a new government was elected on a platform that included a fiscal

---

<sup>4</sup> Indeed, one of the most robust findings to emerge from econometric work in the field of the political economy of structural reforms is that sound public finances are associated with more comprehensive reforms (Tompson, 2009).

relations reform, it tended to act quickly, as shown by the Australian, Belgian, Danish or Portuguese reforms. Governments without a mandate tend to engage in small and often piecemeal reform attempts. Acting against electoral promises can create strong opposition to a reform by special interest groups and the public at large, even if the reform is financially supported by the central government. Compulsory mandates – *e.g.* the obligation to amend fiscal relations every four years as is the case in Austria – may create a positive climate for reform, but again, the scope and outcome depends on the electoral mandate. The more convincing the mandate, the more comprehensive the result of the reform tended to be. Electoral mandates to increase the efficiency of public services, to reduce fiscal disparities or to increase sub-central fiscal autonomy were stronger than mandates for sub-central fiscal consolidation and tighter sub-central fiscal rules, and the respective reforms also tended to be bolder.

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

### 2.3 Some arrangements provide sub-central governments with considerable leverage

Constitutions and electoral systems may give local and regional governments considerable power to shape the reform or veto undesired outcomes. Very basically, members of a national parliament will represent the interests of their jurisdiction. In several federal countries, reforms have to be approved by two parliamentary chambers, with the second chamber representing the states or regions. In some unitary countries, especially in Scandinavia, municipalities enjoy the right to fiscal and administrative self-governance, putting limits on the central government’s ability to change acquired rights against their will. Certain forms of collaborative federalism and comprehensive consultation across government levels and with other social groups add to the constraints. Also, the distribution of sub-central governments in terms of size or economic wealth across the country has a strong impact on the outcome of reform, often favouring small and/or economically lagging SCGs.<sup>5</sup> A system of many small electoral districts is likely to favour redistribution and the interests of certain groups over considerations of efficiency.<sup>6</sup> Finally, SCGs with strong regionalist

<sup>5</sup> The Canadian equalisation formula, with its strict reliance on tax-raising capacity, strongly favours poorer provinces with a lower cost of living (Albouy, 2010). The Austrian reform of 2007 has reduced the equalisation premium for large urban areas, and the new Swiss equalisation formula does not include such a factor at all.

<sup>6</sup> See Rodden (2009). This is why constitutional economists have suggested at least partially abandoning electoral districts and running elections at the national level (national election districts). Given that



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 jurisdictions, without compromising SCGs' incentives to develop their own fiscal base, *iv*) clarifying the allocation of responsibilities across government levels, and *v*) simplifying regulation and administration of intergovernmental grants. Moreover, central governments generally aimed to harden sub-central budget constraints, usually by tightening sub-central fiscal rules or by granting more tax autonomy to SCGs, in order to reduce sub-central deficit bias. In most cases, the various rationales for reform overlap, particularly in their mix of efficiency and equity objectives. SCGs rarely opposed such demands and in some cases even acted as early promoters. Indeed, during several of the case studies, the central government was passively reacting to sub-central demands rather than pushing its own agenda.

Opinions on reform often diverged more between SCGs than across government levels, leaving the central government to balance diverging SCG interests. SCGs with an efficient public sector preferred tax autonomy over grants and subsidies, while the less efficient jurisdictions opposed it. Poorer SCGs, often in a majority, claimed more equalisation, while wealthy SCGs tried to put limits on redistribution. SCGs with high

---

members of a national parliament would need votes from the entire country, they would be more inclined to adopt a “national” and aggregate view of reforms rather than defend special SCG interests.

