

**INTERGOVERNMENTAL
FISCAL RELATIONSHIPS:
AN INTERNATIONAL PERSPECTIVE**

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The opinions expressed in this paper are those of the authors, and may not reflect the views or position of the Department of Indian Affairs and Northern Development.

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EXECUTIVE SUMMARY

Purpose

A critical element in the design of governments for Aboriginal peoples is the development of new fiscal relationships with other levels of government. The purpose of this study is to inform such development by investigating and analyzing the experience of other countries facing challenges of relevance to Aboriginal self-government.

The analysis of international experience proceeds at two levels. First, the Institute summarizes the important principles and best practices that can be derived from the extensive work now going by international financial institutions (e.g. the World Bank) and by a number of academics, several of whom are Canadian. Second, the Institute analyzes in some depth the experience of four countries - Sweden, Denmark, the United Kingdom and Australia.

In the concluding section of the paper, the Institute draws together the main lessons that this analysis of international experience reveals and makes recommendations for future action, including further research that might be useful.

Principles and Best Practices

The major principles and best practices for developing fiscal relationships between national and sub-national governments have been gleaned from recent publications of the World Bank, the International Monetary Fund, the Organization for Economic Cooperation and Development, and a number of academic experts in this field including a number of Canadians.

The overall thrust in the literature reviewed by the Institute is to support strongly greater fiscal decentralization, especially in highly centralized developing countries and in emerging market economies, mainly in Eastern Europe. Most of the arguments supporting this thesis are made on theoretical grounds.

The principles and best practices fall into the following categories:

- ! expenditure responsibilities;
- ! taxation and other own-source revenue;
- ! fiscal transfer mechanisms;
- ! borrowing capacity; and
- ! institutional considerations including performance indicators, auditing and monitoring requirements, strengthening local capacity and the fiscal legal framework.

Case Studies

In conjunction with the Research and Analysis Division of the Department Of Indian and Northern Affairs, the Institute developed the following criteria for choosing the countries on which to base the case studies; such countries should have subnational governments which

- ! have wide taxation powers with jurisdictional powers approximating those of a Canadian province;
- ! have both revenue capacity and expenditure requirements as criteria in determining the fiscal transfer;
- ! have experienced a relatively recent change in their fiscal relationship with the central government;
- ! have a wide range of population bases with some jurisdictions having relatively small populations (under 100,000);
- ! are located, as least in part, in economically depressed areas; and
- ! are located in a variety of countries both in terms of their geographic location and in their level of economic prosperity.

In addition, the Institute undertook to include as one of the case studies an examination of the fiscal arrangements existing in Australia, in particular because of the interesting equalization feature between the Commonwealth government and the states and territories. Finally, for reasons of time and cost, the Institute chose cases in which material was readily available in either English or French.

After a review of the literature on fiscal decentralization, including case studies on a wide variety of developing countries, the Institute came to the conclusion that the most fruitful case studies were of long established liberal democracies, primarily in Western Europe. The Institute chose Australia for reasons already cited and three unitary countries in Europe - Sweden, Denmark and the United Kingdom - as the countries best fitting the criteria noted above with the one exception of the last criterion relating to diversity.

For each of these case studies, the Institute begins with a brief overview of the governmental structure of the country, followed by a description of the major elements of the intergovernmental fiscal relationships. The cases conclude with a discussion of some of the issues each country is facing, particularly in the context of the principles and best practices reviewed earlier in the paper.

Conclusions

The Institute judges that the following points, based on the case studies and the review of principles and best practices, have relevance for the development of a new fiscal relationship between Aboriginal

peoples and the federal government.

- a. **There is no 'one best way' or magic formula on which to base a fiscal relationship between levels of government.** Economic principles and international best practices can be helpful guides but political and historical factors may be as, or even more, important in forging the fiscal relationship.
- b. **Both the case studies and international experience elsewhere confirm that revenue equalization approaches are relatively straight forward** - the tax system generates up to date and reliable data and the relationships between tax and 'capacity to pay' is direct. One contentious area is the degree of equalization and whether a Robin Hood model (i.e. where tax rich jurisdictions transfer funds to tax poor jurisdictions) is employed.
- c. **All the case study countries have equalization mechanisms that provide an incentive for raising own source revenue by using tax potential (as opposed to actual taxes raised) and a standard tax rate as the main equalizing variables;**
- d. **The case studies and the principles section both confirm the importance of establishing a robust set of own source revenues for subnational governments.** Indeed, it is likely no coincidence that the Scandinavian countries, with the largest portion of own-source revenue, appear to have the most viable partnership arrangements between the various tiers of government.

The apparent impracticality of having a tax on business income (a so-called 'mobile' factor) at the local level in the Scandinavian countries may also be instructive in the Canadian context.

- e. **Expenditure equalization, in contrast to revenue equalization, appears to be fraught with political controversy** for a variety of reasons - some indices are at best proxies for what is being measured; data is often out of date or not available; the mathematics becomes complicated (the use of statistical regression techniques, for example); and, more fundamentally,

where the own source revenues are relatively minor. Furthermore, expenditure equalization should be attempted only if there is a high degree of consensus around the basic principle of expenditure equity.

- f. Fiscal transfer mechanisms create continual tension between the principles of simplicity and equity.** In other words, attempts to achieve greater equity invariably lead to higher levels of complexity. Conversely, attempts to realize greater simplicity result in ‘cruder’, and to many, less satisfying approximations of equity.
- g. The experience of the countries making up the four case studies suggests that the borrowing of funds by new Aboriginal governments should be part of any fiscal arrangements agenda.**
- h. The case studies have revealed a wide variety of mechanisms to enhance accountability.** Some of these that are worthy of consideration in the Canadian context are:
 - ! an ombudsman (the UK);
 - ! a common auditing commission (the UK);
 - ! a mechanism or mechanisms for gathering and reporting performance indicators and doing comparative analysis (the UK, Sweden);
 - ! a mechanism for creating greater transparency vis a vis borrowing (Australia).
- i. The case studies also reveal a continuing 'tension' in the degree to which the central governments 'control' or influence the activities of subnational governments.** Such control and influence can come in the form of conditional grants (the importance of these are on the upswing in two cases - the UK and Australia - and on the opposite cycle in the Scandinavian countries) and through legislation passed by the central governments in unitary states through which they can control to a high degree the activities of local governments. Like expenditure equalization, there appears to be no 'equilibrium' point; rather, a continuous cycle from more controls to fewer controls to more controls appears to be the norm. All of this points to the importance of establishing a robust set of mechanisms similar to those outlined in point h) above so as to avoid more intrusive 'control' mechanisms, a development which would not be in the best interests of either the federal or Aboriginal governments. In addition, harmonization mechanisms with all three levels of government will be critical in the Canadian context, given the lack of a national legislative framework for the programs that will fall under Aboriginal jurisdiction.
- j. Another contentious point in any fiscal relationship between levels of government is the determination of the total amount to be transferred to all subnational governments.** In all four cases, the central government determines this amount as part of their budget process but in different ways - in the UK, the amount is a function of a set of published

factors; in Denmark, there is reliance on a set of principles, backed up by a joint forum for discussing the issue; and in Australia, the amount is determined at an annual Premiers' conference. The Danish approach may be worthy of careful consideration in the Canadian context.

- k. **An important conclusion to be drawn from the case studies is that the size or scale of subnational governments appears to matter.** One of the spin-off benefits of expenditure equalization systems is that countries get a better, albeit imperfect, sense of the factors driving the cost of services in the public sector. And the number of inhabitants within a single jurisdiction and their geographic dispersion appear to be important factors. In the three unitary countries there has been a trend toward reducing the number of local governments based to a large degree on questions of scale and efficiency.
- l. **In the Scandinavian countries, a staged implementation of an overall transfer system over several years with set parameters on the degree to which transfers could change from one year to the next has been an effective implementation strategy.** The Danish and Swedish experience suggests that a more incremental approach to implementing change might have resulted in more opposition and have been less successful.
- m. **Another element in the implementation of the transfer systems in the Scandinavian countries has been the use of legislation to set out the major elements of their system, including the factors, their weights and the methods of calculation.** In contrast, Australia and the United Kingdom have put only their institutional elements of their systems in legislation.
- n. **The Danish approach to achieving a high degree of budget security for local authorities by giving them the option of opting for a guaranteed tax base and associated equalization amount, based on the most recently completed fiscal year is worthy of possible emulation in the Canadian context.** Under this option, the central government assumes the risk, should the tax base decline but also reaps the benefits, should the tax base rise.
- o. **A final conclusion relates to the importance of establishing an ongoing process or mechanisms for managing the fiscal relationship, given the inherent problem of dividing a fixed sum among a number of competing entities.** The case studies point to two distinct models - the Australian approach of establishing a 'neutral', non-political agency to help the players manage the contentious issues or the Scandinavian approach, based more on a negotiating model. Both of these models have precedents in the current federal-Aboriginal relationship.

Recommendations

The above set of conclusions lead to the recommendations.

Principles

- a. **The department should revise its statement of principles for a new fiscal relationship** (for example, in its presentation to the Meadow Lake Tribal Council in the fall of 1997), by adding the following points:
- ! **the notion of 'neutrality'** should be central to any fiscal transfer system, neutrality in the sense that the receiving government should not be able to influence the grant that it receives by manipulating its expenditure or tax decisions;
 - ! **any statement of principles should recognize that some of the principles may be conflicting** - in particular, implementing the 'equity principle' tends to move a transfer mechanism away from the 'principle of simplicity'; and
 - ! **to make any fiscal arrangement work, there needs to a strong commitment on the part of all parties to the continuous management of the relationship** because of the ongoing potential for conflict between the Aboriginal governments and the federal governments and among Aboriginal governments over the implementation of any equalization regime.

Borrowing by Aboriginal governments

- b. **The department should propose that borrowing by Aboriginal governments should be part of any agenda for discussing a new fiscal arrangement.** Topics to be discussed under this heading include:
- ! possible mechanisms to lower the cost of borrowing (as in the United Kingdom and Sweden);
 - ! whether borrowing should be restricted to investment projects;
 - ! the adoption of common accounting approaches and principles;
 - ! contingency plans in the case of default; and
 - ! how the transparency principle will be realized.

Fiscal Transfer mechanism

- c. **The starting point for discussions between the department and its Aboriginal partners on a fiscal transfer mechanism should be the current mechanism employed by the**

federal and territorial governments or some variation thereof. The models canvassed in this study are far too complicated for the Canadian context; they represent the results of long, evolutionary processes; and finally they are supported by an institutional structure that has no analogue in Canada. The advantages of the existing territorial formula are several:

- ! Canadians have had direct experience with it for a significant period of time;
- ! this model is suited to a small number of self-governing entities whose numbers can increase slowly over time;
- ! the data requirements are relatively straight forward; and
- ! it has both an expenditure and revenue equalization feature.

In adopting this approach (or some variation), the parties should realize that the expenditure equalization feature is 'crude' at best and the long term tendency will be to refine it and thus render the formula increasingly incomprehensible to most citizens.

Further research

- d. **The department, likely in conjunction with Aboriginal partners, should conduct research on the experience of other jurisdictions with the following accountability devices with an emphasis on how these could be most effectively adopted to fit the federal-Aboriginal relationship:**
 - ! **performance indicator systems** and comparative reporting methodologies;
 - ! **audit and other review mechanisms** jointly serving a variety of jurisdictions;
 - ! **common accounting and financial reporting systems;** and
 - ! **redress mechanisms** such as an ombudsman.

- e. **Again in conjunction with appropriate Aboriginal partners, the department should undertake research on capacity building strategies to support the development of a new fiscal arrangement.** The choice of the countries for the case studies had a number of advantages outlined in Section 3 of this paper. A disadvantage, however, of choosing mature western democracies is the lack of good examples in the building of fiscal capacity. The Institute's review of the literature revealed a number of interesting approaches, both in Latin America and in the newly emerging market economies in Eastern Europe. No doubt there are others as well. These could be profitably mined at relatively modest cost.

- f. **Other potentially useful research projects might centre on the following topics:**
 - ! **the experience with user fees and charges** - where to apply them, the potential for dampening demand, pitfalls to avoid;
 - ! **the experience with joint borrowing agencies** both in Canada and abroad - the expected costs and benefits, organizing principles, pitfalls to avoid;

- ! **harmonization schemes** for such critical areas as tax and environmental management both in Canada and abroad - costs and benefits, pitfalls to avoid;
- ! **questions of scale** - a review of the research literature in Canada and abroad; lessons learned; the nature of the trade-offs involved; options.

INTERGOVERNMENTAL FISCAL RELATIONSHIPS: AN INTERNATIONAL PERSPECTIVE

1. INTRODUCTION

A critical element in the design of governments for Aboriginal peoples is the development of new fiscal relationships with other levels of government. The purpose of this study is to inform such development by investigating and analyzing the experience of other countries facing challenges of relevance to Aboriginal self-government.

The analysis of international experience will proceed at two levels. In the section that follows, the Institute summarizes the important principles and best practices that can be derived from the extensive work now going by international financial institutions (e.g. the World Bank) and by a number of academics, several of whom are Canadian.

With this summary as an important backdrop, the Institute then proceeds to analyze in some depth the experience of four countries, chosen with particular care for their relevance for the federal government's future relationship with Aboriginal self-governments.

In the concluding section of the paper, the Institute draws together the main lessons that this analysis of international experience appears to reveal and makes recommendations for future action, including further research that might be useful.

2. PRINCIPLES AND BEST PRACTICES

The purpose of this section of the report is to summarize the major principles and best practices for developing fiscal relationships between national and sub-national governments. These have been gleaned from recent publications of the World Bank, the International Monetary Fund, the Organization for Economic Cooperation and Development, and a number of academic experts in this field including three Canadians – Harry Kitchen of Trent University, Mel McMillan from the University of Alberta and Richard Bird from the University of Toronto.

