



# GENERAL GRANTS VERSUS EARMARKED GRANTS THEORY AND PRACTICE

## The Copenhagen Workshop 2009

Editors: Junghun Kim, Jørgen Lotz and Niels Jørgen Mau



The Rentekammer Hall (Rentekammersalen) of The Danish Ministry of Finance



**General Grants versus  
Earmarked Grants  
Theory and Practice  
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**Editors: Junghun Kim, Jørgen Lotz and Niels Jørgen Mau**

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Photo of Rentekammer Hall (Rentekammersalen) on the back of the book cover: With its almost 100 square meters, the Rentekammer Hall is the largest hall in the Danish Ministry of Finance. The hall is dominated by a stucco ceiling featuring a large painting by Hinrich Krock (1671-1738). Krock was inspired to paint the scene while studying in Italy.

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# i.

## Foreword

Yun Hi Won

### Foreword

A country's system of intergovernmental fiscal relations reflects various aspects of its governmental system. It is not only influenced by economic conditions but also by politics and institutions. It is also an evolving system, continually responding to changes in economic, demographic and political variables. Due to its complexity in nature, few countries seem to be satisfied with their system of intergovernmental fiscal relations. Most countries therefore have the desire to learn from the experiences of other nations. However, fully understanding the intergovernmental fiscal relations of other countries is not an easy task since detailed information is often unavailable to outside observers. Also, countries that have reached the stage of mature decentralization have developed systems of intergovernmental fiscal relations that countries in the early stage of decentralization cannot easily follow. Despite these difficulties, an international comparison of intergovernmental fiscal relations provides a good learning opportunity when the experiences of other nations are understood in a guided manner. Therefore, combining the insight of academics and the experiences of practitioners is a valuable way to optimize an international comparative analysis.

In this spirit, Korea Institute of Public Finance (KIPF) and the Danish Ministry of the Interior and Health jointly organized a workshop in 2007. This workshop was quite successful in creating a rare opportunity for both renowned academics and experienced practitioners to gather and exchange views on major policy issues relating to intergovernmental fiscal relations. The papers

presented at the workshop were later published as a book titled “Measuring Local Government Expenditure Needs – The Copenhagen Workshop 2007”.

The 2007 workshop was successful in yet another sense, arousing interest to an extent that made us consider organizing a series of workshops in the same format. In 2009, KIPF and the Danish Ministry of the Interior and Social Affairs held a biennial workshop in Copenhagen on the issue of choosing between general and earmarked grants. Both academics and practitioners who participated in the workshop presented provocative views and interesting field experiences. In many ways, the seminar helped participants evaluate the functions of general and earmarked grants from a new perspective. We are therefore pleased to publish a book based on the papers presented at the 2009 Copenhagen workshop. We expect this volume to offer policy guidelines for practitioners and stimulating research topics for academics.

As the president of a government think-tank long devoted to the research on intergovernmental fiscal relations in Korea, I find that the contribution towards establishing worldwide joint research cooperation makes the ongoing collaboration between KIPF and the Danish Ministry of the Interior and Social Affairs both meaningful and successful. I hope the biennial workshop we are organizing will continue to generate stimulating environments and interesting results in the future.

President  
Yun-Hi Won  
Korea Institute of Public Finance

## ii.

### Opening address Niels Jørgen Mau

The Danish Ministry of the Interior is very honoured to host this seminar in Copenhagen. With a little pride I might add: for the second time in a row, as this seminar is a follow-up to the 2007 workshop on how to measure local government expenditure needs. Many of the participants and the participating organisations are old friends from 2007, but we also have new colleagues present that we can share experiences with.

At the 2009 seminar we hope to continue the fruitful debate we had two years ago and yet again benefit from the presence of some of the most renowned experts in the field – *both* on the theoretical and the policy level.

Therefore, I am very happy to see that so many have been able not only to attend the seminar but also to put so much effort into preparing highly relevant and exciting papers.

We hope that the highlights, ideas and conclusions from the seminar will find their way to relevant fora - especially ministries concerned with local financing issues and academics dealing with fiscal federalism matters.

#### The 2007 seminar as a background

The 2007 seminar on expenditure needs provided a unique opportunity to share experience and knowledge across borders. This was in regard to different traditions and attempts to develop and classify actual practice when measuring local government expenditure needs, different ideas of what are the factors behind

demand of local public services and different ways of organising the more practical side of developing the equalisation systems in general.

In the 2007 seminar discussions, the subject of the seminar turned out to be very relevant, as many of the participants and their home countries and organisations were indeed faced with common challenges of establishing relevant expenditure need measures. The revised papers from the seminar were compiled into a book which was published in 2008 and has hopefully been useful to both academics and advisers. In spite of the rather technical character of some aspects of the subject, the discussions at the seminar were both lively and to the point.

However, the 2007 seminar also opened up to a lot of other relevant and interesting questions in the field of fiscal federalism.

At the end of the seminar we had a short exchange of words on grants. Mr Anwar Shah from the IBRD argued that simplicity, transparency and local autonomy would be preserved by having fiscal equalisation via service-oriented (or results-based) transfers. Some of us questioned this argument and stressed the need for coordination across sectors. In the end, this discussion served as an inspiration to organise a seminar on grants – dealing with the “classical” subject of earmarked versus general grants.

#### The subject of this seminar

Compared to the subject of the 2007 seminar on expenditure needs, the focus of this seminar is somewhat broader. Perhaps it could also be said to be less technical – but on the other hand it is more challenging when it comes to reaching a common classification of what we are dealing with. The terminology really is not very clear on those matters. For example, the designation of grants like earmarked grants, specific grants, reimbursement grants or conditional grants are – seen on the surface - used more or less synonymously. But going deeper this is not necessarily with exactly the same meaning.

Moreover, grants often have to fulfil many different purposes at the same time: *First*, grants may be used simply for the purpose of transferring purchasing power from one sector – usually the

Central Government – to another sector, i.e. local governments. *Second*, equalisation between local governments is often handled via Central Government transfers. *Third*, grants – or more precisely regulation of grants - are frequently used to control and accommodate local governments' economy. *Fourth*, some grants are used to motivate recipients to a certain behaviour which the grantor finds commendable. *Fifth*, intergovernmental grants could be used as a means to internalise externalities of local governments' behaviour.

There are thus many potential purposes to keep track of when discussing the structure of grant schemes.

Actually, it is my impression that it is not always very clear what the purposes and actual targets of specific earmarked or general grants are. And it can be difficult to compare countries directly due to the different traditions and ways of organising.

But, nevertheless, a lot of the challenges we are faced with are basically the same. And designing grants is one of the themes that is a permanent item on the political agenda in countries with more than one level of government.

Broadly speaking you might say that the theme of the 2009 seminar basically deals with the question of what kind of government/public sector a country wants to have. – This includes the question of how much autonomy the country wants to establish for the municipalities, and to what extent it might be able to provide an incentive for the municipalities to act more economically and produce what is best for public welfare.

But who is to interpret what is in the interest of the citizens? And do we really need to think about economic incentives to convince local politicians and civil servants to work in the best public interest?

Let me round off these words of welcome by wishing you all a rewarding and inspiring seminar. There are many questions that need answers.

Niels Jørgen Mau  
Deputy Permanent Secretary  
Danish Ministry dealing with local government matters

# iii.

## Introduction

Junghun Kim

This book consists of a collection of papers presented at a workshop held in Copenhagen in August 2009. The workshop was organized by the Danish Ministry of the Interior and Social Affairs<sup>1</sup> and the Korea Institute of Public Finance (KIPF). The motivation behind the workshop was to address the issue of the choice between general grants and earmarked grants. To many readers, this topic will be a naturally interesting one. Others, however, may question the merit of this topic since it is often argued that general grants are a better form of intergovernmental transfers than are earmarked grants. This is in fact the position expressed in the European Charter of Local Self-Government (the European Charter), which stipulates that “as far as possible, grants to local authorities shall not be earmarked for the financing of specific projects.”

In many countries, especially European countries, perhaps influenced by the European Charter, this view dominates policy debates. Fiscal reforms have also been made to replace earmarked grants with general grants. In the 1980s and 1990s, the Nordic countries pursued such reforms, and many other countries, including Japan and Korea, share the view that “grants without strings attached” are always better than earmarked grants.

This view, however, was challenged by *Anwar Shah* in a workshop held in Copenhagen in 2007, also organized by the DMIH and the

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<sup>1</sup> The Danish ministries were in 2010 reorganised and a new Ministry of Interior and Health established

KIPF, on the theme of measuring local government expenditure needs.<sup>2</sup> *Shah's* criticism of the view of the European Charter was greeted by many workshop participants with both skepticism and interest, which eventually led to a follow-up workshop in 2009.

This format turned out to be quite informative. It was particularly interesting to hear practitioners describe the many nuanced characteristics of actual systems of intergovernmental grants that are implemented in the real world. Leading academics who participated in the workshop had the opportunity to learn about diverse field experiences and in turn offered theoretical frameworks and perspectives to digest complicated aspects of intergovernmental grants systems. The interaction between academics and practitioners thus offered an opportunity to share different views and interpretations of intergovernmental grants leading to lively discussions.

Contrary to the initial expectations at the time when the 2009 workshop was suggested, the answers given to the question concerning the choice between general grants and earmarked grants during the workshop were not at all straightforward. In a sense, the workshop offered an opportunity to rethink and reevaluate the role of earmarked grants.

The first paper in this volume, by *Smart* and *Bird*, discusses possible hypotheses on why earmarked grants are prevalent in the real world. The authors consider the factors that affect the different types of intergovernmental grants from the perspective of “second generation theory of fiscal federalism,” which emphasizes information asymmetry and incentive problems between levels of government and voters.<sup>3</sup>

As to a potential role of earmarked grants, the authors initially discuss earmarked grants as a substitute for expenditure need grants. In many countries, the central government provides intergovernmental grants to local governments to support the

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<sup>2</sup> A book that contains the papers presented in this workshop was also published by the DMIH and the KIPF in 2008.

<sup>3</sup> Oates (2005, 2008) and Weingast (2009) provide recent reviews of this second-generation approach.

provision of local public services, especially redistributive ones such as healthcare and education. In providing such public services, local governments are faced with different cost and expenditure needs, and the central government generally tries to take into account such differences when distributing grants to local governments. If the center has complete information on the differences in cost and expenditure needs, they can be taken into account in the design of general grants, and earmarked grants may not be necessary. However, in cases where the information available to the center is incomplete, the second-best way to extract such information from local governments is to match the grants to actual local spendings. The earmarking needs to be closed-ended, however, to prevent low-cost local governments from overproviding subsidized public services.<sup>4</sup>

As *Smart* and *Bird* note, however, two important factors limit the role of earmarked grants as a substitute for expenditure need grants. First of all, the assumption that local governments have better information on local costs and expenditure needs can be challenged. In unitary countries such as Denmark and Korea, it is indeed questionable how much information asymmetry exists between the center and local governments. A second factor that affects the effectiveness of earmarked grants is the fiscal capacity of local governments. If there are large income disparities among local governments, earmarked grants are likely to support high-income local governments rather than high-cost local governments.

The second issue discussed by *Smart* and *Bird* is a soft budget problem created by discretionary changes in block grants. For example, Canada Health and Social Transfers (CHST) was established in 1995 as a block grant in order to rein in federal spending commitments. However, the actual evolution of the CHST has not met this expectation. The budget conditions of the federal government improved significantly around 1997, and between 1997 and 2004, federal transfers rather than provincial own-source revenues financed the majority of incremental provincial health-

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<sup>4</sup> According to Huber and Runkel (2006), who analyze the second-best optimum of intergovernmental grants based on asymmetric information assumptions, open-ended matching grants do not satisfy the incentive-compatibility constraint of low-cost local governments.

care expenditure. *Smart* and *Bird* therefore suggest that matching grants, which can be based on narrowly defined spending targets rather than macro fiscal variables, may be seen as an alternative to avoid a soft budget problem associated with committing to block grants.

The third perspective discussed by *Smart* and *Bird* as a potential role of earmarked grants is a broader issue of electoral accountability. It is of course necessary to question whether earmarked grants serve the local accountability better than do general grants. In the fiscal federalism model of Oates (1972), allocation of local fiscal resources is best determined if spillovers are ignored by local voters. Therefore, when the center transfers fiscal resources to local governments, it is desirable to maximize the choice set of local residents by transferring the fiscal resources as a lump-sum. However, in many countries, the power of voters to determine the allocation of local resources is weak. This is often the case not only in developing countries but also in countries with mature decentralized systems. For example, Rattso (2002) argues that in the Nordic countries, intergovernmental fiscal relations are better explained by administrative federalism, which means that important public services are delegated from the center rather than decentralized.<sup>5</sup> In this case, earmarked grants may serve the role of making government activities more transparent to taxpayers than is the case of general grants, which do not explicitly show the linkage between expenditures and revenues. As *Smart* and *Bird* note, the transparent reporting made available by explicit expenditure-revenue linkage may, over time, make local residents get more directly involved in the determination of fiscal policies.

In *Shah's* paper, the evaluation of the choice between general and earmarked grants is less subtle than that of *Smart* and *Bird*. To *Shah*, general grants are “manna from heaven” that create serious problems of accountability, and earmarked (specific purpose) grants undermine local autonomy and are highly intrusively micro-managed and focused on “command and control”. He therefore

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<sup>5</sup> The idea of administrative federalism is found in Musgrave (1959, p. 183): “The philosophy of fiscal federalism was essentially one of independent units joined only to accomplish overlapping objectives. We now turn to an entirely different view, according to which it is the obligation of the federation to see to it that the citizens of each state can enjoy a given minimum level of public services.”

suggests results-based, performance-oriented grants as an alternative and better type of intergovernmental transfers. However, he notes that results-based grants (RBG) are not widely used in the real world. One may guess that the reason is the difficulty of measurement, which is a common challenge of all performance management. However, *Shah* argues that performance measurement is actually not very difficult for many key public services such as education and healthcare. He argues instead that RBG is not widely used because “the donors perceive such reforms as attempts at chipping away at their powers, and recipients fear such programs will be intrusive.” In other words, *Shah* contends that both general and earmarked grants exist due to political convenience rather than economic benefits.

*Shah's* argument is very clear-cut in emphasizing the merit of RBG over either general grants or earmarked grants. It is especially worth noting that private schools in the U.S. almost always outperform government schools since public school teachers do not have incentives to perform better to stay in business. However, although it is hard to deny the merit of well-functioning performance management, it is unclear whether general grants or earmarked grants can be replaced by results-based grants. The cases discussed by *Shah* as examples of RBG indicate that RBG is more likely to supplement the existing grants so that they function more effectively. The Australian National Partnership Payment, the Performance Reserve Fund of the EU, and the Regional Fiscal Reform Fund of Russia all belong to this category, which are incentives to facilitate the center's fiscal policies or reforms. But an important message of *Shah's* paper is that the common emphasis of general grants over earmarked grants can be misleading. *Shah* argues that by incorporating results (output) based accountability into the design and by removing the conditions for spending, the role of earmarked grants can be broadened rather than shrunk as such grants will be simpler in design, more objective and fairer in allocation, will promote competitive and innovative provision, and will enhance local government accountability to local residents while preserving local autonomy.<sup>6</sup>

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<sup>6</sup> Blom-Hansen (this volume) discusses another type of RBG. In Denmark, the central government recently changed the matching grant for local governments' social security expenses to unemployed citizens. Under the new scheme, the

Since the 1970s, reforms have taken place in Denmark to transform earmarked grants into block grants (general grants).<sup>7</sup> *Blom-Hansen* examines this experience and asks the following question: “do general grants really leave recipient governments with more freedom?” He thus raises a fundamental question about the commonly accepted notion of general grants. Surprisingly, his answer to this provocative question is “no”. He finds that, for the past 40 years, the transformation of earmarked grants into general grants has been followed by an increase in regulatory control of local governments' decision-making. He argues that, unless regulatory controls are also reduced, the transformation of earmarked grants into general grants is not likely to generate real change in the spending patterns of local governments since the center's grants tool box simply pales in comparison with the regulatory tool box. He also discusses the reasons why political demand for earmarked spending is so strong.