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.<sup>7</sup> 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

---

<sup>7</sup> 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.<sup>8</sup> Comprehensive reforms may be necessary if there are many veto players whose support is crucial for success. In many cases under scrutiny, different reform elements, each addressing a subset of actors, were bundled in order to obtain the majority needed to pass the reform. Bundling made it possible to distribute the benefits of reform more evenly across various SCGs and stakeholders. It had the additional advantage of providing governments an opportunity to offer individual actors a “take-it or leave-it” package. Bundling locked in veto players: no single actor could expect to renegotiate reform amendments once the reform proposal was anchored, because that would have threatened the position of other actors and hence the outcome of the entire reform. Bundling also allowed more emphasis to be placed on long-term efficiency. Indeed, while wide-ranging fiscal federalism reforms attempt to strike a balance between efficiency and inter-jurisdictional equity, small-scale reforms, are largely perceived as distributional.

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

---

<sup>8</sup> In this respect, the political economy of comprehensive fiscal federalism reforms tends to be akin to fundamental tax reforms (Bryson, in OECD 2010).

incentives to reduce barriers to interstate trade, while Denmark's was coupled with a health care reform.

One important problem with bundling is that if it goes too far and tries to satisfy too many stakeholders, the distributional aspects can detract from the efficiency-enhancing aspects of the reform. Bundling may turn into log-rolling, *i.e.* special interests joining forces at the expense of other, less well-organised groups.<sup>9</sup> As mentioned above, bundling often ends up with the central government "buying" the support of opponents of reform. Although some additional transfers could be justified on the grounds that efficiency gains – such as internalised externalities or lower administrative cost – accrue to the country as a whole, the country studies suggest that fiscal relations reforms are often too costly for the central government. And even strong bundling may not achieve all the desired objectives: further sub-central tax autonomy, which is sometimes on the agenda when a reform is initiated, may be scaled back or dropped completely during the reform process. In several cases, neither the central government, reluctant to lose central budget oversight, nor sub-central governments, fearing higher uncertainty over revenue, showed sufficient interest in greater tax autonomy.

### 3.3 Sequencing may be an alternative strategy for some reforms

Sequencing may be an option if demands for institutional change and decentralisation are persistent and if decentralisation can be partitioned into steps. A sufficient majority must then be mustered at each step without bundling. Countries in a secular decentralisation process like Belgium, Italy or Spain follow such a pattern. Reforms start with the decentralisation of spending responsibilities, while SCG funding is ensured through a set of corresponding earmarked grants. This is followed by a move from earmarked grants to general-purpose grants and to an increase in spending autonomy, sometimes linked to more result-based regulation. At the next stage, grants tend to be replaced by tax-sharing systems and finally by autonomous taxes, thereby increasing sub-central tax autonomy. Such sequencing gives time to test the gains obtained by decentralisation, which, if considered satisfactory, create impetus for further reforms. However, further reform steps are only successful as long as the efficiency gains of decentralisation outweigh the associated distributional conflicts (Rodrik, 1999). In this respect, spending decentralisation is easier to engineer than tax decentralisation, which can arouse fears of increasing interregional disparities. In several countries, plans to devolve taxing powers to SCGs were scaled back or abandoned. In other cases, distorting SCG autonomous taxes were replaced by tax-sharing systems or intergovernmental grants, supposedly increasing the efficiency of the tax system, but reducing SCG tax autonomy.<sup>10</sup>

---

<sup>9</sup> Log-rolling is an exchange of votes in a legislative process whereby two parties, each of whom needs a partner to push its priorities through, create a common platform. One group supports the demands of another group with which it has little common ground or that it mildly opposes, in exchange for obtaining the other group's support for its own aims. Log-rolling works if the interests of other parties are relatively weak and dispersed. The benefits of log-rolling are controversial in the economic literature: while some see it as efficiency-enhancing during a reform process, others see it as rent-extracting (Crombez, 2000).

<sup>10</sup> In 2000, the Australian Goods and Services Tax replaced a set of inefficient state consumption taxes. Although all tax proceeds are transferred to the states, the latter have no discretion over the tax base or

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 them, but in general, the specific character of fiscal relations reforms calls for wide inclusion.