The overall thrust in the literature reviewed by the Institute is to support strongly greater fiscal decentralization, especially in highly centralized developing countries and in emerging market economies, mainly in Eastern Europe. Most of the arguments supporting this thesis are made on theoretical grounds. In one of the rare empirical studies canvassed, two World Bank economists confirmed that decentralized fiscal systems perform better than centralized systems on all major aspects of the quality of governance such as:

- ! citizen participation: political freedom and political stability
- ! government orientation: judicial efficiency, bureaucratic efficiency, lack of corruption
- ! social development: human development, egalitarian income distribution
- ! economic management: outward orientation, central bank independence and fiscal management."¹

In addition to being useful on their own, the principles and best practices summarized in this section will form a helpful backdrop in which to consider the four case studies presented later in this paper.

The following points capture these principles and best practices:

2.1 An examination of fiscal relationships should encompass the following topics:

- ! expenditure responsibilities;
- ! taxation and other own-source revenue;
- ! fiscal transfer mechanisms;
- ! borrowing capacity; and
- ! institutional considerations including accountability measures such as performance indicators, auditing and monitoring systems; strengthening local capacity; and the fiscal legal framework.

Expenditure responsibilities

¹ Anwar Shah and Jeff Hunter, “A Simple Measure of Good Governance and Its Application to the Debate on Appropriate Level of Fiscal Decentralization”, (World Bank, Washington DC) p. ii).

- 2.2 The allocation of expenditure and tax functions to various levels of governments is the most fundamental issue in a federation;** assigning responsibility for spending must precede assigning responsibility for taxation because tax assignment is generally guided by spending requirements at different levels.
- 2.3 The following principles² should guide the assignment of responsibilities of services to one level of government or another:** whether they
- ! generate spillovers;
 - ! benefit from economies of scale;
 - ! must be provided at a minimum standard;
 - ! involve some redistribution of income; and
 - ! reflect local or regional preferences.
- 2.4 Thus, the central or national government should be responsible for those services³** whose benefits extend across the country (e.g. national defence); that generate spillovers across the country (e.g. monetary policy); that benefit from economies of scale (e.g. certain transportation networks); that are primarily income redistributive in nature (e.g. provisions for the aged); and where uniform country-wide standards are expected (e.g. certain environmental standards) .
- 2.5 Subnational governments should be responsible for those services whose benefits are confined primarily to their geographic area and for which residents should have a choice over both the quantity and quality of service.** Primary and secondary education, health care, local transportation networks, and care of the elderly are typical examples of such services.
- 2.6 When expenditure responsibilities are shared among jurisdictions, responsibilities of each tier of government should be clear and appropriate co-ordination mechanisms should be established.** Otherwise, accountability, among other things, will suffer.
- 2.7 Assigning responsibility for the provision of service to a specific level of government does not imply that government should be directly engaged in its production.** Use of contracting out and voucher systems are two examples of where efficiencies can be obtained through means other than direct delivery.

² Harry Kitchen, "Municipal Finance Guidelines for Thailand: Principles and Best Practices", (Queen's University, 1997) P. 10.

³ Harry Kitchen, op. cit. P. 12 and Anwar Shah, "The Reform of Intergovernmental Fiscal Relations In Developing and Emerging Market Economies", (World Bank, Washington DC., 1994) P. 9-12.

Taxation and other own-source revenue

- 2.8** **User fees or benefit-based taxes are efficient for funding services where the beneficiaries can be clearly identified and the costs correctly determined** (water and sewage systems, recreational services, public transit, and solid waste disposal are areas where user fees are commonly applied). Among other benefits, user fees will help determine the appropriate level and quality of service for a given jurisdiction by creating a market mechanism.
- 2.9** **For those expenditure responsibilities where user fees or benefit-based taxes are not feasible, then the following two principles should guide the assignment of general benefit taxation responsibilities:**
- !** **efficiency in tax administration** (for example, taxes on mobile factors - such as corporate and personal taxes – should be assigned to the national government, taxes on less mobile factors to subnational governments); and
 - !** **fiscal need** (the tax base should be adequate to finance the expenditure responsibilities of the level of government and be able to expand as fast as expenditures).
- 2.10** **The objective should be to attempt to closely match expenditure responsibilities with revenue generation capacities to reduce the need for intergovernmental transfers, which can produce distortions. Even for the poorest of jurisdictions, to achieve accountability, their citizens should be responsible for at least some of the costs of the services provided for them.**⁴

Intergovernmental transfers

- 2.11** **Intergovernmental transfers are appropriate mechanisms for achieving some or all of the following four objectives⁵:**
- a)** **to deal with the fiscal gap**, resulting from insufficient own-source revenues to meet the expenditure responsibilities assigned to subnational governments;
 - b)** **to achieve equalization among subnational governments so that they can provide a comparable level of service by levying comparable tax rates** – achieving this principle may not be possible without a transfer system in place because a) their tax bases differ; b) the cost of providing services differ; or c) the demand for particular services may differ (e.g. the portion of the population made up of students

⁴ Richard Bird, "Financing Aboriginal Governments: An International Perspective", unpublished paper.

⁵ Anwar Shah, op. cit. P. 27-30.

may vary from region to region with significant impacts on the cost of education);

- c) **to deal with spillovers** (a spillover occurs when the benefits or costs of a service 'spill over' or affect another jurisdiction - for example, when one jurisdiction builds and pays for a road which citizens of a neighbouring jurisdiction use for free. Without a transfer from the national government, a subnational government would be inclined to spend less on such roads, given that its citizens do not enjoy all the benefits);
- d) **to achieve national objectives** (e.g. to reduce unemployment through a national infrastructure program).

2.12 There are two broad categories of intergovernmental transfers - conditional and unconditional transfers. Conditional transfers are appropriate mechanisms for achieving objectives c) and d) above and can be either

- ! matching transfers, where the subnational government is required to match all or a portion of the national governments share; or
- ! non-matching transfers.

To achieve objectives a) and b) above, unconditional transfers are the most appropriate vehicle.

2.13 The following are the generally accepted principles⁶ in designing fiscal transfer systems

- ! **equity** - subnational governments with equal fiscal need should be treated equally;
- ! **neutrality** - a subnational government should not be able to influence the grant that it receives by manipulating its expenditure or tax decisions;
- ! **predictability and flexibility** - subnational governments need to be able to budget and plan for the future but, at the same time, have the flexibility to respond to changing circumstances;
- ! **simplicity** - the transfer mechanism should be readily understandable and easy to administer;
- ! **autonomy** - subnational governments should have the independence to set priorities and manage services to respond to local needs; to give these governments increased responsibilities while maintaining considerable control over their actions will not likely lead to expenditure decisions which are fair, effective and accountable to their citizens.
- ! **incentive for sound fiscal management** - the transfer mechanism should not penalize subnational governments for sound management or, in the reverse, should not provide

⁶ Anwar Shah, op. cit. P. 30-33 and Harry Kitchen, op. cit. P. 27-37.

grants to finance deficits; and

- ! **accountability** - the transfer system should enhance the accountability of the subnational government to its citizens by, among other things, not blurring jurisdictional responsibilities etc.

Some of these principles may be conflicting; for example, implementing the equity principle tends to move a transfer mechanism away from the principle of simplicity by introducing more factors or more complexity in the calculations (e.g. the use of statistical regression techniques). Consequently, achieving an appropriate balance among these principles is the best a country can hope for. Further, such conflicts suggest that there will be continuing debates about whether the current balance that has been struck is the most appropriate one.

2.14 The large majority of experts⁷ recommend unconditional grant formulas that include both a measure of expenditure need and fiscal capacity. Such a formula can meet the equity principle by allowing each subnational government to provide an average level of service at an average rate of tax.

2.15 On the fiscal capacity side, there are two basic models⁸ to choose from:

- ! **the Robin Hood model** - whereby subnational governments with above average tax base per capita recompense those with below average tax base per capita (such an approach is usually hotly contested by the 'rich' government entities but does result in complete equity and has a further advantage from the national government's perspective of being cost neutral);
- ! **the grant model** - whereby, subnational governments below the average tax base per capita are provided a grant either at the highest level (thus achieving full equity) or at some percentage of the average (in Canada, for example, provinces with below average tax capacity per capita are brought up to the average.) This model tends to garner greater majority support than does the Robin Hood model, given that the poorest get something and the rich seem not to lose, at least from the perspective of their governments. (Citizens of rich regions end up paying for the cross-subsidization.)

2.16 Expenditure need is more difficult to define and administer than fiscal capacity for a

⁷ Anwar Shah, op. cit. P. 31.

⁸ Joergen Lotz, "Denmark and Other Scandinavian Countries: Equalization and Grants" in "Financing Decentralized Expenditures" edited by Ehtisham Ahmad, (Edward Elgar Publishing Co., Brookfield, Vermont; 1997) P. 200-202.

variety of reasons: defining an equalization standard presents serious challenges; determining cost differentials from input-output relationships is not easy; understanding differences in service sectors, populations, and local needs involves judgment, and finally, there may be significant data availability problems.

2.17 Designers of the expenditure need element of a transfer have a choice of the same two models - the Robin Hood model (i.e. low cost jurisdictions shift funds to high cost jurisdictions) and the grant model - as in the fiscal capacity side. Within each of these models, there are a variety of choices including the following⁹:

- !** **using an historical expenditure level as a base and adjusting this base annually using an appropriate index** - this is the approach used in Canada to determine the expenditure needs of the territories with the index being a combination of population growth and an average of provincial-territorial expenditure growth;
- !** **adopting average expenditure per capita as the standard** - this approach ensures that each subnational government has sufficient resources to meet the average level of expenditures but does not help those entities with greater than average needs;
- !** **adopting a standard expenditure per capita weighted by a factor or index** - for example, if lower density leads to higher costs, then a measure of density would provide additional grants to lower density entities;
- !** **adopting standard expenditures for municipalities grouped by similar characteristics** - entities could be grouped by population size, density, location, employment rates etc. and within each group, the assumption is that each entity has similar needs and costs;
- !** **some combination of the above three approaches** - for example, grouping municipalities with key similarities and then providing an index to correct for some additional factors.

2.18 Implementation best practices for fiscal transfer systems suggest the following points¹⁰:

- !** **it may be wise to adopt a phased approach**, beginning with a representative tax system over a five year period and then moving to a representative expenditure system;
- !** **a full expenditure system requires a lot of effort, a considerable use of judgment, and a high degree of co-operation** among the parties if it is to be successfully implemented;
- !** **it follows that a less ambitious approach on the expenditure side might be**

⁹ Harry Kitchen, op. cit. P. 33-36.

¹⁰ C. Richard Rye and Bob Searle, "Expenditure Needs: Institutions and Data", in "Financing Decentralized Expenditures", op. cit. P. 55.

advisable in the short run - using broad indicators of relative need or confining equalization to the poorer entities;

- ! **data are more likely to be available to measure expenditure need arising from differential demands than those arising from differential costs** - this suggests an alternative approach: to use available data to measure demand needs and to use judgment and qualitative experience to make estimates of cost differences;
- ! **the byproducts of detailed expenditure systems - both the data produced and the analysis of them - can be useful in increasing public sector efficiencies.**

Borrowing capacity

2.19 In general governments should borrow only for investment purposes; otherwise future generations will be saddled with obligations related to benefits received by past generations. This said, there is considerable diversity in approaches to central governments' controlling the borrowing of sub-national governments for a variety of reasons ranging from the state of development of a country's financial markets to whether there exists serious macroeconomic problems (e.g. having to do with exchange rates, foreign reserve management etc.). Four broad approaches¹¹, each with their own advantages and disadvantages, are the following:

- ! **reliance on market discipline** - this is the approach followed in Canada with regards to provincial borrowing;
- ! **a co-operative approach to debt controls** - under this approach subnational governments are involved in formulating macroeconomic policy, including the limits for the borrowing of subnational entities;
- ! **rules-based approaches to the control of subnational approaches** - a number of countries, both unitary and federal, have adopted rules, specified in the constitution or in laws, which, among other things, set limits on the level of indebtedness or specify the purposes for borrowing;
- ! **direct controls over subnational borrowing** - these controls may take a variety of forms including the setting of annual limits to borrowing, the authorization of individual borrowing operations, and centralization of all borrowing with on-lending to subnational governments for approved purposes.

2.20 The major conclusions¹² on the control of subnational borrowing are the following:

- ! **although appealing in principle, sole reliance on market discipline is unlikely to**

¹¹ Teresa Ter-Minassian and Jon Craig, "Control of Subnational Government Borrowing" in "Fiscal Federalism in Theory and Practice", edited by Teresa Ter-Minassian, (International Monetary Fund, Washington, 1997) P. 157-169

¹² Teresa Ter-Minassian and Jon Craig, op. cit.. P. 169-171

be appropriate in many circumstances because one or more of the conditions for its effective working will be absent (e.g. conditions such as free and open markets, adequate information about the borrower's outstanding debt, no perceived chance of bailout in the case of default etc.);

- ! it is likely that, in line with worldwide trends toward devolution, there will be a decline in administrative controls on domestic subnational borrowing;**
- ! borrowing abroad by sub-national governments should be strictly limited in accordance with, among other things, macroeconomic considerations;**
- ! all borrowing should be limited to investment purposes; and**
- ! even in the context of rules-based approaches there is more scope for increased co-operation of all levels of government in dealing with debt levels.**

Institutional Considerations including Accountability Systems

- 2.21 Performance measures - i.e. those that attempt to measure outputs and results rather than inputs - may have a role to play in the structuring of conditional grants. However, the strongest argument in support of them comes when their presence creates a competitive environment in which subnational governments operate¹³.** The opportunity of citizens and officials to compare, via bench-marking, performance across jurisdictions is a strong contributor towards effective accountability.
- 2.22 In a similar fashion, any intergovernmental transfer system should make explicit the role of audit, program evaluation and other monitoring devices of the performance of subnational governments. These functions are often conducted by several agencies in an uncoordinated fashion - consolidation within a single agency could improve overall effectiveness.**
- 2.23 Decentralization of responsibilities and the rationalization of intergovernmental transfers should be accompanied by a strategy to strengthen the institutional capacities of subnational governments.** Central governments (or associations of subnational governments) can identify training needs, offer training programs, provide guidance on management issues, establish 'twinning' programs with more experienced entities, provide technical assistance and operational tools for a variety of functions from personnel management to the monitoring of programs.
- 2.24 Reform of intergovernmental fiscal relations requires comparable institutional arrangements for intergovernmental coordination, planning, budgeting and**

¹³ Harry Kitchen, op. cit. P. 42

implementation.¹⁴ Almost any system accepted on a consensual basis can be made to work, given good will, adequate effort and appropriate flexibility. These conditions are more likely to be realized if formal coordination mechanisms are in place.