*Blom-Hansen* does not discuss the normative implication of this finding, for example whether general grants should be accompanied by a reduction of regulations. His main point concerns theory building, namely that the traditional model of fiscal federalism neglects legal and political environments that affect intergovernmental fiscal relations. Thus, his analysis is, like that of *Smart* and *Bird*, in line with the second-generation theory of fiscal federalism. Also, the connection between regulatory control and fiscal control pointed out by *Blom-Hansen* appears related to the issue of unfunded mandates. As he argues, taking economic, political, and institutional factors that affect intergovernmental fiscal relations into account is like opening a Pandora's Box, but also serves as a very fruitful research agenda.

The title of *Roy Bahl's* paper indicates that he focuses on fiscal federalism issues of developing countries. But the theme of his paper is much broader since he discusses in detail the typology of intergovernmental grants. In the literature of fiscal federalism, terms such as general grants, conditional grants, and block grants

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center reimburses 65 percent of local expenditure if local governments “activate” the social security recipients by, for example, providing local labor market training. Otherwise, the center reimburses only 35 percent of local expenditure.

<sup>7</sup> Table 5 and Table 6 in Mau's paper show these changes in detail.

are used to describe the characteristics of intergovernmental grants. However, the financial flows from central to local governments are in many cases too complicated to match simple one-dimensional definitions. As a result, the conventional terminology often does not fully capture the exact characteristics of intergovernmental grants.

There seem to be at least two reasons behind this complication. Firstly, simple labeling is not enough to capture the complicated characteristics of intergovernmental fiscal flows. The sharing of tax revenue (tax sharing) between the central and subnational governments, which is a major source of subnational revenue in countries like Germany, Australia, Spain, and Belgium, is a good example. If tax sharing is combined with equalization, which is the case in most of the above countries, it can be argued that it is the same as general grants. However, such an interpretation depends critically on the extent of equalization. If the effect of equalization is negligible compared to the effect of tax base sharing, as is the case in Australia, considering tax sharing simply as general grants will be misleading. Then there is expenditure side to consider. The shared tax revenue can be earmarked for specific spending, like the VAT revenue of the regional governments of Italy. In this case, tax sharing can be considered as earmarked grants rather than general grants.

Another important source of confusion on the nature of intergovernmental grants is that different countries use the same labeling for different contexts. In the United States, “block grants” means intergovernmental grants that can be spent for broadly-defined spending categories such as environment, regional development, health, and education. In contrast, in the Nordic countries “block grants” mean general-purpose grants that are not tied to any spending categories.

In *Bahl's* paper, the categorization of intergovernmental grants does not depend on labeling. Instead, *Bahl* uses two-dimensional criteria, namely size determination (vertical sharing) and allocation method (horizontal sharing) which generate ten types of intergovernmental grants. In this categorization, type A is tax sharing without equalization and type B is formula-based general grants. Conditional grants are either determined ad hoc or take

the forms of cost reimbursement and expenditure reimbursement. The advantage of *Bahl's* categorization is that the characteristics of new kinds of intergovernmental grants can easily be identified by adding new criteria. For example, the categorical block grant, commonly found in the U.S. and Canada, is close to type K except for the fact that the expenditure categories eligible for reimbursement are broadly defined.<sup>8</sup> The disadvantage of *Bahl's* classification, which uses alphabetical letters from A to K, is that they cannot be used as common terminologies to describe intergovernmental grants. So the best way to fully describe the complicated nature of intergovernmental grants, it seems, is to combine traditional terms with more detailed qualification, as is done in the paper by *Bahl*. Also, given the complicated and elusive nature of intergovernmental grants it will be desirable to begin any argument by clearly defining the concept of intergovernmental grants.<sup>9</sup>

The lesson *Bahl* draws from his discussion of different categories of intergovernmental grants is that it is very difficult to generalize the advantages and disadvantages of conditional versus unconditional grants. This is more so in the case of developing countries. The weak tax administration, unfinished public infrastructure, low rate of revenue mobilization, and a high level of inter-regional fiscal disparities in developing countries all imply that the role of the central government is more important in developing countries than in advanced countries. This in turn implies that the need for conditional grants can be stronger in developing countries. However, *Bahl* notes that conditional grants can be more easily determined on an ad-hoc basis in developing countries. This then implies that general grants can be more desirable in developing countries. *Bahl* thus argues that the right design of intergovernmental grants is more important than is the choice between conditional and unconditional grants.

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<sup>8</sup> Smart and Bird (this volume) use terms “weak earmarking” and “strong earmarking” in order to differentiate between matching grants and categorical grants. In this sense, there can be “weak K” and “strong K” in *Bahl's* categorization.

<sup>9</sup> In this volume, Smart and Bird, *Bahl*, Blöchliger and Vammalle, Borge, and Brosio and Piperno all use slightly different definitions of intergovernmental grants. So clearly defining one's own terminology of intergovernmental grants seems to be a required practice.

In the paper by *Junghun Kim*, he looks at the evolution of intergovernmental grants in countries such as Sweden, UK, Italy, and the U.S. to see whether there is any pattern that has an implication on the choice between general and earmarked grants. His survey of international experiences shows that there is almost no common feature of intergovernmental grants systems across the surveyed countries. In the Nordic countries, fiscal reforms were made in the 1980s and 1990s to consolidate earmarked grants into block grants (general grants). However, earmarked grants are still a very important component of the intergovernmental grants system in the Nordic countries.<sup>10</sup> In England, general grants (Revenue Support Grant) were a major source of local revenue until 2007. The education block grants (Dedicated Schools Grant) introduced in 2007, however, significantly shifted the balance towards earmarked grants. In Italy, the constitutional reform in 2001 significantly increased the tax sharing revenue of regional governments. However, regional governments' main responsibility is to provide healthcare, making tax sharing essentially earmarked for healthcare.<sup>11</sup> In the U.S., intergovernmental federal grants are mostly earmarked grants or categorical block grants. This feature is unique among the OECD countries, and squarely opposed to the position of the European Charter.

*Kim* also surveys the fiscal federalism literature to see if any theories explain the actual intergovernmental grants system in the real world. The answer seems to be both yes and no. The concept of fiscal externality, discussed in Boadway (2007), rarely plays a role in the actual design of intergovernmental grants. Open-ended matching grants for local redistribution described in the model of Wildasin (1991) were consistent with the AFDC (Aid to Families with Dependent Children) in the U.S., but it was later changed to TANF (Temporary Assistance for Needy Families), a categorical block grant.

As for the conflict between general and earmarked grants, the concepts of horizontal equity and fiscal equity, discussed in

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<sup>10</sup> The intergovernmental grants systems in the Nordic countries are discussed in detail by Borge and Lilleschulstad (Norway), Mau (Denmark), and Hermansson (Sweden).

<sup>11</sup> Brosio and Piperno (this volume) discusses in detail the fiscal federalism issues of the recent Italian constitutional reform.

Boadway (2007), seem to provide a good answer. If the majority in a nation wants horizontal equity, earmarked grants that ensure a universal level of key redistributive public services such as health and education will play an important role. In this case, it is important that earmarked grants are universal rather than selective and provided with high matching rates.<sup>12</sup> If the majority wants subnational governments to decide the actual level of such public services, that is if the majority wants fiscal equity, general grants will be favored over earmarked grants.

The strong preference for general grants, such as that of the European Charter, is perhaps best explained by the political economy literature, since earmarked conditional grants are likely to be more susceptible to pork barrel politics and rent seeking lobbying than are general grants. *Kim* also notes that Huber and Runkel (2006) imply that budgetary pressure on the central government is likely to make the center prefer categorical block grants to open-ended conditional grants.

The paper by *Blöchlinger* and *Vammalle* provides a data analysis of intergovernmental grants in the OECD countries. Their data analysis is based on the OECD categorization of intergovernmental grants, discussed in detail in Bergvall et al. (2006). The OECD categorization first divides intergovernmental grants into earmarked and non-earmarked grants. For earmarked grants, three criteria are used to establish sub-categories: mandatory versus discretionary; matching versus non-matching; and current versus capital. Non-earmarked grants are divided into general-purpose grants and block grants. It needs to be noted, however, that the OECD classification of intergovernmental grants does not sharply differentiate between general grants and block grants. Bergvall et al. (2006, p. 118) note that “since the [block] grant is not earmarked, the grantee’s actual use of the grant is not controlled.” It needs also to be noted that matching grants in the OECD classification can be subdivided into open-ended and closed-ended grants.

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<sup>12</sup> Mau commented that earmarked grants in Denmark were selective in the 1970s and 1980s, an important factor that led to the abolishment of Danish reimbursement schemes for welfare services.

The OECD classification provides definitions of many different types of intergovernmental grants. However, given the complicated nature of intergovernmental grants, there are also many other definitions. The classification made by *Bahl* (this volume) is one such example. *Smart* and *Bird* (this volume) argue that non-matching earmarked grants and non-earmarked block grants are very similar. Also, they emphasize the difficulty of differentiating between general grants and block grants. *Smart* and *Bird*'s different view generates a somewhat simpler classification of intergovernmental grants as is shown in Table 1. *Brosio* and *Piperno* define block grants as broadly defined earmarked grants and categorical grants as narrowly defined earmarked grants. Also, *Borge* uses terminologies such as “wide categorical grants” and “narrow categorical grants”. In addition to these categories, the results-based grant, strongly advocated by *Shah*, also needs to be included in the classification of intergovernmental grants.

**Table 1. OECD taxonomy of intergovernmental grants**

Earmarked				Non-earmarked		
Mandatory		Discretionary		Mandatory		Discretionary
Matching	Non-matching	Matching	Non-matching	General	Block	

1. In *Smart* and *Bird*, both general and block grants are categorized as general-purpose grants. Earmarked grants are divided into ‘strong’ earmarking (open-ended matching grant and closed-ended matching grant) and ‘weak’ earmarking (categorical (sectoral) block grant).
2. *Bahl* uses different criteria such as vertical allocation and horizontal allocation.
3. *Brosio* and *Piperno* differentiate block grants (broad flexibility) and categorical grants (narrowly defined purposes).
4. *Borge* uses terminologies such as “wide categorical grants” and “narrow categorical grants”.
5. Further distinction between current and capital grants is suppressed.

The different terminologies and types of intergovernmental grants used in this volume suggest that a modified taxonomy of the OECD classification is needed. Given that the OECD classification of intergovernmental grants is often regarded as a benchmark case, it seems that establishing consensus on the modified classification of intergovernmental grants among international organizations such as the OECD and academics in this field is an important and

challenging task.

Based on the OECD classification, *Blöchliger* and *Vammalle* conducted a survey on intergovernmental grants in the OECD member countries. This survey found that the average shares of earmarked and non-earmarked grants as of 2006 are almost similar, although there is a large cross-country variance. Given that the European Charter strongly emphasizes the merit of general grants, this result is quite surprising. *Blöchliger* and *Vammalle* also trace the changes in the composition of grants between 2000 and 2006. They find that there was only a slight decline in the share of earmarked grants. The most significant change was the share of mandatory earmarked non-matching grants given to state governments, but this was only 4.3 percentage points. *Blöchliger* and *Vammalle* thus conclude that the survey results indicate some path-dependency of the intergovernmental transfer system.

The paper by *Borge* examines the evolution of the Norwegian grants system since 1986, the year when the block grants system was introduced. He shows that, contrary to the expectation that the role of earmarked grants would decrease after the fiscal reform, there has been a trend towards more targeted earmarking. *Borge* suggests that this has reduced political frustration at the central level, but at the same time reduced local innovation and initiative.

The story of the Norwegian grants system as explained by *Borge* demonstrates the fundamental conflict between horizontal equity and fiscal equity as discussed in *Boadway* (2007). The consolidation of 50 earmarked grants into one block grant system in 1986 was a victory of the fiscal equity principle. However, the share of earmarked grants over total grants has grown from 17 percent in 1986 to 45 percent in 2008. The main reason behind this change is what *Borge* calls a “blame game” between the central and local governments. When local governments are faced with a shortage of financial resources, they blame the center for not giving enough resources for critical public services such as healthcare. The central government on the other hand argues that local governments should move local resources to funding higher priorities. The side that wins this blame game is often local

governments, which makes it hard for the central government to avoid increasing supplementary grants. The central government therefore prefers earmarking, which limits both the blame game and the increase of supplementary grants.

Once the increase in the role of earmarking succeeds, the next concern of the central government is whether it will be effective in the sense that an increase in earmarked grants leads to at least a corresponding increase in the targeted public service. If not, the central government will think that a so-called “leakage” is occurring. Since intergovernmental grants are fungible, it is hard to expect a complete absence of leakage. However, the Norwegian central government has been trying to minimize the leakage, and according to *Borge*, this has taken place in three stages. In the first stage, the central government used sectoral block grants, which did not carry any formal restrictions in the use of the grants, and then introduced categorical block grants, which carried formal restrictions in its use. Neither of these grant types, however, effectively stimulated the targeted public services. In the second stage after the mid-1990s, the central government used open-ended matching grants, which did have a stimulative effect, but did not stop the leakage. Recently the central government introduced a new matching grant system according to which the amount of expenditure that exceeds the original level of the targeted public service is eligible for matching grants. This scheme naturally favors the local government which initially provides a low level of prioritized service. This in turn is likely to create a perverse incentive that leads local governments to not invest in important public services and to wait for the central government's matching grants.

The conclusion *Borge* draws from this observation is that since the 1986 fiscal reform, the central government's effort to increase the role of earmarking has succeeded in its own terms, but it has led to a more complicated grants system that may result in less local innovation.

The paper by *Lilleschulstad*, also about Norway, shows that the evolution of the Norwegian intergovernmental grants system is a dynamic, ongoing process. As of 2009, the share of earmarked grants over total local revenue was about 12.5 percent. However, it

will be reduced significantly to 4 percent in 2011, the year when kindergarten grants, currently an earmarked grant, will be absorbed into general grants.

In her paper, *Lilleschulstad* discusses the practical guidelines for the use of earmarked grants. Firstly, earmarked grants are likely to be used to support public services with initially low national coverage. For example, government support towards kindergartens had been weak, and earmarked matching grants substantially widened local governments' support. Now that kindergarten support has been widened, *Lilleschulstad* observes, the matching grants for kindergartens can be absorbed into general grants. The second case for earmarked grants is when the demand for a public service is restricted to particular districts or groups, as in the case of housing of under-age refugees. The third case for earmarked grants discussed by *Lilleschulstad* is when financial support is needed for a limited period, as in the case of grants for special projects.

However, *Lilleschulstad* warns that earmarked grants should have a very narrow application because they distort local priorities and entail high administrative costs as well as unpredictability of local budgets. She concludes that, with kindergarten grants being absorbed into general grants in 2011, the balance between general and earmarked grants in Norway will shift in the right direction.

In Italy, the constitution will be amended in 2011. *Brosio* and *Piperno* examine the changes that the constitutional reform will bring about on the intergovernmental fiscal relations in Italy. A distinguished feature of the Italian constitutional reform is that "essential services" need to be guaranteed throughout the national territory (article 117). Another equally important feature of the new constitution is that the use of specific grants is constitutionally restricted to a few areas. Article 119 of the constitution stipulates such areas as economic development equalization, social cohesion, natural disasters, and delegated functions.