## **4. DESIGNING THE REFORM PROCESS**

### **4.1 Political leadership tends to accelerate a reform**

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

---

tax rates. At the beginning of the 1980s, Mexico replaced a set of inefficient autonomous state taxes by a tax-sharing system that stripped the states of taxing power.

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.

#### 4.2 External and independent expertise lends credibility to reforms

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

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

#### 4.3 Consultation should focus on a reform’s long-term impacts

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

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

discussing the overall objectives of the reform. By doing so, governments hoped to shift the discussion away from distributional effects and onto the long-term efficiency objectives. It is true that this “veil of ignorance” is difficult to maintain in a policy environment where short-term distributional impacts are easier to quantify than long-term effects.

#### 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 period of time.<sup>11</sup> Job guarantees for civil servants for a limited period reduced opposition from the public administration, as was the case in the Danish reform. In several countries a gradual phasing-in of new arrangements helped to reduce sudden breaks and discontinuities in transfer flows. Grandfathering rights and similar compensation mechanisms kept short-term changes in the SCG revenue-ranking position – e.g. in terms of tax capacity or transfer size - to a minimum. Transitional arrangements have their benefits beyond securing the success of a reform: distinguishing between permanent and transitional arrangements can help ensure overall consistency of a reform, since all messy political compromises can be relegated to the transitional arrangement. However, and in most cases, transitional arrangements put a considerable burden on the central government. As many observers interviewed during the study lamented: “Central government always pays”.

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

#### 4.5 The administration should speak with one voice

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

---

<sup>11</sup> The Swiss reforms provide for a transition period of up to 28 years during which no canton will lose in net terms. In Germany, the new sub-central fiscal rule forbidding the *Länder* from running structural deficits, which was inserted into the constitution in 2009, will be fully applicable only after 2020.

elements, while other countries explicitly pulled back from creating additional bodies on the grounds that they would procrastinate and develop their own agenda.

If administrative leadership was weak or shared between ministries, reforms were more likely to stall. Inter-ministerial infighting tended to weaken a reform. This is why several fiscal federalism reforms were enacted in conjunction with a reform of inter-ministerial financial management, or the reallocation of administrative powers and responsibilities was made part of the reform. In several cases, tasks such as the responsibility for disbursing intergovernmental grants, previously carried out by a range of different administrations, was concentrated in a single ministry. Indeed, many reforms may have resulted in a power shift from line ministries to the Ministry of Finance.

#### **4.6 Communication should present the policy behind the numbers**

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

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

#### **REFERENCES**

- Albouy, D. (2010), “Evaluating the Efficiency and Equity of Federal Fiscal Equalization”, *NBER Working Paper*, No. 16144
- Blöchliger, H. and Vammalle, C. (2012): *Reforming Fiscal Relations and Local Government: Beyond the Zero-Sum Game*, OECD Publishing, Paris



Brosio, G. and G. Pola (1989), “A Survey of Various Attempts to Explain the Distribution of Tax Revenues among Levels of Government”, Proceedings of the 42nd Congress of the International Institute of Public Finance, Athens

Crombez, C. (2000), “Spatial Models of Log-Rolling in the European Union”, *European Journal of Political Economy*, No. 16

OECD (2010), *Making Reform Happen, Lessons from OECD Countries*, Paris.

Olofsgard, A. (2003), *The Political Economy of Reform: Institutional Change as a Tool for Credibility*, background paper to the World Bank Development Report, Washington

Rawls, J. (2001), *Justice as Fairness: A Restatement*, Belknap Press, Cambridge, Massachusetts

Rodden, J. (2009), “Representation and Regional Redistribution in Federations”, in IEB’s World Report on Fiscal Federalism, Barcelona

Rodrik, D. (1999), “The Rush to Free Trade in the World”, in Sturzenegger, F. and M. Tommasi (eds.), *The Political Economy of Reform*, MIT Press, Cambridge, Massachusetts

Tompson, W. (2009), *The Political Economy of Reform. Lessons from Pensions, Product Markets and Labour Markets in Ten OECD Countries*, OECD Publishing, Paris