2.25 In former Soviet Block countries, framework laws on property rights, corporate legal ownership and control, bankruptcy, and financial accounting and control need to be more fully developed in order for a intergovernmental transfer arrangement to work effectively¹⁵. For example, common accounting practices across subnational governments are an absolute necessity if the objective of equity is to be realized.

In conclusion, there is a growing body of literature on the issue of designing effective fiscal relationships with a surprising degree of consensus on the theoretical concepts that should underpin such relationships. In the next five sections of the paper, the Institute examines how these fiscal relationships in four countries have played out in practice and what lessons there appear to be for Canada and its relations with Aboriginal peoples.

¹⁴ Anwar Shah, op. cit. P. 46

¹⁵ Anwar Shah, op. cit. P. 46

3. CASE STUDY CRITERIA

In conjunction with the Research and Analysis Division of the Department Of Indian and Northern Affairs, the Institute developed the following criteria for choosing the countries on which to base the case studies; such countries should have subnational governments which

- ! **have wide taxation powers with jurisdictional powers approximating those of a Canadian province** - this configuration of expenditure and tax powers is in line with current government policy and was essentially the recommendation of the Royal Commission on Aboriginal Peoples;
- ! **have both revenue capacity and expenditure requirements as criteria in determining the fiscal transfer** - this was a recommendation of the Royal Commission and is line with the general consensus of views of academics in this area;
- ! **have experienced a relatively recent change in their fiscal relationship with the central government** - such a criterion would ensure that implementation issues would receive attention;
- ! **have a wide range of population bases with some jurisdictions having relatively small populations (under 100,000)** - this would ensure that the cases would have some entities approximating the size of possible Aboriginal populations; and
- ! **are located, as least in part, in economically depressed areas** - again this criteria would be relevant to many Aboriginal communities; and
- ! **are located in a variety of countries both in terms of their geographic location and in their level of economic prosperity** - this criteria might produce a wider range of experiences in which common lessons would have even greater cogency.

In addition, the Institute undertook to include as one of the case studies an examination of the fiscal arrangements existing in Australia, in particular because of the interesting equalization feature between the Commonwealth government and the states and territories. Finally, for reasons of time and cost, the Institute chose cases in which material was readily available in either English or French.

After a review of the literature on fiscal decentralization, including case studies on a wide variety of developing countries - India, Pakistan, Malaysia, Indonesia, Brazil, Chile, Costa Rica, Columbia, China, South Africa, Philippines and Thailand to name a few - and emerging market economies - Russia, Hungary, Poland, Bulgaria, Slovakia, Czech Republic and Romania - the Institute came to the conclusion that the most fruitful case studies were of long established liberal democracies, primarily in Western Europe. The World Bank, for example, had this to say after its exhaustive

review of the state of fiscal de-centralization:

"Despite the high priority in most countries attached to limiting interregional fiscal disparities and the apparent simplicity and practicability of design, not a single developing or transitional economy has adopted a program of equalization to a specified standard along the lines of the representative tax system...Developing countries...almost without exception have incredibly large numbers of specific-purpose programs. In many of these programs, objectives are not specified or are specified vaguely, and in some instances grant objectives are determined only after release of funds."¹⁶

This view is supported by other authors. For example, after completing a similar survey of intergovernmental fiscal relations, Mel McMillan of the University of Alberta came to these conclusions:

"Among most of our developing countries outside the newly emerging market economies, local governments have even a lesser role than the smallest of those in the Industrialized countries. Their responsibilities and/or authorities are very limited."¹⁷

Based on these strong assertions and the its own survey of possible case study candidates, the Institute concluded that developing countries or those with emerging market economies were not suitable case study candidates. Of the industrialized countries, the United States is not an interesting candidate in that equalization grants are not a part of the fiscal relationships in that country. That left essentially Western Europe, New Zealand and Australia. The Institute chose Australia for reasons already cited and three unitary countries in Europe - Sweden, Denmark and the United Kingdom - as the countries best fitting the criteria noted above with the one exception of the last criterion relating to diversity.

For each of these case studies, the Institute begins with a brief overview of the governmental structure of the country, followed by a description of the major elements of the intergovernmental fiscal relationships. The cases conclude with a discussion of some of the issues each country is facing and the processes to deal with them. To ensure a high degree of accuracy, the Institute provided a draft of each case study to a country expert, asked for comments, and subsequently made any suggested changes.

¹⁶ Anwar Shah, op. cit. (underlining by the Institute) P. 45

¹⁷ Melville McMillan, "Local Governments: An International Perspective on Industrialized and Developing Countries" in "Planning for 2020 and Beyond: Malaysia's Public Sector in the 21st Century, Workshop Proceedings" (Queen's University and the Malaysian Institute for Economic Research, 1997) P. 207

4. CASE STUDY #1: SWEDEN¹⁸

4.1 History and Structure of Government

Sweden has a territory of some 450,000 square hectares (approximately the size of the Yukon Territory) and a population of almost 9 million inhabitants. Fifty percent of the population lives in a geographic area representing 3 percent of the land mass. Thirty percent of the population lives in three metropolitan areas.

Sweden has a long tradition of local government with the foundation of the present system being laid in the 1860s. The local government sector comprises 288 municipalities, 23 county councils (which are not 'superior' to municipalities) and parishes. (The latter are not important for the purposes of this case study). Municipalities range in population from 3,000 inhabitants to 700,000 in Stockholm. Over half the municipalities have less than 20,000 inhabitants. The average county council has approximately 350,000 inhabitants and they range in size from 136,000 to 1.7 million inhabitants.¹⁹

The importance and special role of local government is laid out in the Swedish Constitution but mainly in terms of principles so that the extent of local self-government jurisdiction is a political question. The protection of the local right to taxation is also mentioned in the Constitution but the types of taxes and the tax base are not set out. Only Parliament, and not the executive branch, can impose powers and obligations on local governments.

In addition to the Constitution, the legal framework is provided first by the 1992 Local Government Act, which lays out a governance framework, dealing with such matters as organization, decision-making roles, referendums, redress and financial management. This Act also provides a general power to engage in matters of local concern. The largest part of local government activities, however, are based on special legislation, which regulate their compulsory activities - for example,

¹⁸ Source material for this case study is the following: interviews with three individuals - Lennart Tingvall, Secretary of the Equalization Committee; Andreas Hagnell, economist with the Swedish Association of Local Authorities, and Henrik Tiselius, Department of Local Authorities, Ministry of the Interior - and the following documents: "State Budget Support to Local Governments In Sweden" by Roger Pettersson in "State Budget Support to Local Governments" edited by G. Marcou (Organization for Economic Development and Co-operation; Paris, 1994); "The new proposed equalization system for municipalities and county councils in Sweden", (Ministry of Finance, November 1995); and a speech delivered by Andreas Hagnell at the Ankara Conference on Fiscal Autonomy, July 11, 1996.

¹⁹ Analyses of Swedish municipal structures indicate that the two "most expensive" types of municipalities are small, sparsely populated ones and major cities. Source: Soren Haggroth and Kai Kronvall, "Swedish Local Government."

education, health and social assistance.

4.2 Expenditure responsibilities

Local governments are one of the cornerstones of the Swedish welfare state and account for about 38% of total public sector expenditures and 28% of Sweden's total employment. Education and social services (child care, care of the elderly and disabled and assistance to individuals and families) constitute close to 60% of municipal expenditures. The county councils' most predominant task is health care, which accounts for some 75% of their total expenditures followed by services for mentally handicapped²⁰ (10% of expenditures). Table 1²¹ summarizes municipal and county council expenditures on activities in 1993:

Table 1

health and medical care	24%
social welfare activities	27%
education	18%
administration	5%
energy, water and waste management	5%
leisure and the arts	4%
communications	4%
sundry activities	13%

While expenditure responsibilities in the above areas rest with local authorities, the responsibility for results achieved is very much shared between the national and local governments. This is the case because of the regulatory nature of the national legislation and the fact that the national government provides some of the funding through grants (see below). To illustrate the nature of this shared jurisdiction in the area of education, the national government has established, among other things, a national agency to inspect schools, evaluate the results they achieve and, in general, to make recommendations on how to bring about greater effectiveness. Nonetheless, the decision about what portion of their budget to allocate to the school system is left to municipalities with the result that per student spending on education varies across the country.

4.3 Revenue Generation Capacity

²⁰ Services to the mentally handicapped have been transferred to municipalities as of 1996.

²¹ "The new proposed equalization system for municipalities and county councils in Sweden" op. cit. P. 2.

The three primary sources of revenue for local government in Sweden are taxes (about 67% of the total), grants from the central government (20%) and user fees (7%). Sweden has no local property tax. Rather, the primary tax vehicle at the local level is a flat rate tax on personal income, where the definition of taxable income is determined by the central government but where each municipal and county government can determine its own tax rate. (This flat rate tax is applied on top of a central government tax on personal income.) In 1997, the average local tax rate was 32% and varied from a low of 26.5% to a high of 34.4%, a variation of 8 percentage points. Tax collection is the responsibility of the central government. Prior to tax reforms carried out in the 1980s and in 1991, the local tax base included corporate income, certain real estate taxation and individual capital gains tax. Since the tax reforms, local taxation is confined to taxation of employment income.

The tax base per capita (tax potential) varies enormously for municipalities from 71% to 173% of the average per capita tax base (these figures are for 1996).

4.4 Borrowing

There are no central government restrictions on the borrowing of local governments in Sweden (specific regulations were removed in 1977.) Nonetheless, there are several specific constraints worthy of note. The first is in the current Local Government Act, which states, among other things, that local government economic performance should be in accordance with sustainable economic development. This implies that local government borrowing should be restricted to capital expenditures only. A second restriction is more indirect. By law, local governments must have balanced budgets over a three-year period, a factor that deters borrowing.

Since the end of the 1980s local government debt, excluding pension liabilities, has remained stable at around 5% of Gross Domestic Product. Nonetheless, several municipalities have ended up in economic difficulties because of municipal housing companies' being unable to pay interest payments on their debt. This has led to some pressure on the central government to re-introduce restrictions on the capacity of local governments to borrow.

Another recent development has been the establishment of a municipal bank, owned by some 80 municipalities, the mandate of which is to reduce borrowing costs by having a single borrowing facility with sufficient scale to, among other things, reduce risk from the perspective of potential lenders. This bank has recently applied to the Swedish Government to provide banking services to its members.

4.5 Intergovernmental transfer arrangements

As noted in an earlier section, grants from the central government are an important revenue source for local governments. In 1992, grants accounted for 26% of municipalities total revenue and 15% for county councils. Dependency varied widely. Some municipalities get more than 50% of their revenue from such grants while others receive less than 10%.

Prior to 1993, more than two thirds of the 'dollar' value of these grants were in the form of conditional grants directed at specific local government services – for example, in the area of primary education there were some 30 conditional grants, directed at specific aspects of the education system. These conditional grants were given with a variety of objectives. In some cases, the central government was attempting to control the scope and quality of the services offered; in other cases the grants served as a stimulus for local governments to expand certain services.

Unconditional grants, about a third of the total, were traditionally given to regions regarded as poor to make up for large differences in tax potential or costs.

Since the early 1990s, significant pressures have been building in Sweden to radically alter the relationship of the central government to local governments. An economic slow down, huge central government deficits, a striving for uniformity in the European Union and changes in the political ideology of the government – all of these factors have combined to promote greater economic efficiency and competitiveness with significant implications for local governments in general and the fiscal transfer arrangements in particular. Beginning in 1990, there have been some six parliamentary commissions established to study and recommend changes to the grant system and these Commissions have resulted in two dramatic set of reforms, the first in 1993 and a second in 1996.

The 1993 reforms

The salient feature of the reforms introduced in 1993 was to reverse the portion of conditional to unconditional grants so that approximately two thirds of central government grants became unconditional. This was done for two reasons: first, to promote greater efficiency through local autonomy to set priorities and realize the benefits of sound management; and second, to enhance the equalization aspect of the grant system.

The total cost of the new unconditional grant was determined by the central government in its annual budget and its distribution was established by three factors:

- ! **revenue equalization** – in 1993 each municipality was guaranteed 127% of the average tax potential (this approach is similar to the Canadian provincial equalization scheme with the exception that the 'have-not' Canadian provinces receive grants bringing them up to the average tax potential);
- ! **structural cost equalization** – intended to even out the demand and cost differences for local services, this factor was based on regression analysis of four variables to explain cost

differences: climate, population density, age structure and social structure. The result was an index from 86% to 152% of the average cost.

- ! **supplement for population reduction** – 24 municipalities received a supplement for experiencing a population decrease of more than 2%.

The unconditional nature of the new grant was welcomed and widely accepted but the principles for distributing the grant came under heavy criticism. The most heavily criticized aspect was the structural cost equalization factor – the regression analysis technique used was not generally understood and, moreover, the four variables utilized to explain cost differences were seen as inadequate. In addition to the cost equalization factor, there was criticism levelled at the revenue equalization feature in that three ‘rich’ municipalities over the guaranteed level did not have to contribute to the system (in other words, there was no Robin Hood feature to revenue equalization.) These criticisms led to the establishment of a new parliamentary committee resulting in significant, new reforms in 1996.

The 1996 reforms

To deal with these criticisms, Sweden has adopted a new equalization grant based on three elements:

- ! **a grant from the central government to all municipalities, based on population** – in 1996, this amounted to 57 B. Swedish Krona²² (to put this figure in context, total expenditures of local governments in 1996 were 400 B. Swedish Krona with total local tax revenue of 250 B. Swedish Krona);
- ! **a revenue equalization feature**, based on the Robin Hood principle - that is, local governments above the average per capita tax potential transfer funds (through the central government) to those below the average per capita tax potential (the transfer amounts to 95% of the difference and is therefore not total equalization) – in 1996, these transfers amounted to 11 B. Swedish Krona and, because of the Robin Hood feature, were revenue neutral from the central government perspective ; and
- ! **a cost equalization feature**, again based on the Robin Hood principle, whereby local governments with below average 'standard' costs per capita transferred funds to those with above average 'standard' costs per capita – in 1996, these transfers, which were again revenue neutral for the central government, amounted to 10 B. Swedish Krona.