What *Brosio* and *Piperno* argue is that these features of the new constitution are mutually inconsistent. There are mainly two reasons for this. Firstly, ensuring equal levels of essential services

across national territory will require the center's intervention and undermine local autonomy. Secondly, since article 117 of the new constitution guarantees social cohesion, it is very likely that the term “essential services” is broadly defined. This in turn is likely to make ineffective the constitution's intention of minimizing the size of earmarked grants. *Brosio* and *Piperno* explain that such ambitious and contradictory objectives are contained in the constitution because the new constitution is a result of a political compromise between the southern and northern regions of Italy. It is also interesting that article 119, which stipulates that the use of earmarked grants should be minimized, reflects the position of the European Charter.

As a result of this political compromise, *Brosio* and *Piperno* observe, the new grants system is more likely to interfere with local affairs. This is because a guarantee of an essential level of service provision requires the central government's regulation and shared responsibilities between the central and local governments. From this observation, it is not clear in which direction Italy's fiscal federalism is heading. Will the Italian system become more decentralized as a result of the 2011 constitutional reform? The answer may be “yes in the long-run.” But how long the process will take is not very clear.

Besides the issue of fiscal reform, it is worth mentioning that *Brosio* and *Piperno* use other definitions of intergovernmental grants. Referring to Finegold et al. (2004), *Brosio* and *Piperno* define block grants as intergovernmental grants that give subnational governments broad flexibility to design and implement designated programs, and categorical grants as grants that are allocated by formula but can only be used for rather narrowly defined purposes. The terms “block grants” and “categorical grants” used by *Brosio* and *Piperno* are certainly different from those of other authors in this volume. As a matter of fact, it is noticeable that as far as the terms “block” and “categorical” are concerned, it is hard to find any consistency in their usage among the authors in this volume.

In Sweden, a major reform took place in 1993 to replace most earmarked grants with general grants. *Hermansson* evaluates developments in the Swedish intergovernmental grants system

since 1993 to see how the balance between general and earmarked grants has evolved over time. Notably, he finds that the number of earmarked grants in Sweden has not been reduced to a large extent since the introduction of block grants. In 1993, the number of earmarked grants was 46, down from 64 in 1992. Since then it grew to reach more than 100 in the late 1990s and then has maintained a steady level at around 90. *Hermansson*, however, points out that the number and the amount of earmarked grants has evolved differently. In 1990, the amount of earmarked grants was about six times larger than that of equalization grants. After the reform of 1993, the amount of general grants became slightly larger than that of earmarked grants. The share of earmarked grants in local governments' income, which was about 7 percent in 1993, maintained the level of around 8 percent between 2003 and 2006, implying that the relative size of earmarked grants has not changed much since 1993. As a result, the shares of general and earmarked grants in local governments' income have roughly been the same until 2006. Only recently, the share of general grants has become higher than that of earmarked grants due to the abolishment of some earmarked grants and the replacement of tax deductions for local governments with general grants.

When evaluating the evolution of the balance between general and earmarked grants in Sweden, it is worth noting that the fiscal reform to reduce earmarked grants took place when Sweden was hit by a severe economic recession. *Hermansson* reports that Sweden's GDP decreased by 4 percent during 1991~1993. In contrast, local government consumption grew by 2 percent in 1993. According to *Hermansson*, the main rationale of replacing earmarked grants with general grants in 1993 was to "equalize financial conditions for local governments, to enhance local flexibility, to transfer power for shaping services according to local needs and to promote economic efficiency". However, it is hard to deny that there was a strong central government motivation to control the size of the local public sector by controlling rapidly growing earmarked grants. In short, *Hermansson* argues that the reality in terms of the policy mix between specific and general grants in Sweden may be less impressive than it appears. He thus thinks that there is reason to question whether the intentions of the Swedish grant reform of the 1990's have truly been fulfilled.

The history of decentralization in Korea is short. A decentralized political system began after its independence in 1945, but the political system was centralized in 1961. After a long period of centralization, a decentralized political system was adopted in 1995. Fiscal decentralization in Korea is therefore still an evolving process and quite different from that of more mature decentralized countries. *Hyun-A Kim* presents an overview of the main characteristics of intergovernmental fiscal relations in Korea and discusses its evolution and choices made with regard to general and earmarked grants.

One of her main points is the connection between the changes in the composition of public expenditures and the changes in the structure of intergovernmental grants. At present, the number and size of welfare programs are growing at a rapid pace in Korea. At the same time, the responsibilities of local governments to provide welfare programs are also increasing. *Hyun-A Kim* argues that providing local governments with general grants to enhance fiscal autonomy in offering welfare programs to local residents has not been a successful policy. So she, like many other authors in this volume, questions the policy relevance of the European Charter that unequivocally emphasizes the merits of general grants.

She draws this conclusion based on the following features of the intergovernmental grants system in Korea. Most notably, the mechanism to ensure fiscal accountability is not yet working. This is because most local governments do not exercise the legal right given to them by the Local Tax Act to change local tax rates within certain ranges, usually plus or minus 50 percent, of the standard local tax rates. In these circumstances, *Hyun-A Kim* argues, local residents do not get a price signal of local expenditures, and fiscal accountability is not ensured. She also argues that local governments are reluctant to raise local tax rates because of the complicated and non-transparent system of general grants, which makes local governments believe that raising local tax rates will lead to the reduction in general grants. It can be argued that local governments can then at least lower their local tax burden. This actually occurred after the property tax reform in 2005, but was quickly followed by the central government's intervention to remove local governments' taxing power on properties.

Considering the weak incentive system of local public finance in Korea, it is understandable that *Hyun-A Kim* is critical of general grants that give full fiscal autonomy to local governments. Another issue related to the fiscal autonomy of local governments is the recent introduction of the Local Consumption Tax (LCT). The total amount of LCT is 5 percent of VAT revenue, and is distributed to local governments based on a weighted-population index, which is a decreasing function of the population. Thus LCT is a tax sharing system with an equalization element, which is in effect similar to general grants. *Hyun-A Kim* therefore suggests that LCT is a result of political symbolism and, although it is called a “local tax”, it has not changed fiscal accountability of local governments.

What *Hyun-A Kim* views to be the most important challenge of local public finance in Korea is the establishment of a connection between a marginal increase in local revenue and the increase in local expenditure. Currently, the biggest challenge faced by the public sector in Korea is meeting the increasing demand for welfare programs. Since local governments are not very responsive to this demand, *Hyun-A Kim* argues that earmarked matching grants rather than general grants are needed to make local governments contribute their own resources to welfare programs. In other words, she argues that the institution of fiscal decentralization is weak in Korea, and general grants cannot be relied on to make local governments spend on politically important expenditures. In this sense, *Hyun-A Kim's* argument is in line with that of *Bahl*, who argues in this volume that there are more cases in developing countries that make the choice between general and earmarked grants more difficult than in industrial countries. As far as fiscal decentralization is concerned, it seems Korea is still at the stage of developing political and economic institutions.

Denmark has the largest local public sector in the OECD countries. Therefore the design of intergovernmental fiscal relations and the choice between general and earmarked grants are important policy issues. *Mau* overviews local public finance in Denmark and discusses the factors that affect the desirability of earmarked grants, such as local discretion, expenditure needs variation, measurability, and merit aspects. Based on these criteria, he constructs a composite index to evaluate the appropriateness of the designs of three intergovernmental grants that have been

implemented in Denmark in the last few years: grants to support care for the elderly; grants to support growth in hospital output; and reduced reimbursement rates for long periods of sickness benefits.

The central government's support to the elderly went through several stages from 1998 to 2010. Initially, it was a discretionary grant and then changed into a categorical block grant. Currently, elderly care is supported by general grants. Using his composite index, *Mau* evaluates that there is no strong reason to support elderly care by earmarked grants because of the weak measurability of its quality, although local responsiveness is presumably rather high. The grant to support growth in hospital output was introduced in 2001. This is one type of the results-based grant advocated by *Shah*, and *Mau* argues that this grant has a potential for success since health care is a nationally important public service, and the measurement of hospital output has recently strongly improved. He also notes that despite some criticism at the time of implementation, this grant resulted in an increased number of treatments and reduced waiting lists. Controlling the cost to support employees on sick leave has been a very difficult policy challenge in Denmark for a long time. In the 1980s, all sickness benefits were reimbursed by the central government. The reimbursement scheme has changed since then, and currently the reimbursement is a decreasing function of the length of the sickness benefit period with one year set as the maximum length of the reimbursement period. *Mau* notes that although sickness benefit periods can be influenced by local government policy, there can be some genuine reasons for prolonged sickness periods beyond one year. Also the effect of this grants scheme on the reduction of sickness periods is not clearly known yet. Therefore he leaves the evaluation of grants for sickness benefits as an open question.

*Mau's* evaluation of the Danish intergovernmental grants system shows that emphasis is being placed on the performance of public services such as healthcare and social welfare services. These public services are provided by local governments with the support of the central government's general grants, and the calculation of the costs involved, or cost equalization, has traditionally been an important issue in Denmark. However, as *Mau* puts it, “the

development in techniques of data collection and information storage has profound effects on grant design.” From this perspective, results-based grants can play a more important role in Denmark. But he concludes that for the time being general grants seem to be preferable in most cases. He also points out that earmarked grants, whether input- or output-based, by their very nature, are sector-oriented. Therefore, coordination and general economic considerations might be weakened or more difficult to carry out on both the central and local levels if general grants are replaced by results-based grants.

When we discuss fiscal decentralization, we tend to look at central-local relationships in unitary countries or federal-state relationships in federal countries. A conclusion usually drawn from this observation is that the extent of fiscal decentralization is larger in federal countries than in unitary countries. This conclusion, however, is only partially true and can be misleading since, in federal countries, the extent of fiscal decentralization to local governments is quite different from that to state governments. *Enid Slack* examines the provincial-local fiscal relationship in Canada and discusses how the constitutional framework of the provincial-local relationship has been shaping intergovernmental fiscal relations between provinces and municipalities in Canada.

In Canada's Constitution Act, local governments are mentioned as one of the responsibilities of provincial governments, and provincial legislation lays down the powers of municipal governments. Within this constitutional and legal framework, local governments enjoy only those powers that are delegated to them by the provinces. Therefore it might be expected that municipalities would rely heavily on intergovernmental grants from the province. However, the municipal governments apparently have a high share of own-source revenue. In 2007, the share of own-source revenue was 81.2 percent and that of intergovernmental grants was 18.8 percent. Based on these figures, it can be argued that municipalities enjoy a high degree of fiscal autonomy. But the paper by *Slack* suggests that this conclusion is not accurate. This is because the province mandates the expenditure responsibilities of municipalities and sets standards for local service provision even for services that are not mandated. Under these provincial

controls, municipalities provide a wide range of public services such as transportation (roads, streets, snow removal, public transit), protection (police and fire), environment (water, sewage, solid waste collection and disposal), and social services (homeless shelters, immigration settlement, etc.). Given that the demands for public expenditures related to environment and social services are an increasing trend, municipalities are under constant pressure to fund these expenditures. On the other hand, municipal tax revenue mainly comes from property taxation which has a limited growth potential. In sum, municipalities in Canada are, even with a high share of own-source revenue, constrained by both expenditure responsibilities and limited sources of tax revenue.

Since municipalities have limited fiscal resources, they rely to some extent on provincial grants for the provision of public services. The provincial grants are mostly earmarked: in 2007, for example, about 85 percent of the provincial grants were earmarked, mostly to transportation and environment. As *Slack* notes, there are several theoretical factors in the existence of intergovernmental grants, such as vertical fiscal imbalance, horizontal fiscal imbalance, externalities, and political economy factors. She argues that the first three factors do not explain the current provincial grants structure. She also notes that most Canadian provinces provide non-matching earmarked grants to municipalities so that a minimum standard of public services can be provided to local residents. This means that, as *Slack* notes, the Canadian provincial-local relation can largely be explained by a principal-agent framework.

It is worth noting that as far as the provincial-local relationship is concerned, the intergovernmental fiscal relationship in Canada can be viewed from the perspective of the administrative federalism model, which many authors in this volume think is a more appropriate model for many European countries. Given that Canadian municipalities are “created” by the province, such an interpretation does not seem out of line. What is interesting is the coexistence of a fiscal federalism world (federal-province relationship) and an administrative federalism world (province-local relationship) in Canada. This kind of dual structure is actually observed in many federal countries and unitary countries with strong regions. For those who want to compare

intergovernmental fiscal relations in unitary countries to that in federal countries, the dual structure is worth remembering since the federal-state fiscal relationship in federal countries is often an inappropriate benchmark for central-local fiscal relations in unitary countries.

Spain is a unitary country, but its regions have strong fiscal autonomy as well as substantial expenditure responsibilities such as health, education and social services. However, as is the case of Canada, the fiscal conditions of local governments in Spain are quite different from those of regional governments. *Solé-Ollé* focuses on regional-local fiscal relations in Spain and discusses how the fiscal structure of local governments has been shaped by the constraints imposed by upper level governments.

The expenditure of local governments in Spain was 18.4 percent of total government expenditure in 2006, whereas the share of regional government expenditure was 30.9 percent. Altogether the expenditure share of subnational governments in Spain is about half the total public expenditure. Spain's municipalities have several notable features. The size of municipalities is mostly very small, with 85 percent having less than 5,000 inhabitants. The regions in Spain (Autonomous Communities) enjoy a high degree of autonomy, but, unlike Canada, the region's power over local governments is limited since, by power of the constitution, the main competences of the municipalities lie with the central government. The municipalities of Spain obtain about 60 percent of their revenue from their own sources, and about 40 percent from intergovernmental grants. The intergovernmental grants consist of current transfers and capital transfers. About 60 percent of the current transfers are provided by the central government, whereas about 50 percent of capital transfers are provided by the regions. The current transfers from the central government are mostly non-earmarked, but both current and capital transfers from the regions are mostly earmarked.

In order to evaluate intergovernmental grants to municipalities in Spain, *Solé-Ollé* uses several theoretical criteria such as needs equalization, fiscal capacity equalization, fiscal adjustment, intergovernmental cooperation, and rent-seeking behavior. As for needs equalization, he argues that general grants to

municipalities, which are distributed mainly based on weighted-population index, are not sensitive to specific needs factors. He does find that capital transfers to municipalities are sensitive to the new demands associated with urban growth, but he argues that the economic effect is negative since it encourages municipalities to over-expand.

As for fiscal capacity equalization, he claims that neither non-earmarked nor earmarked grants have any equalizing effects. This is because general grants in Spain are determined as a function of weighted population, and earmarked capital grants require matching contributions from local governments. Based on a recent study by *Solé-Ollé* and Sorribas (2008), *Solé-Ollé* describes the response of intergovernmental grants to fiscal shocks in Spain. Unlike the cases of the U.S. and Germany, where intergovernmental grants respond more to revenue shocks than expenditure shocks, intergovernmental grants in Spain, especially earmarked grants, are more sensitive to expenditure shocks. But this is again a case of economic inefficiency, he argues, since it implies that earmarked capital grants subsidize infrastructure needs caused by an over-expansion of urban areas.

Theoretically, intergovernmental grants, especially earmarked grants, can foster intergovernmental cooperation. *Solé-Ollé* argues that a traditional type of capital grant does not contribute to intergovernmental cooperation and suggests that contract-based earmarked grants have some potential. For the evaluation of intergovernmental grants to municipalities, *Solé-Ollé* lastly considers political economy factors such as rent-seeking and clientelism. Here earmarked grants are strongly criticized for the vagueness of selection criteria, discretionary decision-making, and political alignment. Contract-based earmarked grants, which may have a positive impact on intergovernmental cooperation, score poorly here because the bilateral negotiation process is vulnerable to clientelism.

Based on these observations, *Solé-Ollé* makes the following recommendations: (i) increase the amount of unconditional funding to municipalities; (ii) increase the equalization power of intergovernmental grants; and (iii) limit the amount of funds allocated as capital transfers and improve the transparency of the

allocation process.