²² One Swedish Krona equals .183 Canadian dollars (December 1997) or slightly less than 1/5 of a Canadian dollar

The calculation of the cost equalization feature (in particular, the determination of these 'standard' costs) also underwent dramatic change and now involves for municipalities the calculation of 15 indices using on average some four to five variables for each indice. In some instances, regression analysis is used; in others, the calculation is simply an arithmetic formula. The attached annex provides the activities and factors that form the cost equalization approach among municipalities and county councils respectively.

Another important feature of the 1996 reforms was its implementation timetable – a period of 8 years was chosen so that a maximum per capita reduction on a year to year basis could be established and guaranteed to the local governments that were the big ‘losers’ from a revenue perspective.

The important role that the Swedish Association of Local Authorities played in the development of the 1996 reforms is also worthy of note. Indeed, a new system of annual negotiations between the central and local governments is evolving. These negotiations encompass a dialogue on the long term economic conditions for local government as well as the fiscal relationship. Some of the changes that have resulted, in addition to the transfer mechanism, include the following:

- ! an agreement not to raise taxes at the local or national level; in return, the central government has undertaken not to impose new expenditure responsibilities on local governments without supplying new financial resources; and
- ! a process of reform to reduce the rules and regulations that affect municipalities to allow local governments more scope to use their resources effectively; the central government will exercise control in service areas of national interest increasingly through evaluation of municipal results in fulfilling national goals rather than through rules on how to provide services. One interviewee noted that, in practice, this process is not an easy one for central government institutions and it is not clear where the process will lead.

Finally, an important aspect of the Swedish equalization system is that the basic structure is set out in legislation, including, for example, the 15 indices involved in the calculations of the transfer amounts. The formula and weights in the expenditure system are set out in government regulations.

Issues and controversies

The major issue continues to be the cost equalization element of the transfer mechanism. Upon introduction

Another issue surrounding the Swedish transfer approach is the Robin Hood nature of the design, meaning that there will always be winners and losers. Moreover, the controversies will never disappear; new winners and losers will emerge over time as the data (e.g. population, age structure etc.) making up the formula are updated. Following the 1996 reforms, the five major municipalities on the losing side threatened court action on the grounds that the changes were unconstitutional in that they threatened a municipality's right to tax. These same municipalities have also raised the possibility of their pulling out of the Association of Local Authorities.

A final issue, although not of the same political magnitude as the above controversies, is a proposal for introducing a special accounting law for local government so that the rule of no local authority having a budgetary deficit over a three year period can be administered fairly. Up to this point, the accounting principles have been handled by a committee of the Association of Local Authorities. Local governments in Sweden apply the same set of rules and overall accounting principles as the private sector.

4.6 Capacity Development

The central government does not administer or fund any training programs or other capacity development measures for local authorities in Sweden. The Association of Local Authorities does sponsor conferences on current issues but does not provide formal training courses, which appear to be left to the private sector to establish and run. The Association does perform some central functions for all local authorities such as labour negotiations.

One interviewee explained to the Institute that Swedish officials remain in the same geographic area and with the same organization for much longer periods than is the custom in Canada. Consequently, the building of capacity for local governments is less of an issue.

4.7 Conclusions

The Swedish intergovernmental fiscal arrangements are sophisticated and have been built on a system of local government that has been in place for over a hundred years. With the recent changes over the last decade, these arrangements have moved closer to the 'ideal' set of principles and best practices laid out in section 2 of this paper. In particular, the following features appear noteworthy:

- ! the generation by local authorities of a high percentage of the revenue required for their expenditure responsibilities (i.e. a relatively small fiscal gap exists);
- ! the wide use of user fees;
- ! a trend to providing increasing autonomy to local governments to set priorities and manage

inputs to achieve efficiencies and meet local needs;

- ! increasing emphasis by the central government on results reporting;
- ! increasing co-operation among the actors;
- ! a political willingness to continue the process of reviewing and modifying the arrangements;
- ! a transfer mechanism that meets most of the desired criteria, particularly equity, neutrality, predictability, flexibility, autonomy and incentives for sound fiscal management.

On the other hand, there are a number of features of the Swedish system that do not match the ideal model. These include:

- ! the assignment of taxing power to local governments of a ‘mobile’ factor like employment income (according to one interviewee, the 8% tax rate differential among municipalities does not appear to promote any general moving to low tax jurisdictions, in part because housing costs there are so high; nonetheless, the Swedish experience with taxing corporate income at the local level, prior to tax reform in 1991, may be instructive);
- ! the high degree of shared jurisdiction in the big spending items – education, social assistance and health, which by their nature are not suitable for autonomous delivery at the local level. Accountability becomes difficult to achieve in such a system but recent reforms to provide more autonomy to local governments with the central government concentrating more on monitoring the achievement of results should be a positive step;
- ! the Robin Hood nature of the equalization scheme – while such a design provides a high degree of equity and has significant advantages from a central government perspective, the inherent and ongoing conflict it engenders would not make it suitable for certain jurisdictions with a less homogeneous population than that of Sweden. Furthermore, the equalization regimes involve only a small percentage (just over 5%) of the total local government budgets. The level of controversy would likely rise with regimes involving equalization transfers having a greater impact on subnational budgets. Finally, such a complicated and controversial equalization regime implies that ongoing transaction costs are built into the system as continuous review and adjustment become the order of the day.

In addition to the above points, the Swedish case study illustrates a number of others that arose in the principles and best practices section. For one thing, it demonstrates the conflict between

simplicity²³ on the one hand and equity on the other. Very few Swedish citizens, it would appear, are able to (or want to) grasp the complexities of the equalization formulas, which are technical in nature and yet these formulas will engender continuous political controversy.

Another important lesson from the Swedish experience is the nature of the fundamentals that have to be in place to make such an equalization system work: a well-functioning association of local governments; a neutral statistics agency; the existence of historical data, common to all of the local governments in the system; an agreed on approach for reviewing the system's rules and for placing parameters on the fiscal performance of local authorities; a common tax system; and a high degree of consensus on the value of the equalization principle.

The case study on Denmark, which follows this annex, illustrates many of these points with a few nuances.

²³ One element of the Swedish equalization system that is relatively simple is the revenue equalization approach, given that there is only one local tax involved. In contrast, in the Canadian equalization approach, there are some 33 provincial taxes - the result is that 670 data sets are required to work through the calculations in Canada.

**ANNEX
COST EQUALIZATION FACTORS - SWEDEN**

Municipalities

Activity (or equivalent)	Factors
! child care	age structure, parental employment participation rate, tax potential and population density
! care of the elderly	age structure, balance of the sexes, occupational background, cohabitaion aspects and rural areas
! individual and family care	single women with children aged up to 15, migrants across parochial boundaries, Finnish and non-Nordic nationals, density of settlement
! compulsory schooling	age structure, rural areas, home language (mother tongue), and Swedish as second language
! upper secondary school	age structure, boarding supplements and study program preferences
! water and sewage	sparseness of settlement, geological conditions
! streets and roads	traffic and climate related wear and tear
! enterprise and employment promotion	unemployment
! construction costs	index based on true costs
! heating costs	index based on true costs
! frigid zone allowance	estimated additional expenditure

1. Municipalities (continued)

Activity (or equivalent)	Factors
! additional expenditure due to population loss	population loss during the past 10 years
! additional expenditure due to weak population base	population within a radius of 30 and 90 km.
! administration, travel and rescue services	population, no. of residents per square km., degree of urbanization

2. County Councils

Activity (or equivalent)	Factors
! health and medical care	age structure, average life expectancy, persons living alone, rural areas and supplements for county councils with fewer than 200,000 residents
! higher education	students enrolled
! frigid zone allowance	estimated additional expense
! public transport	density of settlement, workplace localisation, sparseness of population and archipelago communities

Source: "The new proposed equalization system for municipalities and county councils in Sweden", (Ministry of Finance, 1995) P. 6-7.

5. CASE STUDY #2: DENMARK²⁴

5.1 History and Structure of Government

Denmark is a small nation, with a territory of 43,000 square kilometers (roughly one tenth the size of Sweden) and a population of 5.2 million, highly urbanized (85% of its citizens live in cities).

Like its northern neighbours, Denmark possesses a three tiered governmental structure, including two tiers of subnational government consisting of counties (14) and municipalities (273) of differing sizes and populations. (Two large metropolitan areas, Copenhagen and Frederiksberg, enjoy special status in that each is considered both a municipality and a county.) Reforms undertaken in 1970 dramatically reduced the number of municipalities and counties (the criteria for the minimum size municipality was one that was big enough to fill a seven-class school with 175 children). The average size of Danish municipalities was 19,000 in 1990, and for counties, 370,000 inhabitants. No municipality has under a 1000 inhabitants.²⁵ Importantly, there is no hierarchical relationship between counties and municipalities in Denmark – these orders of government possess independent responsibilities and accountability structures.

Over the course of this century, governance powers have shifted from the central government to subnational governments in Denmark, to a point where it now can be argued that Danish subnational governments are more powerful vis a vis their central government than subnational governments in any other nation. Second, Denmark possesses one of the world's most comprehensive welfare states, and many of the responsibilities for social services lie at the subnational government level, therefore requiring significant financial resources.

In addition, subnational governments in Denmark are responsible for spending which equals almost

²⁴ Source materials for this case study are two comprehensive articles and an interview with Henrik Kyvsgaard with Denmark's Ministry of the Interior. The articles are "Municipalities and Counties in Denmark", published by the Ministry of the Interior in 1996 and available at the website of the Ministry of the Interior (www.inm.dk) and "Denmark and Other Scandinavian Countries: Equalization and Grants" by Joergen Lotz in "Financing Decentralized Expenditures", edited by Ehtisham Ahmad, op. cit.

²⁵ According to Joergen Lotz, recent studies in Denmark and Norway suggest that the lowest administrative costs per inhabitant are obtained for municipalities with 50-80 thousand inhabitants. A county should have 200-250 thousand inhabitants to make economic use of a standard-sized hospital. Surveys of citizen satisfaction, however, have shown that satisfaction levels with local government are highest when they are very small with 5,000 or even fewer inhabitants. There is far from consensus on these points, however. In one of the most detailed analysis of this issue of scale, Professor Poul Erik Mouritzen of the University of Odense concluded that there were decreasing costs in the population range from 3,000 to 30,000. Above that size, costs per inhabitant increased.

20 per cent of GDP and 55 per cent of total government expenditure, rates far higher than those found in any other industrialized country (Swedish local governments, for example, account for 38% of total public sector expenditures).

Broad jurisdictional powers and responsibilities are set out in the Danish Constitution, but the majority of specific program and service responsibilities are outlined in various pieces of legislation. Legislation is also an important means of accountability – where compulsory services and standards are constituted. According to one interviewee, Denmark goes through cycles of reducing central government regulations to be followed by an era of increasing central controls. Denmark is also in the midst of introducing a system of performance indicators in the area of education.

As in Sweden, a Local Government Act lays out the governing structures for local authorities and, in addition, prescribes rules for their economic management and a means for supervising them, particularly in cases where local government activities are either illegal or not provided for in law.

5.2 Expenditure Responsibilities

Counties and municipalities in Denmark are major public service actors. Combined, the two orders of subnational government are responsible for health, education, social services, care for the elderly, housing, public protection, fire, transportation, and other traditional local services. The division of functions between counties and municipalities is determined largely by economic efficiency (the primary objective when these orders of government were created was to achieve economies of scale in service delivery).

Counties are responsible for medical care and hospitals, specialized social institutions, tertiary education and major roads. Municipalities are responsible for primary schools, day nurseries, social assistance, care for the elderly, public protection, fire protection, housing, infrastructure, and local roads.²⁶

Although most program expenditure responsibilities reside with subnational governments, in practice, accountability is often shared among the three levels of government. This is the case for two reasons: first, the central government helps to finance initiatives delivered at the local level, and second, it is responsible for national objectives and service standards – these play a role in ensuring both effectiveness and continuity of services across the country.

5.3 Revenue Generation Capacity

²⁶ The central government possesses jurisdiction over the unemployment insurance and old-age pension systems.

Subnational governments in Denmark possess greater taxation powers than their counterparts in other countries. The three main sources of own-source revenue are property taxes, local income taxes and user fees.

a. Property tax – municipal taxes are set, administered and collected by the municipalities, and are adjusted annually. The municipal rate can vary between .6 per cent and 2.4 per cent of the capital value of land. The county tax rate is set by law at 1 per cent of the capital value of land. These taxes have a low yield, however, equalling approximately 6 per cent of county revenue, and 2.5 per cent of municipal revenue.

b. Personal income taxes – these are the largest source of revenue for subnational governments, yielding between 15-16 per cent of GDP, and comprising between 40 and 60 per cent of revenue (depending on the county or municipality involved). These taxes are collected by the national government in a “piggy-back” arrangement where subnational governments collect taxes over and above the central government. Two notable features of this system:

- ! this is a flat-rate tax paid in addition to central government income taxes; and
- ! each county and municipality can choose its own income tax rate (in 1998, this varied by 15.5 and 22.8 per cent for municipalities, 10.6 per cent and 12.0 per cent for counties). According to one expert, there is no evidence that these differences in tax rates have induced people to move to low-tax jurisdictions.

c. User fees - During the 1980s, user fees and charges received increasing attention as an important source of local revenue and now account for over 20% of own-source revenue for subnational governments in Denmark. These are mainly payments for public utilities - water sewage treatment, electricity etc., and have, according to Joergen Lotz, helped to control "excess demand". In the case of public utilities, the user charges by law must cover costs - local governments have no discretion in the matter.

5.4 Subnational Government Borrowing

Borrowing by Danish local authorities is heavily regulated by the central government. Each individual authority is given a "loan bracket" by the Ministry of the Interior, which corresponds to the sum of permitted municipal investments in areas financed by user fees such as water, electricity, sewage etc. Municipal investments for energy-saving measures, slum clearance and certain homes for the aged are also included in the loan bracket calculation. The Ministry publishes detailed rules for borrowing in a special Government Borrowing Order.

To the degree that subnational governments are permitted to borrow externally, borrowing can be done with any lender (including capital markets inside or outside the country). Because the own-source financial position of subnational government is so strong, these governments rarely have

trouble accessing capital.

In 1995, total long term debt of local authorities in Denmark as a percentage of the total local tax base was 9.6%.

5.5 Intergovernmental Transfer Arrangements

Transfers from the central government are a relatively minor source of subnational government revenue in Denmark. The transfer equals approximately 22 per cent of yearly income for municipalities, 9 per cent of yearly income for counties. The vertical gap in Denmark is quite small, equalling only 20 per cent of total local government expenditure. Approximately 2/3 of central government grants to subnational governments are for general purposes -- 1/3 are conditional. Moreover, Denmark uses both revenue potential and expenditure needs factors in its equalization system.

Subnational governments in Denmark strongly resist revenue sharing as an alternative to own source revenue, for two reasons:

- ! revenue-sharing constricts the ability of a subnational government to alter tax rates; and
- ! the grant mechanism will always miss some particular need (because statistics are not readily available) and can be influenced by political interests.

Similarly, the central government does not advocate a broad-based tax sharing system either, for two reasons:

- ! such a system makes the central government more responsible than they want to be for deficits that local governments might incur; and
- ! tax sharing makes local finances “procyclical”, potentially exacerbating the ups and down of the nation’s macroeconomic condition (after strong growth years, local governments would receive increased transfers, driving inflation upward). This is particularly true for a country like Denmark where subnational government expenditure is so high.

Conditional Grants

Conditional grants have historically not played a major role in the Danish intergovernmental financial framework. In many cases, conditional grant regimes have been transitory, used as a means of implementing a new aspect of the social service system. Over time, once program benchmarks and standards have been established, subnational governments are often given responsibility to finance and deliver new programs and the conditionality is dropped.

Currently, conditional grants are used primarily in fields of social welfare and unemployment with municipalities, equalling approximately 10 per cent of yearly municipal revenue. The bulk of these expenditures are dedicated to a 50 per cent matching grant system for municipal expenditure on social benefits of various types (welfare, disability and other types of payments). Conditional grants are also used for long term capital expenditures that fall in fields of subnational government responsibility (for example expensive hospital equipment).

Trends in Denmark continue to shift away from conditional grants and toward user charges and increased use of general purpose grants.

General Purpose Grants

Inequalities, both in terms of revenue generation capacity and expenditure need among counties and municipalities are seen as unacceptable in Denmark. The objective is to enable all subnational authorities to possess adequate financial capacities to provide a minimum level of services.

The Danish equalization system is structured in a manner very similar to the Swedish system and consists of three main elements:

- **a general purpose grant to all municipalities and counties based on their proportion of the total municipal tax base** (thus, there is no equalization feature to this element); in 1996, this grant amounted to about 10% of total revenue of local authorities;
- **a revenue equalization feature**, based on the Robin Hood principle - that is, local authorities above the average per capita tax potential transfer funds to those below the average per capita tax potential but the equalization is less than 100% (the equalization rate for counties is 80%, for municipalities the rate is 45%, for municipalities in the Copenhagen metropolitan region the rate is 85%²⁷, and for municipalities with weak tax bases, i.e. those below 90% of the average, the rate is 85% of the difference between their base per capita and 90% of the average); fees and charges do not enter the calculations nor does interest earned on savings; and
- **an expenditure equalization feature**, again based on the Robin Hood principle, whereby local governments with below average expenditure needs per capita transfer funds to those with above average per capita needs. Again the equalization is not 100% (80% for counties, 45% for municipalities and 85% for the Copenhagen Metropolitan Area.)

²⁷ The reason for having a higher level of equalization among municipalities in the metropolitan area is the very considerable demographic and income variations that exist among them.

The calculation of the cost equalization feature is based on age-derived expenditure needs (for example, the number of school-aged children), accounting for 80% of municipal and county expenditures, and on socially determined needs (for example, the number of children of single parent families), accounting for the remaining 20% of local expenditures. (See the attached Annex to this case for a more detailed listing of these factors.)

The overall amount of the general purpose grant is fixed by the minister of Finance after approval by the Parliamentary Finance Committee. The amount is based on the previous year grant adjusted by three factors: first, any changes to the responsibilities assigned to local authorities; second, changes in "market-sensitive" areas such employment schemes or social security benefits; and third, developments in prices and wages. There is a two year lag to this third adjustment factor.

In practice, the central government goes to great lengths to ensure that grant levels are announced early in the year, to give the subnational governments lead time to make program adjustments. They have adjusted the system several times over the past two decades in order to achieve this objective.

A recent reform, adopted in 1995 by the Danish Parliament, provides local authorities with an option of achieving a high degree of budget security by opting for a 'guaranteed' tax base and associated equalization amount, based on the most recently completed fiscal year. If the actual tax base and equalization amount fall below the guaranteed amount, then the central government pays the difference. If, on the other hand, the tax base turns out to be higher than the guaranteed level, then the central government pockets the extra income.

It is important to note that, when this Danish equalization system was first introduced in the 1970s, it was phased-in over a 3 year period - with the full model introduced at the outset. In this way, all players were provided with sufficient lead time to adjust to the new system. Piecemeal reform, on the other hand, would have turned local authorities against the system, according to one expert, Joergen Lotz, and might have been counter productive.

As in the case of Sweden, the major elements of the Danish equalization system are set out in legislation. Thus, the total weight given the demographic factors (80%) as well as the factors themselves are in legislation. Some technical matters – for example, the calculation of the weights of the demographic factors – are determined by the Minister.

Despite the use of so-called 'objective' indicators to determine expenditure need and despite the significant portion of own-source revenue generated by local authorities in Denmark, the equalization system continues to be subject to much criticism. Many observers view it as being too complicated and subject to political manipulation. For example, when a new government was recently elected in Denmark, changes to the transfer system were seen by some critics as a way of rewarding the 'friends' of the new government.

5.6 Institutional Structures of Cooperation and System Management

The Danish intergovernmental financial system would not work as well as it does without a system of formal and informal coordination arrangements. These arrangements, which were introduced formally in 1979, convene representatives of the Ministry of Finance as well as representative associations of Counties and of Municipalities on a yearly basis to discuss tax rates, transfer arrangements, and macroeconomic policy.

This yearly dialogue between the orders of government was established to facilitate shared objective setting and a higher degree of collaboration in the fiscal system between governments. This regime was initially organized under a formal committee structure, but the system has become more informal over time (although meetings always happen at the same time of year, and the same participants are represented).

Since 1979, the two sides have reached broad agreements on subnational government priorities, tax rates, and transfers for the following year. The dialogue begins each March, when joint technical assessments of local government finances takes place. The final agreements, usually reached by June, oblige the local government associations to support a joint recommendation where the tax and transfer rates are presented – the central government is morally obliged to pay the agreed upon grants.

The yearly dialogue has become not only an effective way to control local expenditure but as well the agreements often entail central government obligations to subnational governments. In addition, regular dialogue ensures that problems are addressed quickly and that efficient means of finding results are passed on and approved quickly.

Among these mutual arrangements, Danish governments have established a local budget safeguard rule, where all new legislation regarding tax and expenditure issues must be vetted through a joint forum to determine the potential effect on subnational governments. This rule works both ways, however. If the national government makes changes which will affect the local governments - by producing cost reductions for their programs - fiscal transfers from the national government will be reduced.

5.7 Issues and Controversies

The Robin Hood equalization model is a zero-sum game, which creates tension among high and low income jurisdictions in Denmark. These tensions still exist despite the less than 100% equalization feature of the Danish system and the relatively small amount of the transfers from the central government.

Denmark possesses a de facto tax sharing system for corporate taxes, a system which has shifted upward from subnational to central government. Corporate income taxes were created as subnational taxes originally, but businesses engaged in transfer pricing practices, shifting monies to low-tax jurisdictions and thus making it difficult to accurately identify the amount of tax payable in any given subnational jurisdiction. Like Sweden, Denmark gave up on implementing business taxes at the local level, and began administering them at the central level.

5.8 Conclusions

The Danish intergovernmental fiscal arrangements are strongly entrenched, highly efficient, and for the most part, they enable each of the players to achieve their goals. Many features of this model meet the ideals outlined in the introduction. Some of these include:

- ! the use of both expenditure needs and revenue means factors in the transfer model;
- ! a low vertical gap (subnational government expenditure responsibilities closely match revenue generation capacities);
- ! the high degree of subnational government autonomy (and accountability), due to high levels of own source revenues and independent tax-setting;
- ! a “neutral” equalization model, a method designed to minimize the impact of cuts (when necessary) without significantly undermining the premise of equalization;
- ! regularized, collaborative dialogue over transfers, taxes, and fiscal policy in general;
- ! joint technical assessments of subnational government finances;
- ! a phased-in model approach to change, but with the full model up front at the outset of reform;
- ! the specific configuration of subnational governments to achieve economic efficiencies; and
- ! an “almost” full equalization model – this helps to ensure that incentives exist for accurate assessments of the tax base by subnational governments, among other things.

Among the features of the Danish model which do not appear to measure up to the ideals discussed in the introduction:

- ! like most other expenditure need formulas, the Danish model is not easy to understand. This potentially weakens the system’s acceptance among citizens, irrespective of its many virtues and makes it more susceptible to charges of political favouritism;
- ! the use of matching grants in Denmark has been criticized for skewing local priority setting;
- ! the capacity of subnational governments in Denmark to borrow is severely constrained by central government regulations; and
- ! performance measures tend to vary in Denmark. In some cases, programs have detailed objectives and benchmarks attached to them, while in others there are only broad principles to be adhered to.

ANNEX: INDICATORS OF MUNICIPAL EXPENDITURE NEEDS IN DENMARK

Weight 1997	National equalization all municipalities	Equalization in the metropolitan area	Type of expenses
Numbers of inhabitants	24,6	23,2	Employment Environment Libraries Public transport Roads Administration
Numbers of inhabitants 0-6-years old	9,8	10,9	Day institutions (day nursery for children) Health visitors
Numbers of inhabitants 7-16-years old	21,1	19,3	Schools, school dentists Youth center
Estimated age-related expenditures for cash benefit	5,2	6,0	Social cash benefit
Numbers of inhabitants 65-74-years old	3,0	2,6	Home care for elderly people Old people's home Pensioners residents
Numbers of inhabitants 75-84-years old	6,2	5,9	
Numbers of inhabitants 85+ years old or more	6,2	5,3	
Calculated expenditure rent support	1,8	0	Expenditure for housing rent support
Estimated employment-related early retirement	2,2	1,9	Early retirement pension for inhabitants under 60 years old
Numbers of children of single parents	6,5	8,1	Politically decided according to statistical analyses and alternative calculation of consequences
Residence criteria (outdated homes and modern rented homes)	5,0	0	
Numbers of rented homes	0	5,0	
Numbers of full time unemployed 20-59-years old in excess of 5 percent	5,0	6,3	
Numbers of inhabitants 25-49-years old without vocational education	0	3,1	
Numbers of foreigners from third-party countries	2,0	2,5	
Inhabitants in areas with severe social problems	1,5	0	
Total	100,0	100,0	

Indicators of Municipal Expenditure Needs
in Denmark Counties

	Weight 1997	
Numbers of inhabitants	17,8	Environment Public transport Roads Administration
Numbers of inhabitants 0-20-years old	5,3	Special schools
Numbers of inhabitants 16-19-years old	5,5	High schools
Estimated age-related hospital expenditures	37,8	Hospitals
Estimated age-related medical expenditures	13,5	Medical expenditures
Numbers of children of single parents	10,0	Politically decided according to statistical analyses and alternative calculation of consequences
Numbers of single inhabitants 65-years old or more	10,0	
Total	100,0	

6. CASE STUDY #3: THE UNITED KINGDOM²⁸

6.1 History and Structure of Government

The United Kingdom is a unitary state with population of 58,395,000²⁹, situated on a land mass of 242,000 sq. km., that includes England, Scotland, Wales and Northern Ireland. The United Kingdom has a long history of strong local governance – powerful shire (town) authorities can be traced back to before the middle ages³⁰. Despite this longevity, the British intergovernmental financial relations system has remained relatively stable up until recently. It has been reformed to a greater degree over the past 15 years than it has over the previous 200.

Subnational government structures in England, Wales and Scotland differ slightly. England possesses a two-tier system (made up of city/town councils and regional councils)³¹, but since 1996, Wales and Scotland have embarked on a complete shift from a two-tier to a one-tier system of local government, reflecting widespread public sentiment that the two-tier arrangement was unnecessary for small countries³². The powers provided to local governments, however, are essentially the same in each of the three nations.

Councils are creatures of statute: they were created by Acts of Parliament, they may be abolished by Parliament and their powers are determined by Parliament. Acts of Parliament lay down specific duties that must be carried out by local governments – *mandatory acts* - and activities that a council may do if its councillors wish - *permissive and adoptive acts*.

Since the early 1980s, central-subnational financial relations in the U.K. have operated within an agenda that has emphasized fiscal restraint for all public services. Beyond this, however, official

²⁸ References for this case study include: Barry Potter, “United Kingdom” in International Monetary Fund, *Fiscal Federalism: Theory and Practice*, 1997; Davey, “Intergovernmental Fiscal Relations in the United Kingdom” in OECD, *Financing Local Governments*, 1994, and “The Role of the Audit Commission”, an information paper produced in 1997 by the Audit Commission of the United Kingdom. In addition, interviews were conducted with Ken Davey, Professor of Economics, Warwick University, Barry Potter, Public Expenditure Management Division, International Monetary Fund, and finally, background information was drawn from two websites, www.open.gov.uk and www.local.gov.uk.

²⁹ England makes up over 80 percent of the United Kingdom’s total population.

³⁰ The first local taxes were levied in England in the 17th century.

³¹ In England the changes to the local government structure will be complete in April 1998. Like Wales and Scotland, the trend is toward creation of more single tier local authorities. By international standards, British local governments serve relatively large areas and populations.

³² The Scotland Act of 1994 came into effect on 1 April 1996. The structure now consists of 32 unitary councils. In Wales the 8 county and 37 district councils established in 1974 were abolished and replaced with 22 unitary authorities.

central government policy has emphasized a desire to preserve the discretion of local authorities to determine their own spending priorities within overall limits set by the central government.