The title of the paper by *Boerboom* and *Huigsloot* may appear confusing, but it is actually the authors' intention to make the point that general and earmarked grants in the Netherlands are moving closer to each other. General grants to municipalities in the Netherlands, currently at about 16 billion euro, consist of four compartments: public area, buildings and environment, public services, and local government. Earmarked grants to municipalities, currently at about 12 billion euro, support employment, transport, rural area, urban renewal, youth care, and addict care, etc.<sup>13</sup>

According to *Boerboom* and *Huigsloot*, new developments in the management of general and earmarked grants are converging these two types of grants. The introduction around year 2000 of cost-oriented indicators for each cluster of general grants has established a strong connection between the distribution of general grants and spending categories. Also, the introduction of the Integration Grant for new functions of municipalities and the Decentralization Grant for devolved tasks has tied general grants to certain spending categories.

The reason why general grants in the Netherlands increasingly take the features of earmarked grants is related to the Dutch government's effort to reduce the number and size of earmarked grants. Many small earmarked grants have been clustered into 'wide target' grants. Also a clustering by department for minor earmarked grants, collective grants, was introduced in 2008.

*Boerboom* and *Huigsloot* explain the background of the convergence between general and earmarked grants in the Netherlands from several perspectives. First, there is a political consensus that lower-level governments should have a large degree of freedom to reduce executive and administrative costs. Second, laws, rules, covenants, and other agreements between the central and local governments made it possible to control local spending

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<sup>13</sup> The size of general grants to provinces is about 1.2 billion euro and that of earmarked grants about 1.7 billion euro.

without relying on earmarked grants.<sup>14</sup> Third, the creation of earmarked grants is now controlled by the Allocation of Finance Act. Also, a periodical maintenance and monitoring system has been introduced to examine the background of differences between the expenditure of municipalities and the effect of the allocation system. Fourth, cost-oriented indicators are used for both general and earmarked grants. As more reliable cost indicators are developed, the use of earmarked grants is becoming less necessary.<sup>15</sup> Finally, the principle of Single Information, Single Audit (SISA) has led to more equalized conditions of reporting and accountability between general and earmarked grants.

It seems that the story of convergence between general and earmarked grants in the Netherlands, the last paper in this volume, makes us go back to our starting point: is it really meaningful to emphasize one type of intergovernmental grants over another? The reason the European Charter advocates the use of general grants is to guarantee local governments' fiscal autonomy as much as possible. But the papers in this volume suggest that there are many factors that make earmarked grants either desirable or practically necessary. First, when new functions are assigned or delegated to local governments, many countries choose to use earmarked grants, as is documented by Lotz (2009). Although there are cases where the cost of new local functions are supported by general grants, as in Denmark, earmarked grants seem, at least in the early stages, to make the connection between the cost of new local functions and required fiscal resources transparent to both the central and local governments.

Secondly, in many countries, redistributive public services are provided by local governments with the support of the central government. In supporting the redistributive function of local governments, the central government takes into consideration the fiscal autonomy of local governments, but it is rare for the center to rely only on general grants. This is because local governments'

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<sup>14</sup> In this sense, the grants systems of the Netherlands and Denmark are becoming similar since, as Blom-Hansen argues, regulations make general grants in Denmark have the effect of earmarked grants.

<sup>15</sup> This argument echoes that of Mau, who suggests that the development in techniques of data collection and information storage has profound effects on grant design.

priority is often different from that of the central government.

Because of these conflicting motives, many hybrid types of intergovernmental grants exist in the real world. The grants which in this volume are called “earmarked general grants”, “wide earmarking”, and “categorical block grants” are all related to the conflicting motives on national priority and local fiscal autonomy. In the cases where intergovernmental fiscal relations are characterized by administrative federalism, these types of grants seem especially popular. Even in the case of tax revenue sharing, of which the main function is to share revenue among different levels of government, it is not uncommon to see the characteristics of broad earmarking, as in the case of Italy. Given the large size and importance of these grants, it is surprising that we do not yet have a consensus on standard definitions and terminologies with regard to these grants. In this sense, it can be said that a more comprehensive classification of intergovernmental grants than the one offered by the OECD is needed.

Lastly but perhaps more importantly, an issue that is broader than was initially expected has emerged from the workshop papers, namely the importance of the impact of laws, regulations, and institutions on the characteristics of intergovernmental grants. As was emphasized by *Blom-Hansen* and *Boerboom* and *Huigsloot*, these factors make general grants similar to earmarked grants.<sup>16</sup> This issue is deeply related to the decentralization model. In particular, as a theoretical model of intergovernmental fiscal relations, administrative federalism seems to have as much relevance as fiscal federalism in many European and Asian countries. It is therefore hoped that the present volume and future works will contribute to a better understanding of the political, institutional, and legal environment of intergovernmental fiscal relations.

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<sup>16</sup> This point was also made by Junghun Kim when discussing the general grants system in England.

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# Chapter 1

## Earmarked grants and accountability in government

Michael Smart and Richard Bird

*Dal momento che dicono che non ha a che fare con il denaro ... ha a che fare con il denaro!*<sup>17</sup>

### 1.1. Introduction

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Money matters. Indeed, in many ways who has the money and who gets the money (and under what conditions) lie at the very heart of intergovernmental fiscal relations. The structure of intergovernmental grants is thus a critical issue in most countries – one that shapes not only who does what, but also how and to what extent different things are done. The 1990s witnessed a broad trend in the grant formulas of many OECD countries away from earmarked and matching grants, and toward block grants that were comparatively simple in structure, lump-sum in nature, and associated with relatively few conditions or mandates from the centre (Blöchliger and King 2006). While a number of factors may explain this trend, many practitioners and academics clearly agreed that earmarked matching grants constituted a distortionary central intrusion into the decision-making sphere of recipient governments and that block grants were both less damaging and a useful means of controlling grant costs for central governments.<sup>18</sup> More recently, there is some evidence that earmarking and matching are on the rise again, at least in certain categorical areas (Bergvall et al. 2006). As Blochliger and Vammalle (2009, 11) note, “recently, the financial and economic crisis has triggered a surge in the use of discretionary earmarked

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<sup>17</sup>“The moment they say it's not about the money...it's about the money!”

<sup>18</sup> For example, this view is stated clearly by Kim and Lotz (2007, 32) as well as Blöchliger et al (2007, 21). For a particularly strong characterization of conditional grants as “instruments of occupation”, -- that is, one way by which central governments in effect take over subcentral powers and functions -- see Breton (2006, 94).

grants in national stimulus packages, as these have proven to be very flexible fast instrument[s] to address exceptional situations, which require timely, geographically targeted responses.” In Canada, for example, as Snoddon and Hobson (2009) document, infrastructure financing, almost all of which is both earmarked and matching, constitutes a significant fraction of the “stimulus” package put forward by the federal government to cope with the current economic downturn.

In this paper we suggest some factors that may explain the recurrent demands for earmarking and other forms of conditionality in intergovernmental grants. The standard textbook treatment of fiscal federalism argues that matching and/or earmarked grants should be reserved for situations in which there are significant positive spillovers from expenditures by government in one jurisdiction to residents of other, neighbouring jurisdictions so that there is a case for grants to act as Pigouvian subsidies (Oates, 2005). In other circumstances, matching/earmarking is generally held to be counterproductive, since the ultimate effects of conditionality are apt either to be small (because of the fungibility problem) or undesirable (because matching grants distort local priorities).

However, the limited role of matching grants to address spillovers from the Pigouvian perspective explains neither the number and importance of earmarked grants nor the changes observed over time in different countries in the importance of earmarking. Nor does it explain the extensive use of categorical block grants and closed-ended matching grants which do not as a rule affect spending choices directly, as the Pigouvian argument requires. We therefore consider in this paper three alternative roles for matching and earmarking in grants, drawing on what Oates (2005) labels “the second generation theory of fiscal federalism”, which emphasizes the role of information and incentive problems between governments and with voters.

First, we consider the potential role of **earmarked and matching grants as a substitute for expenditure need grants**. Matching grants and tightly conditional categorical block grants may allow central governments to target grants to places where expenditure need is highest. Where cost drivers or need factors are difficult for

the granting authority to measure accurately, designing a grant that simply shares in actual costs, such as a matching grant, may provide a second best way of targeting funds to where need is highest (Bucovetsky, Marchand and Pestieau 1998; Huber and Runkel 2006).

Second, we consider the role of **earmarked and matching grants as a substitute for commitment** in grants policy. Matching or cost-sharing grants are in effect a rules-based, non-discretionary means of sharing fiscal risks between governments and among regions. Other forms of grant systems could in principle be designed to deal with the insurance problem. For instance, the central government could simply adjust block grants from time to time to deal with local cost pressures as they arise.<sup>19</sup> However, such discretion in block grants implies a soft budget constraint and hence creates a moral hazard. Local authorities will soon recognize and take advantage of the dependence of the grants they receive on actual spending patterns, thus creating a serious difficulty for the centre – the risk that it will be seen to reward bad behaviour by increasing grants to its more profligate local governments. To avoid this undesirable outcome, a formal system of matching grants may provide a rules-based insurance mechanism to local authorities without recourse to bailouts and the moral hazard problems they may create. To put it another way, such grants may perhaps be said to represent a ‘soft commitment’ response to the soft budget problem.

A third perspective emphasizes the potential role of **earmarked grants as a substitute for electoral accountability** – that is, as a means of creating stronger incentives for public service delivery and cost control than would exist otherwise through the political process. Even when untied (general-purpose) block grants might be the optimal transfer mechanism based on purely economic considerations (as a means of closing the optimal vertical fiscal gap, for example), such grants may nonetheless be undesirable if political failures imply that recipient government officials are insufficiently accountable to local voters. In these circumstances,

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<sup>19</sup> This is, for example, how block grants to government-funded hospitals have often been determined in the Canadian province of Ontario. As Rattso (2003) shows, a similar pattern can also be seen in Norway.

when local accountability mechanisms are weak, earmarked grants may offer one important means by which central governments can strengthen local accountability to local voters. Moreover, even if local accountability mechanisms are strong, voters may want reassurance that governments at all levels are working on the 'hard problems' – that is, those that are high on the political agenda, such as health. If so, meddling in the affairs of lower-tier governments in such ways as earmarking more grants and imposing tighter conditionality may be an important way in which the national government can demonstrate its competence and accountability to voters. Central government officials may thus use earmarked grants directed to politically salient program areas as a way to demonstrate their own competence and relevance to voters (Pincus 2008).

The three alternative views of earmarking just sketched are quite disparate. Arguably, however, each of them may well be more useful in explaining the actual practice of earmarking in some situations than is the Pigouvian approach of the textbooks. Moreover, these alternative views are also associated with rather different welfare implications and hence suggest rather different views of where and to what degree earmarking may be normatively desirable.

The plan of the rest of the paper<sup>20</sup> is as follows. Section 2 deals with preliminaries, offering a framework for thinking about earmarking and block grants, and presenting the traditional view of earmarking as a Pigouvian device for addressing spillovers in a decentralized system of governments. The three alternative views of earmarking based on informational, commitment, and accountability considerations are presented in Sections 3 through 5. Section 6 concludes.

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<sup>20</sup> We are grateful for detailed comments on an earlier version of this paper by Jorgen Lotz as well for comments from other participants in the Conference on "Policies of Grants to Sub-central Governments: Local Accountability or Control?" Copenhagen, September 2009.

## 1.2. Earmarking: The traditional view

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### 1.2.1 Preliminaries

Before discussing what the theory of fiscal federalism implies for design of intergovernmental grants, it is useful to define the types of grants we analyze and to state explicitly the fundamental problem of fungibility that is at the heart of the theory and practice of grant design. In particular, for purposes of this paper, we define

- An *earmarked grant* -- sometimes called a *categorical* or *specific-purpose* grant -- is any grant for which the amount received is conditional in some way on the spending decisions of the recipient government.
- Any grant that is not earmarked in this sense is a *general-purpose grant*.

Earmarked grants may be further differentiated on the basis of the manner and extent to which they depend on recipient spending:

- An *open-ended matching (or cost-sharing) grant* is an earmarked grant for which the amount paid is a fixed share of the amount spent on the assisted category.
- A *closed-ended matching grant* is an earmarked grant for which spending increases are similarly matched up to some upper limit, but above that preset amount are not subject to matching.
- A *categorical block grant* is a non-matching grant that is conditional on the recipient government meeting certain conditions with respect to its spending in the targeted category. One such condition, for instance, might be to spend an amount no less than the grant received.

This categorization is related to the standard terminology for grant types employed by the OECD (e.g. Bergvall et al. 2006). However, using that terminology in the present context may obscure some of the key economic points at issue. For example, the OECD distinguishes between non-matching earmarked grants, which under the terms of the grant must be spent on a specific program or activity, and ‘non-earmarked block grants’ which, though given for a specific purpose or program, come without legal restrictions on how the grant money is to be spent. Although this distinction

may at times have important legal and political ramifications, as we argue later there is essentially no difference in economic terms between these two types of grants. Both are designated for a given purpose; however, in the presence of fungibility problems, there is no reason to expect non-matching earmarked grants to have any greater incremental effect on spending than block grants unless there are very tight restrictions on how other spending may change in response to the grant.<sup>21</sup> Nor does the OECD distinction between ‘general purpose’ and ‘block’ non-earmarked grants mean much in practice, as indeed Blochliger and Vammalle (2009) note. In contrast, in our terminology, which focuses more sharply on the different ways in which linkages between grants and spending may be established, we distinguish what we label above as categorical (sectoral) ‘block’ grants – as well as what the OECD calls ‘non-matching earmarked’ grants -- as examples of ‘weak’ earmarking, as opposed to the ‘strong’ earmarking of a matching grant (whether open-ended or ‘closed-ended’). As we discuss below, the traditional Pigouvian explanation is particularly unhelpful in explaining such weak earmarking, although it is precisely this sort of earmarking which is found most commonly with respect to grants.<sup>22</sup>

Earmarked grants, as defined here, are thus grants that are notionally tied to the provision of certain spending programs by recipient governments. The allocation of funds among jurisdictions may also be tied to caseload or other factors deemed related to spending in those program areas. In the province of Ontario, Canada, for example, a significant fraction of education grants to local school districts are earmarked for certain expenditures, such as capital grants, grants for such specific programs as second-language instruction in English and French or special education. These earmarked grants are allocated on a different basis than the main ‘foundation grants’ designated specifically for “education in the classroom.” On the other hand, in a characteristically complicated way, other education grants that appear on the surface

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<sup>21</sup> In addition, the OECD further divides each category into mandatory and discretionary. For our purposes, however, the distinction between mandatory and discretionary, which relates to the budget flexibility of the central government, is not relevant; nor is the further distinction made in the OECD data between current and capital grants.

<sup>22</sup> A more detailed classification of varieties of earmarking may be found in Bird (1997)

to be earmarked, being designated for such purposes as, for example, continuing education or language training -- although they may be allocated among districts to some extent on the basis of certain 'needs' criteria -- are not in fact earmarked for the designated programs. Although these grants are nominally tied to the delivery of programs in these specific areas, there is no mechanism that constrains recipient governments to spend the grants on incremental programs within the assisted area -- or even to have a special program to be eligible to receive the grants earmarked for that program. Such earmarking in the end is little more than one way to explain why a particular allocation formula is used for the grant, which is tied to particular case load factors or other needs criteria and cost drivers.

In addition to being tied at least nominally to spending on the designated activity, earmarked grants of all types may sometimes carry with them other conditions less tightly tied to the amount spent and more related to how it is spent. For example, recipient governments may be required to make grant-aided services available to all citizens, whether residents in the jurisdiction or not, or they may be required to provide such services at specified levels or in specified ways. Grants that are earmarked in this sense -- related to recipient spending decisions -- may be further distinguished from output-related block grants that may, for instance, tie the grant in one budget period to the performance level, measured against earlier periods. And so it goes: in almost every jurisdiction, the world of intergovernmental grants turns out to be a complex and convoluted confusion of labels, intentions, and realities.