In the United Kingdom, subnational governments have responsibilities that result in 36 per cent of total government spending. They generate through own source revenue less than 20 per cent of their total expenditures, however, leaving a large mismatch (vertical gap) between expenditures and revenue capacities.

6.2 Expenditure Assignments

In the United Kingdom, subnational governments are responsible for education, housing, social services, public protection, fire, transportation, and other sundry local services. The principal functions allocated to lower tiers of subnational government include housing, environmental services, and certain local transport responsibilities, while the higher tier governments are responsible for education (accounting for about 50 per cent of subnational government spending), police, fire, social services, and structural planning. Note that health services are not within the envelope of subnational government responsibility³³.

Subnational government spending is falling as a proportion of total government expenditure in the United Kingdom. In 1979, these governments accounted for 42 per cent of total government spending; by 1994, this number fell to 36 per cent. The major factors involved in these reductions have had to do with broader public service reform issues (i.e. privatization, elimination of subsidies, and elimination of many public services). These reforms have been driven by strong central government concerns about public sector over expenditure.

In 1994, the central government imposed new overall restrictions on local government spending. Under these arrangements, current expenditures must not exceed amounts determined under the Standing Spending Assessment (see below).

6.3 Revenue Generation Capacity

The central government in the UK has power over almost all taxes, and controls all of the taxes that generate the greatest amount of revenue: personal and corporate income taxes, excise and customs duties and value added taxes.

Subnational governments possess relatively few taxation powers – property taxes are their main source of revenue. These taxes are comprised of the following:

a. the national non-domestic rate (a business property tax). Valuations are carried out by the

³³ Separate authorities are responsible for delivery of the UK's National Health Service programs.

national revenue authority and the tax rate is set annually by the central government at a uniform national level. It is technically a shared tax, although it is 100 % distributed to local governments.

b. a council tax (a residential property tax). Houses and apartments are valued in eight broad bands according to their approximate market value (and are re-evaluated every five years). Subnational governments have the authority to levy their own council tax rates on a common base (set by the central government).

6.4 Borrowing

In the UK, subnational governments are prevented by law from borrowing for current expenditure purposes. Subnational authorities are permitted to borrow for capital spending, and may do so from the private or public sector, as well as by issuing bonds. The central government manages subnational borrowing by setting annual “capital spending guidelines”, which act as de facto borrowing limits.

The central government also circumscribes subnational government borrowing in other ways. One example of this influence: local authorities are required to devote 75 per cent of receipts from sales of government owned properties toward redeeming existing loans, and only 25 per cent of capital receipts from housing may be used for capital expenditure³⁴.

Basic Credit Approvals

Another even more stringent control on subnational borrowing is through the "basic credit approval", which allows local governments to borrow up to a certain limit. Each year, the central government issues annual capital guidelines to each subnational authority, establishing spending guidelines based on estimated local capital expenditure³⁵. Supplementary credit approvals are issued on occasion to cover

³⁴ Potter, “The United Kingdom”, p. 348.

³⁵ The projected yield of capital receipts is deducted from this estimate, and the balance constitutes the *basic credit approval*. This is carried out in a similar way as done for SAAs - see the intergovernmental transfer arrangements section below.

channelled through this board - 71.5 per cent of all outstanding subnational government debts are held by this body³⁶. The board borrows money from the National Loans Fund (the channel through which the central government borrows) and lends to local authorities. What makes the Public Works Loans Board particularly interesting is that its scale of operation enables it to lend to subnational governments at advantageous interest rates (better than could be achieved on the open market).

6.5 Intergovernmental Transfer Arrangements

As indicated above, central government grants have historically played a major role in financing the expenditures of subnational governments³⁷. The system comprises of a block grant (known as the Revenue Support Grant or RSG) and a number of specific grants. Block grants represent over 80 per cent of central government support to local governments.

Specific Grants

Specific grants represent less than 20 per cent of UK subnational government's operating revenue. These grants are paid in addition to block grants, essentially boosting expenditure for the relevant expenditure item. Specific grants were initiated as a means of delivering on central government priorities and ensuring (through rigorous conditionality provisions) that the money was spent as it was intended. Although 71 per cent of these monies go toward police and court related services, recent reforms have slowly increased the proportion of specific grants in the total transfer envelope.

Block Grants - Revenue Support Grants (RSGs)

RSGs are based largely on the **Standard Spending Assessment (SSA)**, the government's estimate of what each local authority should be spending on public services, based on the goal of achieving a common standard of services across the country. To calculate SSAs, the Government determines a **Total Standard Spending (TSS)** rate for the entire envelope of subnational government expenditure, which, in turn, becomes an overall target for transfers.

The TSS formula is based largely on historical factors. The base is the previous year's total for the nation as a whole, adjusted for four factors:

- ! inflation;
- ! shifts in responsibility between the levels of government;
- ! any expenditure arising from new national policies; and
- ! efficiency savings potential.

³⁶ Potter, "The United Kingdom", p. 351.

³⁷ Although less of a role in financing capital expenditures.

In 1994-95, for example, the TSS equalled the 1993-94 total plus 2.3 per cent.

The TSS is then divided into functional categories, according to the government's assessment of relative spending needs at the local level (again this is initially carried out for the whole country). These functional categories (and their assessment in percentage terms) include: education (40.1 per cent), personal social services (15 per cent), police (13.6 per cent), highways (4.1 per cent), debt service (4.5 per cent), fire (2.7 per cent) and other (20.0 per cent)³⁸.

The central government then makes assessments of relative spending needs within each of these functional categories for each local government.

For example:

Education was dedicated 40.1 per cent of TSS spending in 1994-95. This envelope of money was then divided into the various educational categories (42.8 per cent to primary schools, 40.2 per cent to secondary schools, etc).

Each local authority was then apportioned a share of the overall funding for education in each category as well as the total, based on:

- ! age group population
- ! additional spending needs (for children from low-income families, etc.)
- ! population sparsity
- ! needed entitlement to free school meals
- ! geographical area cost adjustments.

After these factors were integrated into the formula, the transfer differentials among local governments on education ranged between 36 and 44.5 per cent in 1994³⁹.

The Standard Spending Assessment (SAA)

The calculation of RSG transfers to subnational governments is based on the Standard Spending Assessment (SAA). The standard spending assessment for each government authority is built up on a service-by-service basis, usually by multiplying the numbers in the applicable client group (based on estimates from the previous year) by an estimated unit cost, allowing for additional costs (e.g.

³⁸ Davey, 1994.

³⁹ Davey, 1994.

transportation of children to elementary schools). These allowances are based on cross-sectional regression analysis, used to attach weights to factors such as climate and population density. These calculations are done by the responsible central government department, in consultation with subnational government authorities.

To determine the RSG for each subnational government, the central government then deducts from the SSA:

- ! the projected share of non-domestic property tax revenue and
- ! council tax (property tax) revenue based on a "standard" rate established by the central government

or RSG equals: SSA minus (non-domestic property taxes plus domestic property taxes at "base" rates)

While grant entitlements are calculated from combinations of service-specific indicators of need, the general grant is not attached to specific service expenditures. Subnational governments control the distribution of grants among local services. For example, grant receipts justified by greater unit costs for police services need not be spent in that area at all.

Capping

During the 1980s, the central government, concerned with reducing government expenditures and its role in society, decided to add another level of central control to the intergovernmental fiscal system. Rate capping was established, a mechanism which enabled the central government to judge whether a given local government's absolute expenditures (vis a vis the SSA guideline or year-on-year increases) were excessive. If the expenditure level was found to be excessive, the central government could cap local tax rates. In practice, application of the cap happens rarely – it is the threat of the cap that keeps a tight rein on local governments⁴⁰.

6.6 Institutional Mechanisms – Coordination, Conditionality and Accountability

As the previous sections illustrate, the British central government has wide de jure and de facto levers of control over subnational government expenditures. Specific grants carry with them detailed conditionality arrangements that must be followed to the letter. General grants carry fewer direct conditionality mechanisms, but many indirect conditionality mechanisms, including the Audit

⁴⁰ Potter, "United Kingdom", p. 350.

Commission. It has also recently established another accountability mechanism for local government in the form of the Local Government Ombudsman.

The Audit Commission

An interesting feature of the United Kingdom's intergovernmental fiscal system is the Audit Commission. In place since the 1700s, it was not until 1982 when the Audit Commission began to take on the major role it now has within the British system of local governance. In 1982, the Government brought local authority auditing in England and Wales⁴¹ under the control of this single, independent body. In 1990, the Commission's role was extended to include National Health Services authorities, trusts and other bodies. Under the Local Government Act 1992, the Commission was given additional responsibilities in respect of the production of annual comparative indicators of local authority performance. Today, its mandate covers more than 13,000 bodies⁴² and its primary objective is to promote transparency.

The Audit commission carries out not only audits of all subnational governments and makes those results public; it also conducts a long list of value-for-money assessments and comparisons among local authorities, "to promote best practice in local government, encouraging economy, efficiency and effectiveness in both the management and delivery of services"⁴³. In addition, the Commission has a mandate to conduct independent analyses of the impact of central government legislation, action or advice on local governments.

The Audit Commission each year draws up a list of indicators for measuring the performance of local authorities. The authorities must then publish details of how they perform in terms of these indicators. Once they have done this, the Audit Commission collects the information together at a national level, analyzes it and then publish this comparative data, along with year-on-year comparisons, together with a commentary. Schools is one example of where performance is compared by the Commission on a national basis.

The Local Government Ombudsman

Local Government Ombudsmen investigate complaints of injustice arising from maladministration by local authorities and certain other bodies in England.

⁴¹ In Scotland, the Commission for Local Authority Accounts in Scotland is responsible for the audit of the accounts of Scottish local authorities, the audit of National Health Service bodies in Scotland and for carrying out value-for-money audits.

⁴² See "The Role of the Audit Commission" at www.audit-commission.gov.uk.

⁴³ The Audit Commission has rapidly grown in importance and authority since the early 1980s. It has a chairman, deputy chairman and up to 18 members drawn from across British society. For more information, see "The Audit Commission" at www.audit-commission.gov.uk

The objective of the Ombudsmen is to secure, where appropriate, satisfactory redress for complainants and better administration for the authorities. Since 1989, the Ombudsmen have had power to issue advice on good administrative practice in local government based on experience derived from their investigations. To this end, they have to date published five guides on good practice - notes on setting up complaints systems, good administrative practices, council housing repairs, members' interests and disposal of land.

There are three Local Government Ombudsmen in England and they each deal with complaints from different parts of the country. They investigate complaints about most council matters including housing, planning, education, social services, consumer protection, drainage and council tax. The Ombudsmen can investigate complaints about council actions but they cannot question what a council has done simply because someone does not agree with it.

6.7 Recent Reforms

As indicated, significant changes have occurred in recent years in the United Kingdom, many by fiat. Since 1994, subnational government spending had dropped by 6 per cent since 1979, due to reforms such as privatization and sales of subnational government assets. These changes were incremental in nature, and did not directly remove responsibility from subnational authorities. Rather, levers for independent action were simply retracted (like the elimination of the right of local authorities to build or buy houses for social housing).

Other reforms, like the establishment of new private governing associations (for example, one such association has taken responsibility for new housing development), are essentially spending agencies financed by the central government. In many cases, these bodies represent a direct threat to the authority and responsibility of subnational governments. There are no outlined requirements for coordination between these bodies and subnational governments, despite broad areas of overlap.

Other areas of recent reform include:

Improvement of the local government capital expenditure system. Realizing that the past 15 years of cuts have depleted local infrastructure and capital spending, a new system has been established to put \$30 billion into capital projects (through new conditional grants). This regime, called “Challenge funding”, is a new initiative that will pit subnational governments in competition for conditional grants drawn from these funds.

The brief tenure of the community charge (or poll tax) during the 1980s. This controversial, regressive, and some say excessive tax, created by the central government, caused widespread upheaval in the UK. After two years, the community charge was eliminated – in the opinion of some experts, this political debacle has inhibited intergovernmental fiscal reform since that time, and will continue to present a barrier to the expansion of own-source revenues for subnational governments.

6.8 Issues and Controversies

Many of the controversies that prevail in the UK are common to many intergovernmental fiscal systems. Some of these include:

Overall subnational government expenditure is determined by Total Standard Spending, and the TSS depends almost exclusively on central government macroeconomic policy. Moreover, Standard Spending Assessments, the core of the intergovernmental fiscal system, are not based on the most accurate and current indicators of expenditure need. They are largely derived from historic aggregates and patterns of allocation. Moreover, other methods of calculation have been criticized (by the Audit Commission) because they have changed from year to year and because they include some subjective weight factors.

The scope of central control over the allocation of general purpose grants is significant. Although local governments receive 60 per cent of their funding through block grants, they have little room for independent action, or independent policy making. This has significant accountability implications for subnational governments.

Under the austerity regime of the past 15 years, local governments have often received a real reduction in transfers because inflation targets are set at rates less than actual inflation. This “secondary cut” has caused significant friction between central and subnational governments in the UK.

For many years, the system neglected capital funding. Now, demand far exceeds available resources, and this is beginning to take its toll on local infrastructure. Governments are in the midst of attempting to redress this problem through avenues discussed briefly above, although concerns are already being raised about the actual effectiveness of such programs.

6.9 Conclusions

British intergovernmental fiscal arrangements reflect some of the attributes of ideal intergovernmental fiscal regimes outlined in the introductory section of this report. But the British system also has many less-than-ideal features of an effective intergovernmental fiscal regime. Above all, the case illustrates that the implications of reform in political and social terms are as important to understand as they are in economic terms.

In some ways, the British are moving toward the ideal. In particular, the Audit Commission is a feature of the British model that is worth emulating, as it promotes transparency, shares information on best practices, and on occasion, voices criticism about central government policy toward subnational governments. Other exemplary features of the British model include:

- ! a high level of general-purpose grants in the system;
- ! a 'neutral' equalization system based on both revenue and need factors;
- ! a pooled borrowing scheme for subnational governments that enables them to borrow funds at low interest rates;
- ! the Local Government Ombudsman, who acts as a key public accountability mechanism; and
- ! flexibility to allow local government structures to differ in different jurisdictions (one and two-tier governments).