The key analytical distinction that we stress in this paper is that general-purpose grants are lump-sum transfers in the sense of consumer theory, whereas earmarked grants -- whether block or matching -- are not. Obviously, in practice this distinction is not always easy to make: for example, a broad categorical grant with loose conditions that are very weakly enforced may at times be difficult to distinguish from an unconditional lump-sum transfer. In many cases, therefore, it is appropriate (as the OECD classification does) to think of categorical grants as effectively equivalent to non-earmarked and lump-sum grants. In other cases, however, it is not, and it is critical to keep this distinction in

mind in appraising the actual and potential role of earmarked grants.

This is true despite the fact that a central idea in the theory of fiscal federalism is that *all* grants, earmarked or not, are essentially *fungible* in the sense that they may in effect be reallocated to other than the targeted spending categories – or indeed result in local tax reductions instead of spending increases of any sort – as a result of the policy decisions made by recipient governments, given the grants they receive. The potential for grant funds to crowd out spending that the recipient government would otherwise undertake in the targeted area is generally less for open-ended matching grants, which lower the relative price of targeted spending, than for the other forms of earmarked grants -- closed-ended matching and categorical block grants – distinguished above. In conventional theory, the effects of both categorical block grants and closed-ended matching grants should be little different than those of general-purpose grants, since in all these cases grants have an income effect on recipients but no price effect. In other words, despite their nominal earmarking to particular expenditures neither categorical block grants nor closed-ended matching grants (as defined above) have any marginal effect on local spending decisions and are thus essentially simple income transfers. As we discuss below, however, even such nominal earmarking may turn out to have real and important allocative effects when viewed through the perspective of ‘second-generation’ fiscal federalism theory.

### **1.2.2. Earmarking and spillovers**

In the traditional theory of fiscal federalism, although both matching and block grants have a place in a well-designed system of intergovernmental transfers, the role for matching grants is narrowly circumscribed.<sup>23</sup> While subcentral expenditure responsibilities in the traditional view should generally be confined to local public goods and services, in some situations such local expenditures will have some (positive) spillover effects on residents and businesses in other jurisdictions. In these instances, matching

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<sup>23</sup> A recent cogent statement of the traditional view is Oates (2005). For our own earlier take on this issue in the context of developing countries, see Bird and Smart (2002).

grants may act as Pigouvian subsidies that internalize the positive externalities from local expenditures to the rest of the nation, thus raising local spending to the nationally optimal level. In effect, such grants are a way in which the central government can, as it were, ensure that local decision-makers make the nationally 'right' decisions because their budget constraint is adjusted to ensure that they face the nationally 'right' (subsidized) prices.

In reality, however, the list of government activities with significant interjurisdictional spillovers is probably short. Intercity and interstate transportation is one obvious example. When residents are mobile, redistributive tax and benefit policies – for instance with respect to education – is another. For example, tax competition may leave subcentral governments with inadequate revenue to finance education at desired levels. If a country wishes to deal with the revenue competition argument while still leaving education spending in the hands of subcentral governments, on the whole it is probably better advised to establish some form of general revenue equalization grant rather than a special matching grant for education spending.

Even for activities that clearly give rise to interjurisdictional spillovers, the paucity of reliable estimates of the extent of such spillovers is in most countries as striking as the number of grants that provide matching rates much higher than seem warranted in spillover terms. For instance, matching rates are often observed as part of categorical grant formulas for spending, such as health programs, for which economic studies find little or no evidence of significant spillovers among individuals or across jurisdictions. Moreover, even where spillovers seem more plausible, matching rates typically exceed the levels that might be justified based on Pigouvian considerations (Bergvall et al. 2006). Excessive matching rates for activities giving rise to spillovers are as ill-advised as using matching grants at all for other activities. In both cases, the result is to distort the relative prices of the different activities from the perspective of local governments – and hence their spending priorities as well.<sup>24</sup>

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<sup>24</sup> As mentioned, the case for matching is more general in the presence of interjurisdictional competition for mobile tax bases – a positive spillover (e.g. Wildasin 1991). However, any matching feature in grants driven by this concern

Even though categorical non-matching block grants represent about one-third of total grants in OECD countries (Oates 1999), there is no place for such grants in the traditional theory. Because grant funds are in principle fungible in the hands of recipient governments, such earmarking is irrelevant to actual total expenditures. Grants that are tied to local spending in a particular functional category but which do not change the marginal tax price of spending to the local government have a Pigouvian role only if conditionality is so restrictive that the constraints are indeed binding. In this case, since recipient government spending is then no more than the amount of the grant, grant funds are effectively no longer fungible. Alternatively, additional legal restrictions may be put in place by the centre to limit fungibility – for example in the form of the ‘maintenance of effort’ rules found in many US categorical grants. The effectiveness of such regulatory attempts to confine money to its designated silo seems unlikely to be high, however, so in most cases it is unlikely that grants from the centre cause incremental spending in the assisted category.

The Pigouvian view that earmarked grants exist to correct under-spending due to interjurisdictional spillovers thus seems demonstrably wrong with respect to most actual grant programs. Indeed, even in the few cases in which this view may be plausible, there is little or no evidence that the matching rates established correspond to the interjurisdictional spillovers generated or that local spending decisions respond to such grants fully at the margin. (See Box 1 on the ‘flypaper’ effect.)

Block grants are, by definition, even less tightly tied to effects on spending. Of course, block grants may be allocated on the basis of many things – particularly proxies for expenditure need such as those discussed in Bird and Vaillancourt (2007). As we discuss further in Section 3, such allocation formulas, although having no direct effect on expenditure patterns, may nonetheless play an important role in overcoming the inevitable information asymmetry between donor and recipient. Similarly, these and

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should be tied to revenues from specific tax bases, not to spending. Moreover, other grants may be more effective as a corrective for tax competition (Koethenbuerger 2002; Bucovetsky and Smart 2007).

other characteristic features of categorical grants, as we develop in Sections 4 and 5, although they are mainly ‘symbolic’ in terms of their effects on expenditure patterns, may nonetheless constitute an important part of the institutional structure ensuring adequate accountability between governments and citizens.<sup>25</sup>

### **Box 1. The Flypaper Effect**

The flypaper effect is the notion that ‘money sticks where it hits’, in the sense that grants do not simply crowd out spending that would otherwise have been undertaken by the recipient government but result in incremental spending. In the U.S. for example, a survey of a number of studies found that, on average, a marginal dollar of categorical grants induced an increase in public spending of \$0.64 (Hines and Thaler 1995). Lump-sum block grants thus tend to result in larger increases in spending by recipient governments than can be explained by income effects alone. Similarly, categorical block grants tend to increase spending in the assisted category rather than simply being reallocated to other spending programs (or even to tax cuts) through fungibility.

A number of ingenious explanations have been proposed to reconcile theory to fact. Some authors, for example, have proposed alternative theories in which an increase in federal grants induces a change in political equilibrium and therefore different local spending decisions than would a corresponding increase in local private incomes. Others (Moffitt 1984) have questioned whether the empirical regularity of the flypaper effect constitutes a true causative effect of grants on local spending, suggesting that many grants have implicit or hidden matching components that induce price as well as income effects on local behaviour. Still others (Chernick 1995) stress the problematic nature of estimating the behavioural response to federal grants in general. Estimates using cross-section or time-series variation in the level of grants for identification may partly capture permanent differences across jurisdictions in spending propensities or changes in underlying economic environments in the case of across-the-board transfer reforms. Occasionally, however, reforms yield a natural experiment from which to gauge their behavioural impacts. For example, Baker, Payne and Smart (1999) examine a reform that converted a matching grant to a block grant for some provinces in Canada but not others and found robust evidence that assisted spending was lower under the block grant than the matching grant.

Much of the evidence for and against a flypaper effect comes from high-income, federal countries where subcentral governments often have considerable fiscal resources of their own as well as long traditions of independent decision-making that may stand in sharp opposition to federal objectives. In many countries, however, subcentral authorities are far more dependent on federal

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<sup>25</sup> For an extended discussion of the difference between ‘substantive’ earmarking, which results in incremental changes in expenditures, and ‘symbolic’ earmarking, which does not have such direct effects on expenditures, see Bird (1997) and, with application to Korea, Bird and Jun (2007).

transfers and have less autonomy in decision-making. In Colombia, for example, which imposes tight conditions on the way in which grants are spent by local authorities, Chaparro, Smart and Zapata (2005) examined a reform in the grant program that reallocated funds among municipalities to estimate the extent to which such conditions are binding. They find that on average in most communities, additional funds were allocated to spending areas in almost exactly the proportions specified by federal legislation. For large urban municipalities, however, there was much more evidence of reallocation across programs. This is unsurprising, since it is only the large urban governments in Colombia (as elsewhere) that have sufficient own fiscal resources to undo the effects of federal grants and for which money is truly fungible.

While the flypaper effect is undoubtedly a real phenomenon in some cases and to a certain extent undermines the sharp distinction we draw between matching and (earmarked or general-purpose) block grants, further exploration of this subject is outside the scope of this short paper: see Gamkhar and Shah (2006) and Inman (2008) for recent surveys. In any case, all we need to motivate the present discussion is the simple observation that in many cases even very specifically earmarked grants are non-incremental in terms of their effects on spending on the designated function. How can earmarking make sense in such situations? That is the question discussed here.

### 1.3. Earmarking and expenditure need

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To begin with, we consider an alternative approach that has received much attention in the theoretical literature in recent years. This approach views matching and earmarked grants not as a way of ‘pricing’ externalities but instead as a means – and perhaps even in some instances an optimal mechanism – that central governments may employ to achieve their allocative objectives in the face of imperfect and asymmetric information about the appropriate allocation of grant funds among jurisdictions. That is, earmarked grants may be viewed as a substitute for block grants that seek to redistribute among jurisdictions on the basis of exogenous differences in costs, in expenditure needs, or in local demands for public services.

In the presence of imperfect information about cost drivers -- the real and necessary unit costs of government services at the local level -- it may be difficult for the centre to design a lump-sum (block) grant that appropriately redistributes among residents of different jurisdictions in accordance with the sorts of caseload factors usually assumed to determine expenditure need (Bird and Vaillancourt 2007). One aim of expenditure need grants is in a

sense to insure all citizens against localized fiscal shocks in the form of differential costs and needs for particular services. While no country goes so far as to guarantee precisely equal service levels to all people regardless of where they live and how much the provision of such services might cost, many countries (for example, Germany and to a lesser extent Australia) do make considerable efforts to ensure that local residents do not have to bear locally all the cost of providing equal services when cost and need factors are out of line with those in other localities. If the central government has such an objective, but does not have the necessary information to implement it satisfactorily, it may make sense to make grants depend positively on local expenditures within some spending categories, as a matching grant does. In effect, actual spending thus serves as a proxy for its exogenous determinants.

In this vein, Bucovetsky, Marchand and Pestieau (1998) study a theoretical model in which the taste for local public goods is known by local governments, but not by the centre, which in turn wishes to target grants to high-demand communities to insure against such local 'taste' shocks. In a related study, Huber and Runkel (2006) study an environment in which local governments differ in their cost of supplying public services, and the centre can observe neither the cost nor the quantity of public goods provided at the local level. In both cases, an optimal grant scheme is one which, in certain cases at least, depends positively on actual local spending levels, as in a matching grant. There is thus a trade-off between the better targeting of grant funds as a result of matching and the distortions to local decision-making that result from the moral hazard resulting from matching.

Moreover, Huber and Runkel (2006) observe that an optimal grant scheme in their setup, while admittedly stylized, is consistent with the structure of closed-ended matching or categorical block grants, as opposed to either general purpose block grants or open-ended matching grants. To take a simple example, a categorical grant for local labour training programs in effect targets districts with high unemployment in precisely the same way as the theory of second-best income support programs shows that an in-kind subsidy targets the needy (Blackorby and Donaldson 1988).

Such models are based on a fundamental asymmetry of

information about spending. Local governments are assumed to be better informed about local preferences or local costs than is the centre. While this is an assumption often made implicitly or explicitly throughout much of the literature on decentralization, it is not clear whether it is persuasive or even plausible in some cases. Presumably a central government concerned with the allocation of grants could gather the same information about local environments as a local government concerned about spending. For example, it might perhaps be suggested that what may be called the Nordic model of ‘administrative federalism’ (Rattso 2002) in a sense finesses this point by assuming in effect that the institutionalized structure of central and local cooperation in countries such as Denmark suffices to ensure that each level of government is seeking to achieve the same objectives and acting on the basis of the same information. In these circumstances – which of course do not hold in other fiscally decentralized countries such as Canada and the United States – it is not at all clear why a first-best centralized allocation may not be equally feasible.

At a more practical level, the usefulness of spending as a proxy for expenditure need – and therefore the role of matching grants in targeting expenditure need – is reduced to the extent that there are other, extraneous factors that also drive cost differences among recipient jurisdictions. Chief among these for many spending functions is probably revenue capacity. Government spending increases with increases in local incomes and revenue capacities, and separating expenditure need from tastes in this sense is difficult. While some matching grant programs do attempt to adjust parameters to reflect capacity differences, doing so is difficult. One might therefore expect to see matching and earmarked grants serving as a substitute for expenditure need grants especially in cases in which capacity differences are small – either because local income differences are small, or because significant general-purpose equalization grants are in place. Such equalization grants, by reducing effective differences in revenue capacity, correspondingly reduce the distortionary effects of such differences on cost functions in localities with different income and revenue levels.<sup>26</sup>

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<sup>26</sup> As Smart (1998) and others have noted, equalization grants may themselves introduce other distortions in revenue structures.

This view suggests that matching should be most prevalent when inequality among jurisdictions is small, and when the central government's desire for regional redistribution is large. This last prediction is certainly consistent with the experience in Canada during the 1990s, when a move to block grants coincided with a significant shift at the centre away from the demand for redistribution across provinces.<sup>27</sup> Similar shifts in regional politics may perhaps lie behind the move to (or from) block grants in other OECD countries (Blöchliger and Vammalle 2009)

On the other hand, as Blöchliger and Vammalle (2009, 11) also note, earmarked grants are often employed on a temporary basis to “help building capacity at the SCG [sub-central government] level during decentralisation processes, when new tasks are assigned to SCGs, or [to] finance recovery policies after crisis or natural disasters.” Thus earmarked grants are especially useful when the central government seeks to grow expenditures of all governments in the targeted category. This life-cycle model of grant formulas can be explained by the asymmetric information perspective, given that the centre may use matching to target local funds where they are most needed and to encourage local program development in particular areas. Once such programs mature, however, there is no longer a need for central matching, and the grant is converted to a block grant.

This interpretation seems consistent with the history of several major grant programs in Canada and the United States. For example, with the introduction of a national publicly funded health care system in Canada in 1966, open-ended matching grants financing a given percentage of provincial health spending were made to provincial governments. Subsequently, in 1977 when these programs were deemed to have become “established” (and the federal government faced budgetary pressures of its own), the federal health transfer was converted to a block grant. Likewise, in the United States the elimination of federal matching grants for

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<sup>27</sup> In addition, as we discuss further below, an intended result of the shift to block grants was to reduce both federal spending in the assisted areas and, more importantly perhaps, to stabilize federal budgetary risks, relative to the previous system of matching grants.

state welfare spending under the Aid to Families with Dependent Children (AFDC) in 1996 occurred at a time when a primary policy goal appeared to be reduction in federal spending on welfare programs.

The notion that shifting to block grants is a way to reduce federal spending is seriously incomplete. As we discuss further in the next section, in some circumstances a shift to block grants might actually *increase* the share of spending financed through grants from the centre since matching has stimulative effects on recipient government spending. Converting grants to block form may reduce fiscal risks for the centre, but it is unlikely to prove an effective way to shift fiscal effort to lower level governments. In the present section, we have emphasized the role of matching as a means of targeting spending to where cost or need is greatest. In effect, from this perspective a matching grant may be seen as a sort of self-selection mechanism under which, through their own actions in terms of spending more on the designated activity, those whose need, taste, or cost is greatest get the largest grants. Equity may thus be improved, albeit at the cost of introducing further distortion in local spending decisions. The utility of such self-targeting is presumably greatest in the early years of a program, when information on real local needs and costs is most limited. This approach is, as we noted earlier, most likely to be revealing of reality when, as in Canada in the 1960s, a substantial general-purpose equalization grant system is already in place so that the effects of regional income inequality on spending levels are muted.<sup>28</sup> Once a program has matured, however, historical experience provides considerable information on spending patterns, and a block grant allocated based on past spending may in some instances be relatively well attuned to need.

#### **1.4. Grant design and soft budget constraints**

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As discussed in the previous section, matching grants may be viewed as a means of sharing fiscal risks between the centre and local governments – in effect, providing some insurance against fiscal factors (shocks) that might affect the costs of government

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<sup>28</sup> Of course, as May (1969) noted long ago, countries may differ markedly in their taste for such regional equalization.

services differently in different localities. In periods of fiscal restraint, central governments may view a shift from matching to block grants as a way not only to reduce their own spending but to harden local budget constraints, thereby exerting restraint on local spending as well. In principle, given sufficient information and sufficient power of commitment, the central government could still design these block grants to help insure local government against fiscal shocks. For example, the central government could simply adjust block grants from time to time in order to deal with local cost pressures as they arise (Rattso 2003).

However, such discretionary changes in block grants create the potential for a soft budget constraint problem (Pettersson-Lidbom 2009). If not immediately, then soon, local authorities may recognize and take advantage of the dependence of local grants received on actual spending patterns by inflating spending in the (justified) expectation of being bailed out -- rewarded by increased grants -- for doing so. This commitment failure in the negotiation of block grants between governments thus results in a potentially significant moral hazard. In these circumstances, again there may be a role for earmarked and matching grants to take the place of block grants – this time essentially as a means of substituting rules for discretion in determining how the centre will respond to future fiscal shocks. From this perspective, a formal system of matching grants provides a rules-based insurance mechanism for local authorities without affording them recourse to bailouts and the moral hazard problems they may create.

The problem of commitment to block grants has a neat illustration in the recent history of federal transfers for health and social services in Canada. Federal transfers to provinces in Canada have historically been characterized by the usual mix of matching and lump sum grants, with the latter being divided into general purpose (equalization) and categorical grants. As already mentioned, since 1977 the federal government has increasingly relied on block grants in place of matching for major social programs. This trend culminated in 1995 with the conversion of all federal grants for health and social services into a single block fund, the Canada Health and Social Transfer (CHST), which was allocated among provinces on a basis close to their population

shares.<sup>29</sup>

The principal objective behind establishing the CHST as a block fund was to rein in federal spending commitments, in response to the generally difficult fiscal position then facing the federal government (Lazar 2008). Federal officials wanted to reduce the fiscal risks to which they were exposed through matching grants. Converting to block funding appeared (at least when the idea was first conceived) to create perfect certainty about the magnitude of future transfer expenditures. Arguably, another federal objective was to sharpen incentives for the provinces to control spending increases, relative to what had occurred under the previous regime of matching grants.<sup>30</sup>

However, actual experience with block grants in Canada has been rather different. Since Canada engages (albeit somewhat sporadically) in multi-year budgeting, it is possible to compare the federal government's announced intentions for the program to what has actually evolved over time. We report in Figure 1 the level of cash transfers under the CHST (since 2004 separated into the eponymous CHT and CST programs) set in each federal budget from 1995 through 2005.<sup>31</sup>

It is evident that conversion to block grants was associated with a federal desire for fiscal retrenchment – indeed, nominal transfers actually declined up to 1997-98. By 1997, however, the era of belt-tightening was over. The federal fiscal balance improved quickly thereafter, and pressure from recipient governments to restore transfers to the previous growth track was pronounced. Subsequent federal budgets have repeatedly announced a plan for stable or even declining transfers under the CHST over the

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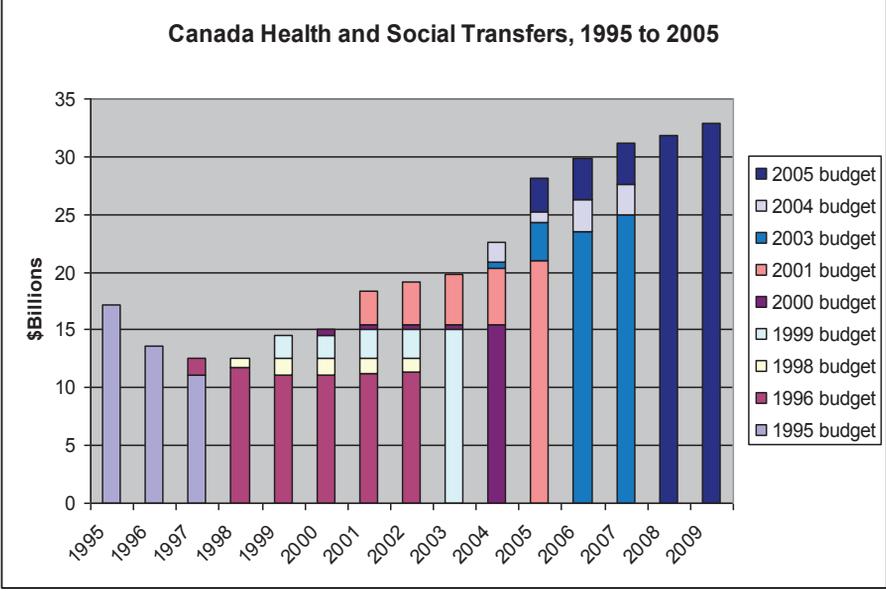
<sup>29</sup> Provinces with above-average revenue capacity have received somewhat less than their population shares.

<sup>30</sup> Coincident with these budgetary changes, the federal government promised greater flexibility to the provinces in the assisted policy areas, and restricted use of the federal “spending power” to influence provincial priorities. In this respect, policy developments in Canada at the time paralleled those in the United States, where the 1996 reform that replaced federal matching grants for state welfare programs under Aid to Families with Dependent Children (AFDC) was labelled the “New Federalism” by its proponents.

<sup>31</sup> This analysis has been extended to subsequent budgets by Snoddon and Hobson (2009).

medium term, only to have those commitments overturned and replaced by higher spending tracks in the next fiscal update or budget. In the face of higher-than-forecast surpluses, federal officials faced exceptional pressure from the provincial governments to “pay their fair share” of increasing health expenditures.

**Figure 1**



Source: Snoddon and Hobson (2009)

Their response was to introduce a curious accounting device under which ongoing transfer increases were “booked” against surpluses of previous years. Frequently, such transfer increases resulted from deals negotiated directly among First Ministers (the federal prime minister and the provincial premiers) at their annual meetings – as was notably the case in 2000, 2003, and 2004.

The result is a transfer system that has very different effects than those envisaged at the time of the original shift from matching to block grants in 1995. Far from ensuring predictability of federal spending commitments, CHST cash transfers increased by nearly \$17 billion in nominal terms between 1997 and 2004, to \$28.1 billion from \$11.1 billion. Far from sharpening incentives for

provincial governments through hard budget constraints, it is federal transfers rather than provincial own-source revenues that have financed the majority of incremental provincial health-care expenditures. Over the same period, provincial government spending on health care rose by only \$28.8 billion (in nominal terms), so that 58.9 per cent of the increase was effectively financed by federal transfers and only 41.1 per cent by provincial taxes.

In effect, then, the federal health-care grant has, unofficially, been operating just like a matching grant – indeed, much like the dollar-for-dollar matching grant that existed officially prior to 1977.<sup>32</sup> In the post-1995 period, it is provincial spending that is pushing federal transfers higher, rather than the reverse, but the effect on the federal budget and on provincial incentives is arguably the same as if a formal matching grant were in place.

The notion that block grants weaken the commitment power of grantor governments and may ultimately result in softer budget constraints is not confined to the Canadian provinces. For example, Rattso (2003) discusses how the use of block grants to finance hospitals in Norway led to excessive discretion for the central government to adjust grants in response to fiscal shocks, with a resulting increase in pressures for renegotiation of grants and weakening of incentives for cost control.

In recent years, reflecting the increasing dislike of many for the input orientation of traditional categorical grants (Blöchliger et al., 2007, 21), considerable attention has been paid to the desirability of making more use of performance indicators in government (Shah 2006). Some have suggested that the move to output-based budgeting in place of input-based budgeting should be mirrored with respect to grants by moving to performance-based grants

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<sup>32</sup> CHST transfers have in principle been linked to provincial expenditures on post-secondary education and social services, as well as to health care, so that the effective matching rate for all assisted expenditures is somewhat lower than reported here. However, education and social service expenditures have grown little compared to health, and provincial demands for federal transfers have been based on health-care costs rather than the other expenditure components. It therefore seems appropriate to include only health-care expenditures in the denominator of the calculated effective matching rate.

(Steffensen 2009). However, this approach simply cannot work for most intergovernmental grants. There may be a limited role for a 'reward' system of grants, in which those who behave best in terms of the performance standards established get the most. But such a post-hoc approach is unlikely to amount to much in a world in which most local governments depend on secure (pre-committed) grant funding to carry out many of their activities, in which many grants are intended in large part to meet needs rather than to reward those who have already succeeded in doing so, and in which, in any case, good performance invariably lies in part in the eyes of the beholder. (See Box 2)

### **Box 2 Performance-Based Grants**

In a decentralized setting, to make performance-based grants work, substantial prior consultation with potential recipients would appear to be a *sine qua non*. As Lazar (2008) discusses (in a somewhat different context), such consultation would ideally encompass a wide range of matters and, for success, would appear to require prior agreement between both sides (donor and recipients) on (1) objectives – the desired results, (2) results-oriented accountability provisions, (3) performance indicators that will be used by all to measure such results, and (4) who will gather such information, and how (as well as the provision of adequate incentives to insure that this is actually done). In addition, ideally all should agree to make regular public reports to residents, and not just to central government, on progress relative to the desired results. Moreover, in all likelihood to make progress with this agenda, the central government would have to agree to observe the fine but important line between monitoring and control by, for example, agreeing not to reduce grants for recipients who make slower progress towards results. That is, to implement performance-based grants in a decentralized setting it may be necessary to decouple grants from performance within some specified time period (say, three or five years). Of course, both parties might agree to renegotiate the arrangement within a shorter period if they do not like the results.

Operating a performance-based grant system might work very differently in a context in which, in effect, subcentral governments are essentially implementing central government policy under contract. In such circumstances, for example, one might perhaps envisage operating a performance-based reward system with increased grants going to those who perform best according to predetermined standards. However, even in this case, in order to reduce the obvious bias arising from unequal local access to own resources and differential program needs, either a substantial equalization system must be in place or a kind of 'handicap' system (perhaps, as in Australia, adjusting for needs and cost differentials) in order to make the contest fair by bringing all potential 'contestants' up to the starting line on equal terms.

Committing to block grants is difficult for governments that cannot

determine the decisions of future governments, and commitment failures can lead to significant moral hazard and block any efforts to control grant outlays. It is unclear that the idea suggested above -- that matching grants may be in some circumstances be seen as an alternative to commitment -- has actually influenced the thinking of government officials. It may, or may not. It might be argued, for example, that in the Nordic model of administrative federalism set out by Rattso (2002) – an essentially integrated system under which redistributive spending is centrally financed but locally administered – under which central and subcentral governments in effect work almost as one, it is unlikely that any local authority would be able to – or expect to be able to – obtain a bailout by increasing spending. Commitment failures are thus not a serious problem. On the other hand, as much experience in the rest of the world suggests, such problems are clearly endemic in many decentralized systems (Rodden, Ekesland, and Litvack 2003). The idea sketched in this section thus appears to deserve further consideration as a possible normative rationale for the prevalence of earmarked matching and conditional grants in many countries.

Certainly, in many cases the non-incrementality of conditional grants from the centre is so clear that other explanations for the existence of such grants than the traditional Pigouvian one must clearly be sought. Often, indeed, it is tempting to conclude that a central grants policy is not really intended so much to do something about spending within the assisted category as to be seen by voters as a signal that something is being done. As Lazar (2008) points out, the federal government in Canada increased its block grants to provinces for health expenditures substantially between 1997 and 2005, while doing essentially nothing to ensure that the new federal funds actually resulted in incremental provincial spending. He suggests that the federal government was quite content to see federal grant dollars simply replace spending that would otherwise have been financed from provincial own-source revenues, because this outcome nonetheless resulted in a significant increase in the proportion of spending financed from the centre and thus met provincial demands for the federal government to ‘pay its fair share’ of program costs. What Searle and Martinez-Vazquez (2007, 411) call federal “public relations conditions” were thus served by increasing federal grants for

health, even if the increases had no incremental effects at all on provincial health spending.<sup>33</sup>

If such interpretations are correct, to a considerable extent the explanation for the level and structure of grants must lie in political accountability considerations rather than in simple economics. Such grantsmanship games may be comparatively benign. For example, one might argue that the real purpose of such broad categorical block grants may be simply to close the (presumably optimal) vertical fiscal gap in the federation. After all, when it comes to closing a fiscal gap, a dollar is a dollar, no matter what label it carries. Labelling funds as being ‘for health care’ may primarily serve the purpose of enabling the federal government to provide voters with a more understandable explanation for the federal role than simply gap-filling as a result of the Oatesian mismatch between the optimal decentralization of revenues and expenditures. At least in the case of Canada, this explanation also serves nicely to explain both why over the years the broad federal-provincial categorical grants have gradually moved closer and closer to simple per capita grants and why so little effort has been made to enforce even the very loose conditions attached to those grants. Vague as they may be, such considerations appear to provide a better explanation of grants than is to be found in the traditional fiscal federalism literature. In the next section, we consider further the question of whether there may perhaps even be a persuasive normative rationale for such symbolic earmarking.

### **1.5. Earmarked grants and electoral accountability**

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Our analysis of earmarking thus far has fundamentally been an economic one: the structure of the transfer system affects the budget constraints facing recipient governments either directly (e.g. through explicit matching grants, as in the traditional view) or indirectly (through the informational and renegotiation constraints on redistributive grants policies). We noted earlier

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<sup>33</sup> Other, less overtly political, motives may also have been in the minds of federal politicians such as attempting to assure the delivery of services to citizens or compensating provincial governments for costs incurred in carrying out centrally-desired programs. But PR does seem the most plausible explanation.

that the conventional economic effects of earmarking may be small especially with respect to categorical block grants, since such earmarking is essentially non-binding on recipient governments due to fungibility. Even in such cases, however, earmarked grants may have a role in mediating political issues as well as economic ones. Earmarking may play a role in reinforcing accountability mechanisms between levels of government, and between voters and their governments.

Earmarking injects the central government into decision-making over local spending and makes local officials accountable in part to the central government for spending. Thus, even in cases where untied block grants might be the optimal transfer mechanism based on purely economic considerations (as a way of implementing the optimal vertical fiscal gap, for example), earmarking and matching may nonetheless be an appropriate way to alter local decision-making. This is particularly the case in systems of administrative federalism (Rattso 2002), in which, with respect to much of local expenditure, local officials are responsible explicitly to the centre but not directly to voters.<sup>34</sup> The same logic may also apply in cases in which political failures imply that recipient governments are inadequately accountable to local voters. Thus, for example, Kochar, Singh and Singh (2009) find that earmarking and conditionality in grants in India have been effective in counteracting the potential for capture of local governments by local elites and so directing funds for redistribution to the neediest.