Unfortunately, the British system fails to meet the ideal in other ways, the most obvious being the large vertical gap. Moreover, the central government exercises significant control over subnational governments. Specific drawbacks of the British model include:

- ! a low level of subnational government autonomy caused, in part, by a high degree of shared jurisdiction;
- ! a major gap between expenditure responsibilities and own-source revenue capacity with little incentive for local governments to seek ways of generating more own-source revenue;
- ! a growing number of special purpose bodies at the local level;
- ! rate capping – this is a particularly intrusive force on subnational governments;
- ! the perception that the transfer system is becoming more, rather than less political. New initiatives like the competitive challenge funding program (for infrastructure grants) are likely to exacerbate this problem.

In many ways, the system's hands have been tied during the Conservative party's reign in the UK. The combination of economic austerity and political baggage attached to any structural or tax reform idea has rendered change difficult, and when achieved, it has been piecemeal and incremental. In weighing the pros and cons of the British system, one expert concluded on this pessimistic note: "The current systems seem to reflect a deep-rooted lack of confidence in local government and in local democracy."⁴⁴

Several of our interviewees noted that there is room for optimism with the recent election of a new government. They predict a reduction in the mechanisms for central government control over local authorities (the "basic credit approval" will likely be eased as will "capping"). Furthermore, the new political bodies in Scotland and Wales will operate much like Canadian provinces with their own source revenue capacities as well as transfers from the central government. One interviewee gave the following advice: "come back to study the UK in a couple of years!"

⁴⁴ Barry Potter, *op. cit.* p. 358.

7. CASE STUDY #4: AUSTRALIA⁴⁵

7.1 History and Structure of Government

Australia's 18 million inhabitants occupy a total land mass of over 7.7 million square kilometers, although the vast majority of the population is situated in urban centres. Australia possesses a Westminster model of government, handed down from British, which, like its Canadian relative, has three tiers (commonwealth, state, and local). There are six Australian states, and 900 local governments. In addition, Australia possesses two territorial governments, which have the same expenditure responsibilities and revenue bases as the states. Also like the Canadian model, the vast majority of government powers in Australia reside in the upper two orders of government – local governments possess relatively few powers, and have no constitutional standing.

The Australian Constitution was formed in 1901. The Constitutional agreement assigned significant powers to both the Commonwealth and the state governments. The Constitution defined a “layer cake” approach to tax assignment, where the two orders of government were reserved their own tax bases (although the Commonwealth government received the vast majority of tax categories, including all of the most lucrative taxes).

7.2 Expenditure Responsibilities

State governments in Australia carry the majority of expenditure responsibilities in the system – in total, states spend 59 per cent of total government outlays⁴⁶. These expenditure responsibilities include health, education, social security and social assistance, welfare, economic services (roads, transport, industry assistance, water resources), and other services (housing and urban renewal, regional development, disaster relief). The majority of state government spending is dedicated to health and education.

⁴⁵ Source material for this case study includes the following: Interviews with Jon Craig, Asia Division, International Monetary Fund, and I.J. Robinson, Assistant Secretary, State Finances Branch, Department of the Treasury, Australia; Richard Rye and Bob Searle, “The Fiscal Transfer System in Australia”, in Ahmad, ed. "Financing Decentralized Expenditures" (Elgar Publications; Brookfield, US, 1997); Jon Craig “Australia” in Minassian, "Fiscal Federalism: Theory and Practice" (International Monetary Fund, Washington, 1997); Anwar Shah, ed." State Support to Local Governments" (Organization for Economic Cooperation and Development, 1994); and Department of the Australian Treasury, “Horizontal Fiscal Equalization”, 1994.

⁴⁶ Rye and Searle, 1997, p. 155.

7.3 Revenue Generation Capacity

The Commonwealth government dominates the field of revenue generation, controlling the four main sources of revenue – personal income tax, customs and excise duties, corporate taxes, and sales tax (Australia does not have a VAT).

Own-tax revenues constitute an average of 40 per cent of state government revenue. Payroll taxes are the largest revenue source, followed by property and land taxes, goods and service taxes, motor vehicles, gambling, and insurance taxes. State governments also make up an average of 12 per cent of their revenue from proceeds from publicly owned enterprises through user charges. The tax bases and sources of revenue are similar for each state, although the amounts and proportions vary somewhat in two of the less affluent states. The tax base per capita (tax revenue potential) varies from 75 per cent (Tasmania) to 108 per cent (Western Australia) of the average per capita.

The Australian system exhibits a high vertical fiscal imbalance (or vertical gap). The Commonwealth government collects 67 per cent of total revenue and is responsible for only 33 per cent of expenditures, while state governments collect roughly 28 per cent of total revenue, and are responsible for 59 per cent of expenditures (Australian Bureau of Statistics, 1994).

7.4 Borrowing

State government borrowing in Australia was tightly controlled by the Commonwealth up until 1984. Before that time, the Commonwealth set debt ceilings each year for each province, administered through a National Loan Council. The National Loan Council, established in 1923, played a significant role in securing loan financing for the state governments. It is comprised of one representative from each of the provinces and territories as well as the Prime Minister or delegate from the Commonwealth.

Since 1984, reforms were introduced to enable the states to take greater responsibility for their own borrowing - states were enabled to offer bonds, refinance securities and loans, etc. The Loan Council now plays primarily a “watchdog” role, by creating and enforcing reporting requirements which enhance fiscal transparency. However, all governments (including the Commonwealth) must still provide the Loan Council with borrowing estimates, and the Loan Council has the ability to ask the government concerned to make adjustments based on national macroeconomic objectives. The Loan Council’s role enables citizens to have greater access to public financial records, access which ultimately acts as a check on state government borrowing.

7.5 Intergovernmental Transfer Arrangements

The Commonwealth Grants Commission (CGC)

The Commission was established in 1933 to report on applications by individual states to the Commonwealth for special assistance. The CGC defines its role as “an independent, impartial and authoritative arbiter in relation to distributional aspects of fiscal federalism in Australia”⁴⁷. Its main function is to make recommendations on the distribution of all general purpose funding to the states on the basis of the principles of horizontal fiscal equalization. Membership consists of a Chairman and three members, along with a secretariat. Commissioners are appointed (by the Commonwealth government) strictly based on their personal merits. States are always informally included in decision-making about CGC members. The commissioners are supported by a staff of about 50, although much of the data collection work is carried out by the Australian Bureau of Statistics.

Although the CGC has no official decision-making control over transfers, its recommendations are usually accepted and implemented by the Commonwealth government. This is more true now than ever – in fact, the CGC has been given increasingly greater stature in the system over the course of the century, and is now the “hub” of the Australian system.

Specific Purpose Payments

Transfers from the Commonwealth comprise an average of 40 per cent of state revenue, and up to 60 per cent in some states. Over 50 per cent of these are *specific purpose payments (SPPs)*, conditional grants dedicated to both current and capital needs. The formulas which underlie these specific purpose grants are not complex: they derive primarily from historical patterns and political perceptions of need.

Over the past 20 years, the proportion of specific purpose grants to total intergovernmental transfers has increased, a trend which is a point of some contention between the orders of government in Australia (and a pattern which runs counter to trends in other industrialized nations). Nevertheless, according to one observer, conditionality is as much political gamesmanship as actual decision-making influence in Australia⁴⁸. States in Australia have a relatively high degree of discretion over the allocations of specific purpose grants. The central government often attaches conditions to grants in order to demonstrate its interest and participation in a field of jurisdiction over which states have Constitutional authority.

The conditions to specific purpose grants vary widely. Some of these include:

⁴⁷ Rye and Searle, 1997, p. 152.

⁴⁸ Spahn, op. cit., p. 152.

- ! general program requirements (guarantees of free public hospital treatment in exchange for hospital grants);
- ! agreements covering service provision and program delivery mechanisms;
- ! detailed conditions on the operation of joint expenditure programs; and
- ! matching expenditure requirements.

The financial and performance accountability requirements for SPPs will differ according to the particular category of payment. For most of the largest SPPs, the states are required to report annually (in public) against performance or input indicators as agreed between the Commonwealth and the states.

General Purpose Grants

Approximately 45 per cent of payments from the Commonwealth to the states are general purpose grants emanating from a pool of funds which is then divided among the states. The evolution of these grants followed a pattern with some similarities to what occurred in the Scandinavian countries.

Originally, the CGC was to act as an administrative structure managing a claimancy system for general purpose grants, where the less populous states applied to the Commonwealth government for special grants of general revenue assistance in years when they thought they had a “sufficiently convincing case”⁴⁹.

Australia grew to implement more formula-driven models for determining transfers (calculated by the CGC). Essentially, the model grew in phases. It began as a financial assistance grant model, with transfers determined by a formula stressing three factors:

- ! population changes in the state;
- ! average wage increases in the state; and
- ! a flexible “betterment” factor which allowed states to expand the scope of social services.

Over time, a number of different models with different underpinning principles and variables were implemented, but disagreements among the players (and new political leaders) resulted in a constant process of “tinkering”. The key principle that now underlies the current Australian general purpose grant system is the following: “that each state should be given the capacity to provide the same standard of state-type services as the other states, if it makes the same effort to raise revenues from its own sources and conducts its affairs with the same level of operational efficiency.”⁵⁰

⁴⁹ Rye and Searle, 1997, p. 146.

⁵⁰ Jon Craig, op. cit., p. 184.

In the mid 1980s, the process for determining the Australian general purpose grants began with an allocated pool of funds earmarked for distribution among the states. The Commonwealth government calculated this pool at a fixed per cent of personal income tax collected (by the Commonwealth) in the previous year. This system has now given way to determination of the size and growth of the pool at the annual Premiers' Conference on the basis of factors which include macroeconomic considerations and Commonwealth and state financial positions.

Australia possesses a complex equalization system, which accounts for differences both in revenue generation (potential) and expenditure need. The three key variables included in this formula include:

- ! relative per capita revenue raising capacities
- ! relative per capita expenditure needs
- ! the differential per capita amounts of recurrent specific purpose grants

In effect, each state's share of the total general revenue grants depends on its "standardized deficit", a product of the population *multiplied by* its per capita grant relativity.

The calculation is as follows:

per capita grant relativity = standardized expenditure need per capita – own source revenue capacity per capita +/- differential per capita of specific purpose grants

Own source revenue capacity per capita is calculated based on an assessment of 19 revenue categories. In contrast, there are some 41 expenditure need categories. Expenditure need factors which are applied to these categories are as follows:⁵¹

scale factors

- population and related factors
- dispersion - urbanization
- social composition - age structure

environmental factors

- physical - economic

An example:

expenditure category: health
subexpenditure: general medical services
units of use: total population

⁵¹ Anwar Shah, op. cit. p. 49.

other adjustment factors:

- age and sex composition factor based on hospital bed use data;
- index of health status based on mortality rates adjusted by female fertility rates
- social composition factor based on Aboriginal population

The CGC calculations are subject to review in joint forums among representatives of each state. Once this is complete, a final recommendation report is given to the Commonwealth Cabinet for review. Cabinet usually makes some small revisions based on its own view of fiscal needs and upcoming expenditures. The final determinations are made at the annual Premier's conference.

The CGC undertakes a major review of relativities every five years, with updates in intervening years. Recommendations of the CGC are usually, but not automatically, accepted by the Commonwealth government.

Except for the role and mandate of the CGC, none of the elements of the Australian equalization system is set out in legislation.

7.6 Recent Reforms

The National Loan Council

As discussed briefly above, the National Loan Council has undergone a number of important reforms in recent years. Until 1984, the Council coordinated and controlled borrowing by all governments in Australia. Due to pressures from states, revisions were made at that time to make the states more responsible for their own borrowing. The states became responsible for financing and refinancing, but borrowing limits were still imposed upon them by the Council.

The intended controls established in 1984 were continuously circumvented by the states, and the system was replaced by a two pronged approach in 1992-93. The approach uses transparency and moral suasion as its key operating principles. Recommended borrowing limits continue to be set by the Loan Council, and these limits are made public. In addition, the Loan Council adopted procedures which force states to be transparent with their borrowing activities, placing the onus of scrutiny in the hands of the media and the public. Two key elements of the new system:

- ! the Commonwealth and each state government must now submit its net financing requirements each year, and if the submissions raise concerns, the Loan Council has the right to demand that the government concerned modify its strategy; and
- ! reporting requirements on a day-to-day basis have also been enhanced. If a government exceeds a 3 per cent difference between its plan and the actual situation at any given moment, that government is compelled to explain it to the Loans Council (unlike the yearly

submissions, this is not public).

Interviews with experts indicate a positive response to these changes – the publication of debt details has enhanced market discipline on government borrowing. The Loan Council appears to have become relevant again.

7.7 Issues and Controversies

Conflict Over the Vertical Fiscal Imbalance

In spite of assertions to the contrary, and constant complaint by the states, the Commonwealth government has chosen not to rectify the large vertical fiscal imbalance in Australia by reordering the tax system (to match more closely expenditure responsibilities with revenue generation capacity). According to some, this would a) minimize the Commonwealth government's role in society, and b) make macroeconomic coordination more difficult to achieve – combined, these factors help explain the lack of movement on this issue. In the absence of reform, the states have sought to consolidate their financial position in recent years by:

- ! increasing own source revenues;
- ! curtailing expenditures (public sector employment reductions); and
- ! implementing substantial privatization programs.

While these measures have clearly improved the deficits facing states, they have not significantly addressed the issue of vertical gap in Australia.

State Tax Reform

According to several observers, state taxes tend to be regressive and distort incentives⁵². These taxes (especially including property taxes and payroll taxes) are narrowly based, subject to variable rates on similar transactions, and involve high costs of compliance.

Conflict Over the Horizontal Imbalance

Like most zero-sum games, conflict between rich and poor states in a pool-based equalization system is a natural occurrence. Reforms to the allocation system and the CGC formulas have mitigated this tension of late, but debates continue on the assessment measures of per capita relativities factors such

⁵² Craig, "Australia", p. 197.

as dispersion, urbanization, and revenue capacity. Changes in these areas could mean a reduction of equalization transfers in the near term. In addition, some are asking whether a single overall measure of revenue capacity would be more accurate (and less complex) than the present tax-by-tax system (which looks at 19 different tax categories).

Horizontal Equalization and Economic Efficiency

Some observers argue that the equalization system distorts incentives for resource allocation decisions, in particular labour mobility⁵³. This is primarily an argument among economic theorists – elimination of the system is not likely anytime soon.

Equalization and Special Purpose Grants

A debate continues as to whether special purpose grants should be included in the CGC’s assessment of the relative fiscal needs of the states. Some claim that special purpose grants should be “quarantined” from the CGC’s assessment in order to prevent the distribution of general purpose grants from overriding the policy objectives of special purpose grants. For this reason, certain specific purpose grants are already quarantined from the CGC’s assessments.

Matching requirements and state spending

Through matching grant requirements, the Commonwealth government creates incentives for the states to focus on one area above others. Such a system detracts from other programs of equal significance – such as different levels of the education system. This skews resource allocations, and according to some, can do more harm than good.

7.8 Conclusions

Few observers would dispute that the Australian intergovernmental fiscal regime is progressive and effective in several aspects. Some of the most noteworthy features of the Australian system include:

- ! the use of revenue means and expenditure needs factors in determining equalization payments;
- ! the “relativities” formula, which meets a number of equality and distributive tests. It is particularly applicable among jurisdictions with widely varying degrees of revenue generation capacity and infrastructure (although the many variables integrated into the model may not be necessary in order to reach a close approximation of its results);
- ! the “independent, neutral” CGC and its role in determining the equalization framework;
- ! the National Loan Council structure, which is an effective manager and facilitator of access to capital among subnational governments. In particular, recent reforms which focus on

⁵³ Rye and Searle, “The Fiscal Transfer System in Australia”, p. 171.

- promoting financial transparency have proven efficient and effective in promoting accountability; and
- ! the regularized and structured system of discussing the equalization system between the Commonwealth, States, and the CGC.

The Australian system's limitations include:

- ! a high vertical gap, which shows few signs of abating -- the Commonwealth government possesses effective control over the purse, in spite of the fact that state governments are responsible for the majority of public services;
- ! an equalization system, which some few as excessively complicated and open to political manipulation;
- ! state governments possess few tax powers, many of which are regressive;
- ! a high (and growing) proportion of special purpose grants, which, in the opinion of some experts, impose an unnecessary degree of Commonwealth government influence over state areas of jurisdiction, and which are subject to far less rigorous formulae than general purpose grants are; and
- ! minimal state influence over the structure of the transfer system. In particular, the size of the equalization pool is largely determined by the Commonwealth government.

8. CONCLUSIONS AND RECOMMENDATIONS

8.1 Conclusions

The Institute judges that the following points, based on the case studies and the review of principles and best practices, have relevance for the development of a new fiscal relationship between Aboriginal peoples and the federal government.

a. **There is no 'one best way' or magic formula on which to base a fiscal relationship between levels of government.** Economic principles and international best practices can be helpful guides but political and historical factors may be as, or even more, important in forging the fiscal relationship. Thus, a highly egalitarian equalization approach, based on the Robin Hood model, may work well in Sweden but is likely inappropriate in a country like Canada with important regional fissures.

b. **Both the case studies and international experience elsewhere confirm that revenue equalization approaches are relatively straight forward** - the tax system generates up to date and reliable data and the relationships between tax and 'capacity to pay' is direct. One contentious area is the degree of equalization and whether a Robin Hood model is employed. Canadian experience has been to minimize such controversy by avoiding a Robin Hood style approach and by aiming for less than full equalization. The Dane's have also avoided full equalization. While revenue equalization is relatively straight forward, it is important to note two points:

! subnational governments in each of the case studies had a common set of taxing powers;

! for each tax, they also had a common tax base.

Without these two conditions, revenue equalization will become much more complicated.

c. **All the case study countries have equalization mechanisms that provide an incentive for raising own source revenue by using tax potential (as opposed to actual taxes raised) and a standard tax rate as the main equalizing variables;** nonetheless, central governments have attempted to exert some control on overall tax levels through a variety of means - from moral suasion and negotiation in the case of the Scandinavian countries to the capping mechanism employed in the United Kingdom.

d. **The case studies and the principles section both confirm the importance of establishing a robust set of own source revenues for subnational governments.** Indeed, in is likely no

coincidence, that the Scandinavian countries with the largest portion of own-source revenue appear to have the most viable partnership arrangements between the various tiers of government. In the Canadian Aboriginal context, one starting point to consider might be with user fees for the following reasons:

- ! such fees can be a significant source of revenue (over 20% of Danish own-source revenue, for example);
- ! user charges are an important means of 'dampening' demand for services and act as a brake on the expenditure side; and
- ! there is already existing experience with user fees in Aboriginal communities with some utilities

The apparent impracticality of having a tax on business income (a so-called 'mobile' factor) at the local level in the Scandinavian countries may also be instructive in the Canadian context.

Expenditure equalization, in contrast to revenue equalization, appears to be fraught with political controversy for a variety of reasons - some indices are at best proxies for what is being measured; data is often out of date or not available; the mathematics becomes complicated (the use of statistical regression techniques, for example); and, more fundamentally, cost differentials between jurisdictions are sometimes difficult to understand or explain. The result is that expenditure equalization has two, somewhat contrasting characteristics: it is on the one hand highly technical and yet, on the other, highly political. All four countries making up the case studies have employed institutional mechanisms to deal with these controversies from parliamentary commissions to regular 'negotiating' fora between levels of government to an ongoing advisory body as in Australia - the Commonwealth Grants Commission. Given the nature of the exercise - dividing a fixed amount of funds among a fixed number of entities - that lies at the heart of a fiscal arrangement, the controversy will be ongoing and will likely be more severe in those case where the own source revenues are relatively minor. Furthermore, expenditure equalization should be attempted only if there is a high degree of consensus around the basic principle.

- f. **There is continual tension between simplicity and equity.** A British Scholar has summarized the 'cycle' that has developed in the UK, one that has been evident in Australia, Sweden and Denmark:

"A cycle has developed whereby the government (or more accurately government officials) reduce the number of programs or subprograms and indicators, most recently in 1989, in the interest of transparency. Then programs are subdivided over time in the name of greater

sensitivity and fine-tuning until the resultant complexity again overwhelms understanding. In early 1996, the government announced that the Institute of Fiscal Studies would review the formulas again."⁵⁴

- g. The experience of the countries making up the four case studies suggests that the borrowing of funds by new Aboriginal governments should be part of any fiscal arrangements agenda.** There are three reasons underlying this conclusion: first, certain measures could be initiated, as demonstrated in the cases of the UK and Sweden, to lower the costs of borrowing for Aboriginal governments; second, other means exist, as shown in the Australian and UK case studies, for improving transparency in this area; and finally, the conditions that would permit a complete 'market' approach to borrowing may not be present - for example, the question of whether the federal government would be responsible for defaults needs to be explicitly addressed.
- h. The case studies have revealed a wide variety of mechanisms to enhance accountability.** Some of these that are worthy of consideration in the Canadian context are:
- ! an ombudsman (the UK);
 - ! a common auditing commission (the UK);
 - ! a mechanism or mechanisms for gathering and reporting performance indicators and doing comparative analysis (the UK, Sweden);
 - ! a mechanism for creating greater transparency vis a vis borrowing (Australia).
- i. The case studies also reveal a continuing 'tension' in the degree to which the central governments 'control' or influence the activities of subnational governments.** Two important mechanisms for exercising such control and influence can come in the form of a) conditional grants (the importance of these are on the upswing in two cases - the UK and Australia - and on the opposite cycle in the Scandinavian countries) and b) through legislation passed by the central governments in unitary states through which they can control to a high degree the activities of local governments. Like expenditure equalization, there appears to be no 'equilibrium' point; rather, a continuous cycle from more controls to fewer controls to more controls appears to be the norm.

All of this points to the importance of establishing a robust set of mechanisms similar to those outlined in point h) above so as to avoid more intrusive 'control' mechanisms, a development which would not be in the best interests of either the federal or Aboriginal governments. In addition, harmonization mechanisms involving Aboriginal and other levels of government will be critical in the Canadian context, given the lack of a national legislative framework for the

⁵⁴ Barry Potter, op. cit. p. 348.

programs that will fall under Aboriginal jurisdiction. Such mechanisms will not be inexpensive.

- j. Another contentious point in any fiscal relationship between levels of government is the determination of the total amount to be transferred.** In all four cases, the central government determines this amount as part of their budget process but in different ways -in the UK, the amount is a function of a set of published factors; in Denmark, there is reliance on a set of 'rules', backed up by a joint forum for discussing the issue; and in Australia, the amount is determined at an annual Premiers' Conference. The Danish approach may be worthy of careful consideration in the Canadian context.
- k. An important conclusion to be drawn from the case studies is that the size or scale of subnational governments appears to matter. One of the spin-off benefits of expenditure equalization systems is that countries get a better, albeit imperfect, sense of the factors driving the cost of services in the public sector. And the number of inhabitants served by a single jurisdiction and their geographic dispersion appear to be important factors. Indeed, in the Scandinavian countries scale appears to have been a central factor in determining the size and expenditure responsibilities of their subnational governments. Furthermore, in the three unitary countries there has been a trend toward reducing the number of local governments based to a large degree on questions of scale and efficiency.**
- l. In the Scandinavian countries, a staged implementation of an overall transfer system over several years with set parameters on the degree to which transfers could change from one year to the next has been an effective implementation strategy.** The Danish and Swedish experience suggests that a more incremental approach to implementing change might have resulted in more opposition and have been less successful.
- m. Another element in the implementation of the transfer systems in the Scandinavian countries has been the use of legislation to set out the major elements of their system., including the factors, their weights and the methods of calculation.** In contrast, Australia and the United kingdom have put only their institutional elements of their systems in legislation.
- n. The Danish approach to achieving a high degree of budget security for local authorities by giving them the option of opting for a guaranteed tax base and associated equalization amount, based on the most recently completed fiscal year is worthy of possible emulation in the Canadian context.** Under this option, the central government assumes the risk, should the tax base declines but also reaps the benefits, should the tax base rise.
- o. A final conclusion relates to the importance of establishing an ongoing process or mechanisms for managing the fiscal relationship, given the inherent problem of**

dividing a fixed sum among a number of competing entities. The case studies point to two distinct models - the Australian approach of establishing a 'neutral', non-political agency to help the players manage the contentious issues or the Scandinavian approach, based more on a negotiating model. Both of these models have precedents in the current federal-Aboriginal relationship.

8.2 Recommendations

The above set of conclusions lead to the following set of recommendations.

Principles

a. **The department should revise its statement of principles for a new fiscal relationship** (for example, in its presentation to the Meadow Lake Tribal Council in the fall of 1997), by adding the following points:

- ! **the notion of 'neutrality'** should be central to any fiscal transfer system, neutrality in the sense that the receiving government should not be able to influence the grant that it receives by manipulating its expenditure or tax decisions;
- ! **any statement of principles should recognize that some of the principles may be conflicting** - in particular, implementing the 'equity principle' tends to move a transfer mechanism away from the 'principle of simplicity'; and
- ! **to make any fiscal arrangement work, there needs to a strong commitment on the part of all parties to the continuous management of the relationship** because of the ongoing potential for conflict between the Aboriginal governments and the federal governments and among Aboriginal governments over the implementation of any equalization regime.

Borrowing by Aboriginal governments

b. **The department should propose that borrowing by Aboriginal governments should be part of any agenda for discussing a new fiscal arrangement.** Topics to be discussed under this heading include:

- ! possible mechanisms to lower the cost of borrowing (as in the United Kingdom and Sweden);
- ! whether borrowing should be restricted to investment projects;
- ! common accounting practices;
- ! contingency plans in the case of default; and
- ! how the transparency principle will be realized.

Fiscal Transfer mechanism

c. The starting point for discussions between the department and its Aboriginal partners on a fiscal transfer mechanism should be the current mechanism employed by the federal and territorial governments or some variation thereof. The models canvassed in this study are far too complicated for the Canadian context; they represent the results of long, evolutionary processes; and finally they are supported by an institutional structure that has no analogue in Canada. The advantages of the existing territorial formula are several:

- ! Canadians have had direct experience with it for a significant period of time;
- ! this model is suited to a small number of self-governing entities whose numbers can increase slowly over time;
- ! the data requirements are relatively simple; and
- ! it has both an expenditure and revenue equalization feature.

In adopting this approach (or some variation), the parties should realize that the expenditure equalization feature is 'crude' at best and the long term tendency will be to refine it and thus render the formula increasingly incomprehensible to most citizens.

Further research

d. The department, likely in conjunction with Aboriginal partners, should conduct research on the experience of other jurisdictions with the following accountability devices with an emphasis on how these could be most effectively adopted to fit the federal-Aboriginal relationship:

- ! **performance indicator systems** and comparative reporting methodologies;
- ! **audit and other review mechanisms** jointly serving a variety of jurisdictions;
- ! **common accounting & financial reporting systems** shared by many jurisdictions;
- ! **redress mechanisms** such as an ombudsman.

e. Again in conjunction with appropriate Aboriginal partners, the department should undertake research on capacity building strategies to support the development of a new fiscal arrangement. The choice of the countries for the case studies had a number of advantages outlined in Section 3 of this paper. A disadvantage, however, of choosing mature western democracies is the lack of good examples in the building of fiscal capacity. The Institute's review of the literature revealed a number of interesting approaches, both in Latin America and in the newly emerging market economies in Eastern Europe. Undoubtedly there are others as well. These could be profitably mined at relatively modest cost.

f. Other potentially useful research projects might center on the following topics:

- ! **the experience with user fees and charges** - where to apply them, the potential for

dampening demand, pitfalls to avoid;

- ! **the experience with joint borrowing agencies** both in Canada and abroad - the expected costs and benefits, organizing principles, pitfalls to avoid;
- ! **harmonization schemes** for such critical areas as tax and environmental management both in Canada and abroad - costs and benefits, pitfalls to avoid; and
- ! **questions of scale** - a review of the research literature in Canada and abroad; lessons learned; the nature of the trade-offs involved; options for realizing economies of scale.