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<sup>34</sup> As with labelling grants, each author appears to define decentralization differently to fit the circumstances being considered. Some distinguish administrative, economic, and political decentralization. Others (e.g. Bird 2001) distinguish deconcentration (administrative decentralization), delegation (the principal-agent case), and devolution (full political decentralization). Still others (Hellerberg et al. 2009) distinguish delegation (which they define as full agreement of both centre and local governments on policy), from contracts (where there are differences, but they can be negotiated – not necessarily symmetrically), and fiefdoms ('nested' or hierarchical structures under which each jurisdictional level, as in classic political federalism, has its own autonomous sphere of power). The reference in the text is, specifically to the definition of administrative federalism in Rattso (2002), cited earlier in the text, which contrasts sharply with the traditional (essentially American) approach to fiscal federalism, which emphasizes the need for benefit taxation for local accountability in a context in which resources are mobile across jurisdictions.

Central governments have various channels through which they may attempt to influence or control local government spending. They may, for example, regulate such spending in greater or lesser detail. Legislation may explicitly limit the choices local authorities can make with respect to procurement, employment, and so on. In addition, especially in the Nordic version of administrative federalism alluded to earlier, central and local authorities may engage in dialogue and consultation in order to achieve particular objectives. For example, in Denmark, the central government cooperates closely with the National Municipal Association in determining the precise balance between central control of the quality of services and local freedom to adjust to local conditions in the local delivery of services determined to be in the national interest. In addition, the central government may of course earmark grants. While the same objectives can usually be achieved through regulatory policies, one advantage of enforcing such controls through grant policy is that the built-in reporting back to the centre of how grant funds are spent may make it easier to monitor what local governments actually do. Obviously, this objective will be most readily achieved when decentralized governments have a uniform and high standard of public finance management and are obliged both to announce their service objectives for each function and to report publicly on the extent to which they live up to them. (See also the discussion in Box 2.)

In some circumstances, however, excessive reliance on earmarking, matching, and mandates – funded or unfunded -- from the centre may weaken local accountability. Matching grants can induce a form of soft budget constraint among recipient governments, and inhibit adjustments at the local level that would be forced on officials through the political process in the absence of transfers. Some authors indeed find empirical support for the proposition that fiscal adjustment is slower among subnational jurisdictions that are more transfer-dependent (Stehn and Fedelino, 2008). Others find the evidence far from overwhelming.<sup>35</sup> In any case, it is clear that earmarked grants may make it more difficult for

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<sup>35</sup> In Canada, for example, it is by no means clear that, over time, there has been any strong correlation between the transfer dependence of provinces and the extent of their adjustments to fiscal crises. On the contrary, one might equally well make the case that provinces with greater 'own resources' have on the whole been slower to adjust.

voters to understand the assignment of expenditure responsibilities to governments in the federation or, in the case of formally shared responsibilities, to know which level of government to hold accountable for poor performance. Such ambiguities tend to weaken the link between government performance and re-election incentives and hence may result in worse outcomes overall (Joanis 2008).

A related perspective emphasizes the role of earmarking in strengthening the political accountability of the central government, rather than that of recipient governments.<sup>36</sup> Viewed from the perspective of the central government, the fungibility of grant funds is a significant obstacle to accountability: if it cannot be explained to voters on what central grant money is ultimately being spent, then accountability for the funds may be weakened. Restrictive earmarking permits the central government to have a stake in particular spending categories that are of tangible benefit and salience to voters. It thus in a sense allows the central government to display its competence in selecting and managing spending projects in areas of local government responsibility. As Pincus (2008) argues in the Australian context, voters may be best served by having officials of all levels of government at work on issues of the highest salience – and earmarking of grants may be the best means available for central government officials to exert influence in a particular direction, given constitutional or conventional restraints on the direct spending power of the central government. As Pincus (2008) notes, echoing Breton (1996), the tendency for vertical overlap and duplication of efforts is often regarded as inefficient in a multi-level system of government: in reality, however, overlap may sometimes simply be an indication that vertical competition is operating.

There is, however, a contrary view. When the centre establishes an earmarked grant, it becomes involved in a program area that – at least in the less integrated versions of federalism found in many countries – is considered the responsibility of the subcentral government.<sup>37</sup> This may indeed have some beneficial effects, as

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<sup>36</sup> For a related view, see Seabright (1996).

<sup>37</sup> This is the heart of the problem of ‘occupation’ (Breton 2006) that arises in most federal countries in one way or another as a result of what is often called the

postulated in the vertical competition literature (Breton 2006). On the other hand, it may also confuse citizens and create a sort of fiscal illusion that reduces transparency and accountability and makes it possible for both levels of government to exploit the situation to some extent. For example, we noted earlier the Canadian case in which prolonged political controversy followed the federal decision in 1995 to cut federal health and social transfers. To many observers, the emphasis placed by provincial officials on the need for federal transfers to be restored was an attempt to exploit fiscal illusion to shift the blame for health care cost increases to the higher level government (Smart 2005). When federal transfers were subsequently increased in 2004, Lazar (2008) suggests that the reason was because the federal government was equally content to exploit voters' fiscal illusion and that in fact the objective of the new federal grants was to crowd out provincial spending from own-source revenues, so that federal officials could demonstrate to voters that the federal share of program costs had increased substantially. The case that one level of government or another should be responsible for the program may be far from clear to economists: however, the impact on electoral accountability of being associated with good spending – that valued by the populace -- seems to be rather clearer to politicians at all levels.<sup>38</sup>

This diagnosis of the problem with block grants fits best a federation like Canada, where the high degree of co-occupancy of revenue bases means that the size of the 'optimal' vertical gap is indeterminate. In the standard view of fiscal federalism, the central government may commit to an appropriate level of federal transfers simply by computing the appropriate level of vertical fiscal gap – the difference between the desired state expenditures and state revenues – and paying it to states as a block grant.<sup>39</sup>

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federal 'spending power' – the power of the central government to spend in areas that are constitutionally subfederal: see the discussion in Watts (1999). This problem does not really arise in highly decentralized unitary countries with only administrative federalism (Rattso 2002), as opposed to 'real' federal systems in the sense of Wheare (1963).

<sup>38</sup> As Rattso (2002, 279) notes, when it comes to spending mandated (cost-reimbursed) central redistributive funds, "...the local politicians have gladly accepted the increased responsibilities."

<sup>39</sup> The following argument is based on Bird and Smart (2009), where it is

This approach assumes that everyone can make the same calculation. However, it cannot work in a system in which major tax bases are shared between central and subcentral governments. In this situation, no one can easily assess whether the level of grants from the centre is appropriate or not, and everyone can – and often does – assert his or her own views as if they were facts.

Indeed, when tax bases are ‘co-occupied’ it is difficult to determine the appropriate level of intergovernmental transfers on any principled basis.<sup>40</sup> Should federal personal income taxes rise to finance increased health-care expenditures, or should states with access to the income tax base impose their own increased rates? In the absence of important inter-provincial spillovers in taxation or spending, the *economic* consequences of the two options are little different. When federal and state governments have access to essentially the same tax bases, there is no apparent reason why states should not raise their own tax rates to finance increased spending rather than relying on the federal government to do so. Vertical fiscal imbalance when there is base co-occupancy is thus fundamentally a political concept, not an economic one. Canadian reality is a very long way from the canonical model of what might be called ‘paternalistic federalism’, in which revenue collection is centralized and transfers must finance the bulk of decentralized expenditures. Much the same is true in other decentralized federations in the developed world – such as the United States and Switzerland – in which the major tax bases are largely co-occupied. Even in Germany, local business taxes are levied on a base that is similar to the federal corporation income tax base.

When the appropriate vertical gap is essentially indeterminate, it is not surprising that governments have a difficult time in determining the appropriate level of central transfers, with the result of muddying accountability. Vertical overlap of taxes is of course also a source of potential waste, inefficiency, and citizen

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developed in the context of a discussion about the appropriate degree of tax decentralization.

<sup>40</sup> By co-occupancy of tax bases, we mean a system in which real tax powers are shared, so that each level of government may make independent decisions about the tax, particularly with respect to rates. It is important to distinguish this case from revenue sharing systems, in which both levels of government may derive revenues from a single base, but decision-making is not shared.

irritation. More importantly in the present context, rather than strengthening accountability such overlap may weaken it by sowing yet more doubt in voters' minds about who does what and exactly who is paying for it. To the extent it reinforces the idea that all responsibilities are ultimately federal, co-occupancy of tax bases may thus exacerbate the problems of soft budget constraints. On the other hand, as Breton (1996, 2006) has argued in general and Pincus (2008) has suggested in the Australian case, vertical fiscal competition between governments may equally well work in the opposite direction and end up improving both accountability and the efficiency of government spending and taxation at all levels.<sup>41</sup>

If earmarking is at least in part a substitute for local accountability, we would expect to see greater use of it in environments of administrative federalism, or where for other reasons there is little direct accountability of local officials to local voters. One testable implication might be if there is a robust relationship between earmarking of grants and the rate of turnover among local elected officials.

For the other views of accountability sketched in this paper, however, it seems harder to develop either clear testable implications or welfare implications. Arguably, we should expect to observe more earmarking in spending areas – like health care in Canada and elsewhere – that are viewed as highly salient in the political process as well as, perhaps, in such highly visible ‘ribbon cutting’ activities as new infrastructure projects. Perhaps survey information on changes in the salience of such electorally relevant spending programs might provide a better explanatory rationale of the changes observed in the level and structure of different grant programs over time in different countries than does the traditional Pigouvian analysis. From a normative perspective, perhaps the major role of earmarking transfers might be to improve the accountability of governments by making taxpayers more aware of the costs of public services and making more transparent the way in which different governmental levels interact in funding and providing such services.

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<sup>41</sup> For a recent theoretical argument that in certain circumstances interregional redistribution can ‘cure’ the soft budget syndrome, see Akai and Silva (2009).

Earmarking may sometimes constitute unwarranted interference in local affairs. It may also at times reduce accountability by confusing voters as to who is responsible for what and who is paying for what. On the other hand, in times of crisis every level of government may be expected to become involved in the policy areas most salient to voters, so central governments are only to be expected to attempt to demonstrate their competence and relevance by engaging in earmarking in such areas. Voters are unlikely to care much about who does what, and they are likely to expect more from the central government than a policy to maintain the optimal vertical fiscal gap based on Oatesian principles. All these considerations suggest that, even when earmarking cannot be rationalized by conventional economic arguments, some political benefits nevertheless remain. Indeed, given that fungibility limits the effectiveness of earmarking, it may generate substantial (first-order) gains in political accountability, notwithstanding its small (second-order) negative consequences for the optimal functioning of a federal fiscal structure.

In general, this line of argument suggests that perhaps even economists should be devoting more attention to what Dafflon and Mischler (2007, 237) call the 'efficiency in process' of grant systems than to the extent to which they affect specific outcomes or intergovernmental competition. In principle, the ultimate deciders of what is done should be those who are most directly affected, and the best that analysts can do to ensure that the relevant decision-makers make the right decision is to ensure that they and all those affected are made as aware as possible of all the relevant consequences. In this light, it is perhaps time to rethink the traditional reluctance of public finance experts to condone such 'misconceived' ideas as earmarked (but non-incremental) grants. Such practices undoubtedly have led to problems in the past in some countries. But past ill experience need not preclude more careful consideration of more explicit expenditure-revenue linkages in the future – even across governmental levels.

Indeed, such linkages may not only be essential to determining good policy outcomes in a democratic setting, but subjecting them to more transparent reporting and electoral discussions may, over time, prove also to be one way in which the preferences of the people who are allegedly being served by the state may perhaps

gradually enter more directly into the determination of state policies. As Richard Musgrave (2000, 89) once said, “the bottom line ... is not whether the voting process will yield an optimal result, but whether it will be superior to an arbitrary solution.” He went on (p. 101) to add “...I share Wicksell’s underlying optimism...that society is capable of resolving its common concerns in a reasonably efficient, just and democratic manner,” concluding that “I am aware this is not the best of times for that hypothesis, but there is more time to come.” We must all hope that he was right and that time is on our side in developing a more comprehensive and normatively satisfactory perspective on the process and outcomes of the intergovernmental grant systems found in every country.

## **1.6. Concluding remarks**

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In this paper we have sketched several alternative perspectives on earmarked grants that differ substantially from that found in the traditional fiscal federalism literature. That literature’s Pigouvian approach to matching and categorical grants is normatively sensible, but explains almost nothing about the real world of grants. Introducing asymmetric information considerations to treat such grants as a means of encouraging self-selection in terms of expenditure needs fits well within the accepted economics canon and perhaps moves us a step further towards understanding reality.

It does not, however, go far enough. In particular, it seems insufficient to explain the changing trends in grant patterns we noted at the beginning of this paper. We have argued that a fuller explanation of observed grant levels and structures and of changes in that pattern is probably best found by exploring in much more depth the potential role of grants in terms of improving government accountability in a multi-level system of government, both between governments and, perhaps more importantly, between government at both levels and citizens. This perspective is obviously critical in normative terms since all allocative analysis implicitly assumes that government policies are ultimately intended to improve citizens’ well-being – and who is better qualified (in a democratic setting) to judge success in these terms than citizens themselves? Exploring these perspectives is likely to

lead those wishing to understand grants policy in any country into focusing more closely on the (perhaps changing) political-bureaucratic structure within which grant policy and practice is developed, carried out, and amended. Such work has just begun (see Hellerberg et al. 2009); there is much more that can and should be done.

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# Chapter 2

## Autonomy with accountability: The case for performance-oriented grants

Anwar Shah

### Abstract

Intergovernmental finance is a significant source of sub-national revenues in most countries. In both industrial and developing countries, formula-based “manna from heaven”, general-purpose transfers dominate, but co-exist with highly intrusive micro-managed “command and control”, specific-purpose transfers. Both these types of transfer undermine political and fiscal accountability. Reforms to bring in design elements that incorporate incentives for results-based accountability are resisted by both donors and recipients alike.

This is because the donors perceive such reforms as attempts at chipping away at their powers, and recipients fear such programs will be intrusive. This paper presents conceptual and practical underpinnings of grant designs that could preserve simplicity, objectivity and local autonomy objectives while furthering citizen-centric, results-based accountability. The paper further highlights a few notable recent initiatives in both the industrial and the developing world that embrace such directions for reform. The paper concludes that results-based intergovernmental finance offers significant potential to minimize tradeoffs between local autonomy and accountability while furthering access to merit goods<sup>42</sup>.

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## 2.1. Introduction

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Intergovernmental finance is a significant source of subnational revenues in most countries as there are greater opportunities to decentralize spending as opposed to taxing responsibilities. The design of such finance has implications for efficiency, equity and accountability and therefore invites a great deal of public scrutiny and debate in most countries. Ironically, perpetual debates on these issues have not resolved even some fundamental questions as to the appropriate roles and designs of general-purpose vs. specific-purpose transfers. The debate is not well-informed about the autonomy and accountability tradeoffs in such transfers due to the predominant mode of practice of such transfers in both industrial and developing countries.

In both industrial and developing countries, “manna from heaven”, general-purpose transfers co-exist with micromanaged specific-purpose transfers. This paper aims to: (a) clarify the debate on the practice of general vs. specific-purpose transfers and propose a results-based framework for subnational finance to create responsive, responsible, fair and accountable governance; and (b) make a case for increased attention to results-based finance for merit goods to combine local autonomy with citizen-centric, results-based accountability for all levels of government.

The paper is organized as follows: Section 2 provides an introductory overview of the conceptual underpinnings of intergovernmental finance. It highlights how grant design may blur the distinction between general and specific-purpose transfers, and underscores the futility of debate on general vs. specific-purpose transfers in practice. Section 3 presents a case for results-based intergovernmental finance for merit goods and demonstrates that with an appropriate design, such transfers can preserve local autonomy while strengthening local accountability to its residents. Section 4 presents real-world examples which come close to the idealized view of such transfers. A final section

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presents some conclusions.

## **2.2. The debate on general-purpose versus specific-purpose transfers**

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General-purpose (unconditional) transfers augment the budget resources of the recipient without imposing any conditions on how funds are to be spent. Therefore such transfers preserve autonomy. They can also enhance inter-jurisdictional equity if the allocation criterion is based on equalization principles. These transfers, however, act like manna from heaven and induce a lack of political and fiscal accountability if there is little discretion to raise revenues at the margin. Specific-purpose transfers (conditional, earmarked grants), on the other hand, are intended to provide incentives to undertake specific activities.

These transfers can potentially undermine local autonomy and distort local priorities if, as is usually the case, conditions on spending have been imposed and fungibility is not feasible as would be the case of spending that receives low priority in local allocation choices. Conceptually, it is possible to design specific-purpose grants (conditional, earmarked grants) that advance the grantor's objectives while preserving local autonomy by having output-based conditionality only – the so-called output-based or performance-oriented grants as advocated by Shah (2006, 2009). Such output-based grants are a rarity in practice.

Even conceptually, the international development assistance community has shown reluctance to embrace this concept and incorporate it in the monitoring of government finances. For example, government finance classifications used by the International Monetary Fund and the Organization for Economic Cooperation and Development (OECD) so far do not conform to the classification proposed by the Council of Europe in 1986, which argued for classifying conditional earmarked grants into two separate categories: “actual costs” and “standard costs” with a view to accommodating output-based grants under the latter category (see Lotz, 1986). Box 1 provides a broader framework for local finances highlighting how results-based finance fits into the overall scheme of local government finances.

## Box 1. Key considerations and tools for growth-oriented local government finances

### *Key considerations*

The overall objective of local governments is to maximize social outcomes for residents and provide an enabling environment for private sector development through efficient provision of public services. This requires that local financing should take into account the following considerations:

- Local government should limit self-financing of redistributive services.
- Business should be taxed only for services to businesses and not for redistributive purposes.
- Current period services should be financed out of current year operating revenues and future period services should be financed by future period taxes, user charges/fees, and borrowing.
- Residential services should be financed by taxes and fees from residents.
- Business services should be financed by site/land value taxes and user charges. Profit, output, sales, and moveable asset taxes may drive business out of the jurisdiction.

### *Tools for local finance*

- *Local taxes* for services with public goods characteristics – streets, roads, street lighting
- *User charges* for services with private goods characteristics – water, sewerage, solid waste
- *Conditional, non-matching, output-based grants* from national/state-order governments for merit goods: education and health
- *Conditional matching grants* for spillovers in some services
- *Unconditional grants* for fiscal gap and equalization purposes
- *Capital grants* for infrastructure if fiscal capacity is low
- *Capital market finance* for infrastructure if fiscal capacity is high
- *Development charges* for financing growth with higher charges for developing land on local government boundaries
- *Public-private partnerships* for infrastructure finance but keeping public ownership and control of strategic assets
- *Tax increment financing districts* to deal with urban blight. For this purpose, the area should be designated for redevelopment and annual property tax revenues frozen at pre-vitalization levels. For a specified period, say 15-35 years, all tax revenues above base are used for redevelopment. Capacity improvements are undertaken through municipal borrowing/bonds against expected tax increments.

Source: Inman (2006) and Boadway and Shah (2009)

In practice, the distinction between the two types of grants is often blurred, especially in developing countries. For example, revenue-

sharing programs in a number of countries introduce a tax effort component (contributing to inequity) or other administrative requirements, such as requirements for a development plan, a technical planning committee, internal audit requirements in Uganda and Tanzania, submission of budget estimates to the central Ministry of Finance as in Kenya and Nepal (see Steffensen and Larsen, 2005). Even an equal, per-jurisdiction component of revenue-sharing creates incentives for a breakup of existing jurisdictions, as was observed in Brazil with the Municipal Participation Fund (see Shah, 1991).

### **2.3. Results-based intergovernmental financing as a tool to respect local autonomy while strengthening bottom-up accountability for provision of merit goods**

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The economic rationale for output-based grants is traceable to the emphasis on contract-based management under the new public management (NPM) framework and strengthens the demand for good governance by lowering transaction costs for citizens under the new institutional economics (NIE) approach. The NPM seeks to link financing with reward or punishment for performance. This is done by changing the management paradigm in the public sector from permanent appointments to contractual appointment and continuation of employment dependent on fulfilment of service delivery contracts. It further seeks to create a competitive service delivery environment.

The NIE approach argues that dysfunctional public-sector governance results from the opportunistic behaviour of public officials as citizens either lack the power or face high transaction costs to hold public officials accountable for their non-compliance with their mandates or for corrupt acts. In this framework, citizens are the principals and public officials are agents. The principals have a bound rationality - they act rationally based on the incomplete information they have. In order to have a more informed perspective on public sector operations, they face high transaction costs in acquiring and processing information.

On the other hand, agents (public officials) are better informed, and their self-interest motivates them to withhold information from the public domain as the release of such information

contributes to their being held accountable. This asymmetry of information allows agents to indulge in opportunistic behaviours which go unchecked due to the high transaction costs faced by principals and a lack of or inadequacy of countervailing institutions to enforce accountable governance. Results-based accountability through the use of output-based grants empowers citizens by expanding their information base and lowering their transactions costs in demanding action.

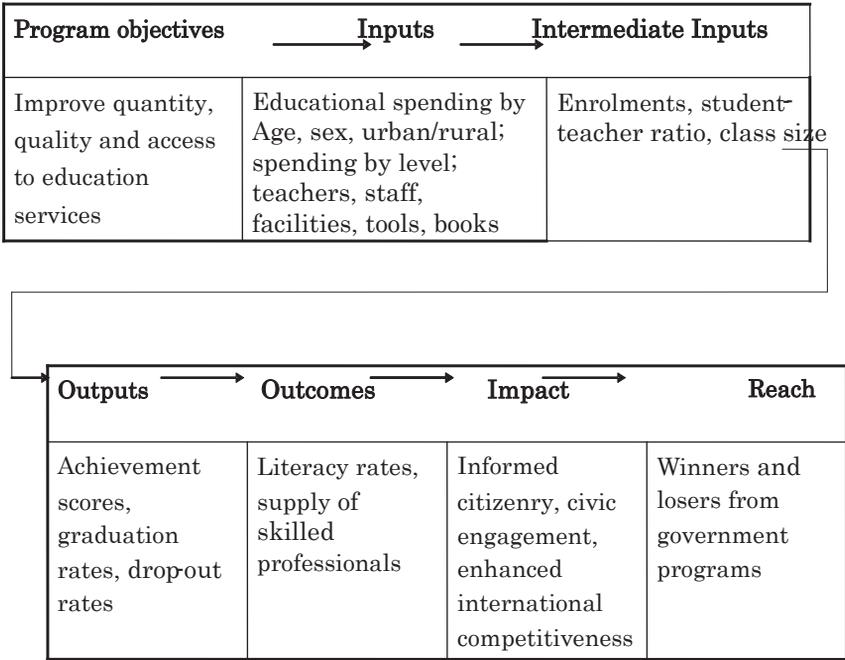
Output-based transfers (in this paper this term is used interchangeably with performance-oriented transfers) link grant financing with service delivery performance – this is the essence of the NPM approach, which seeks to link financing or monetary rewards with incentives for good performance and accountability for results. These transfers place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve those results. This helps restore the recipient's focus on the results-based chain and alternate service-delivery framework (the competitive framework for public service delivery) to achieve those results. Figure 1 provides an illustration of this results-based chain for education services.

In order to achieve grant objectives, a public manager in the recipient government would examine the results-based chain to determine whether or not program activities are expected to yield the desired results. To this end, he needs to monitor program *activities and inputs*, including intermediate inputs (resources used to produce outputs), outputs (quantity and quality of public goods and services produced and access to such goods and services), *outcome* (intermediate to long-run consequences for consumers/tax payers of public service provision or progress in achieving program objectives), *impact* (program goals or very long-term consequences of public service provision) and *reach* (people who benefit from or are hurt by a program).

Such a managerial focus reinforces the joint ownership and accountability of the principal and the agent in achieving shared goals by highlighting terms of mutual trust. Thus internal and external reporting shifts from the traditional focus on inputs to a focus on outputs, reach and outcomes - in particular, outputs that

lead to results. Flexibility in project definition and implementation is achieved through a shift in emphasis from strict monitoring of inputs to monitoring of performance results and their measurements. Tracking progress toward expected results is done by means of indicators that are negotiated between the provider and the financing agency. Such joint goal-setting and reporting help ensure client satisfaction on an ongoing basis while incorporating partnership and ownership into projects (Shah, 2005).

**Figure 1 Results-based chain - application in education**



Source: Shah, 2005

Note that output-based grants must have conditions on outputs as opposed to outcomes as the latter are subject to influence from external factors beyond the control of a public manager. Public managers can only be held accountable for factors under their control. Outcome-based conditions diffuse the enforcement of

accountability for results. Since the grant conditions are concerned with service delivery performance in terms of quality of output and access, the manager is free to choose program and inputs to deliver results. To achieve those results, grant conditions offer a public manager positive incentives to encourage alternative service delivery mechanisms by contracting out or outsourcing, or simply to encourage competition among government and non-government providers for a market share by establishing a level playing field through at par financing, or competition for the market by offering franchises through competitive bidding or rewards for performance through yardstick competition. Such an incentive environment is expected to yield a management paradigm that emphasizes results-based accountability to clients with the following common elements:

- Contracts or work program agreements based on pre-specified outputs, performance targets and budgetary allocations.
- Lifelong rotating employment replaced by contractual appointments with task specialization.
- Managerial flexibility but accountability for results.
- Public sector as a purchaser, but not necessarily a provider of public services.
- Subsidiarity principle, i.e. public sector decision-making at the government level closest to the people unless a convincing case can be made for higher level/order assignment.
- Incentives for cost efficiency.
- Incentives for transparency and competitive service provision.
- Accountability to taxpayers.

Under such an accountable governance framework, grant-financed budget allocations support contracts and work program agreements that are based on pre-specified outputs and performance targets. The grant recipient's flexibility in input selection - including hiring and firing of personnel and program execution - is fully respected, but at the same time there is strict accountability for achieving results. The incentive and accountability regime created by output-based transfers is expected to create responsive, responsible and accountable

governance without undermining local autonomy, whereas traditional conditional grants with input conditionality, on the other hand, undermine local autonomy and budgetary flexibility while re-enforcing a culture of opportunism and rent seeking (see table 1).

**Table 1. Traditional and output-based (performance-oriented) conditional grants**

Criterion	Traditional conditional grant	Output-based grant
Grant objectives	Spending levels	Quality and access to public services
Grant design and administration	Complex	Simple and transparent
Eligibility	Recipient government departments/agencies	Recipient government provides funds to all government and non-government providers
Conditions	Expenditures on authorized functions and objects	Outputs -service delivery results
Allocation criteria	Program or project proposals approvals with expenditure details	Demographic data on potential clients
Compliance verification	Higher level inspections and audits	Client feedback and redress, Comparison of baseline and post-grant data on service quality and access.
Penalties	Audit observations on financial compliance	Public censure, competitive pressures, voice and exit options for clients
Managerial flexibility	Little or none. No tolerance for risk and no accountability for failure.	Absolute. Rewards for risks but penalties for persistent failure
Local government autonomy and budgetary flexibility	Little	Absolute
Transparency	Little	Absolute
Focus	Internal	External, competition, innovation and benchmarking
Accountability	Hierarchical and to higher level government, controls on inputs and process with little or no concern for results	Results-based, Bottom-up, client-driven

Source: Boadway and Shah, 2009.

***Examples of output-based grants that encourage competition and innovation in education and health***

Output-based grants create an incentives regime to promote the results-based accountability culture. Consider the case where the national government aims to improve access to education by the needy and poor as well as enhance quality of such education. A commonly practiced approach is to provide funds to government schools through conditional grants.

These grants specify the type of expenditures eligible for grant financing, for example, books, computers, teachers' aids etc., as well as financial reporting and audit requirements. Such input conditionality undermines budgetary autonomy and flexibility without providing any assurance regarding the achievement of results. In practice, such input conditionality is difficult to enforce as there may be significant opportunities for the fungibility of funds.

Experience has also demonstrated that there is no one-to-one link between increase in public spending and improvement in service delivery performance (see Huther, Roberts and Shah, 1997). To bring about accountability for results, consider an alternate, output-based design of such grants. Under the alternative approach, the national government allocates funds to local governments based upon school-age population. The local governments in turn pass these funds to both government and non-government providers based upon school enrolments.

Conditions for receipt of these grant funds by non-government providers are that they must admit students on merit and provide tuition subsidy to students whose parents do not have sufficient means to afford such fees. Conditions for the continuation of funds for all providers will be to improve or at the minimum maintain school-specific baseline achievement scores on standardized tests, improve graduation rates and reduce dropout rates.

Lack of compliance with these conditions will invite public censure and in the extreme case a threat of discontinuation of funds in the event of perpetual non-compliance. In the meantime, reputation risks associated with poor performance may lead to reduced

enrolments and an associated reduction in grant funds.

There are no conditions on the use of funds, and schools have full autonomy in the use of grant funds and to retain unused funds. Such grant financing would create an incentive environment for both government and non-government schools to compete and excel to retain students and establish a reputation for quality education, as in the final analysis it is parental choice that would determine available grant financing to each school.

Such an environment is particularly important for government schools where staff typically has lifelong appointments and financing is assured regardless of school performance. Budgetary flexibility and retention of savings would encourage innovation to deliver quality education. Thus output-based grants preserve autonomy and encourage competition and innovation while ensuring strict accountability for results to residents. This accountability regime is self-enforcing through consumer choice (in the current example parental choice).

Such a school financing regime is especially helpful in developing countries and poorer jurisdictions in industrial countries plagued with poor quality of teaching and worse teacher absenteeism or lack of access to education in rural areas. The incentive regime provided by results-based financing will create market mechanisms to overcome these deficiencies over time.

A similar example of such a grant in healthcare would allocate funds to local governments based upon weighted population by age class, with higher weights for senior citizens (65 years and over) and children (under 5 years). The distribution by local government to providers would be based upon patient use. Minimum standards of service and access to healthcare will be specified for the eligibility to receive such transfers.

***Is there a case for results-based finance in industrial countries?***

Influential policymakers from industrial countries would argue that results-based financing in industrial countries represents an overkill, as in both political and bureaucratic circles there is a strong culture of citizen-based accountability (see Kim and Lotz, 2008). Local politicians in these countries hold themselves to

higher ethical standards, and the bureaucrats maintain high professional standards. Electoral accountability for politicians and the internal civil service culture for bureaucrats incentivize both parties to aspire for better economic and social outcomes for their residents.

Both voting by ballots and voting with their feet (relocation decisions by residents to a local jurisdiction with a desired menu of public services and taxes) reinforce political and fiscal accountability. Policy-makers in industrial countries would therefore argue that under such circumstances not much is lost if all grant monies are pooled together as general purpose transfers. Such bundling together of all higher level assistance strengthens local autonomy without having any adverse impact on their performance. Granted that rent seeking and opportunism by officials may be more circumvented in industrial countries, still the impact of competition can hardly be overstated.

Contrasting the experiences of USA and Canada with respect to school financing and their impacts on school performance highlights the importance of competition in school financing. In most states of the USA, government schools are financed by property taxes, fees and state grants, whereas private schools are financed by school endowments, fees and donations. This separation of government and private school financing leads to a lack of competition among government and private schools with detrimental effects on school performance.

Private schools almost always outperform government schools. This is even true when government schools spend many times more than private schools per pupil, as is the case in Washington DC. A recent Washington Post report shows that private parochial (religious) schools on average spend nearly half of the amount per pupil than do government schools, but nevertheless perform much better than government schools in the Washington Metropolitan area covering the District of Columbia, Maryland and Virginia. In the USA, government schools generally perform poorer on achievement scores than their private-school counterparts. This result is understandable as government schools in the USA have assured finances and have no incentives to perform better to stay in business. Strong teachers' unions almost always succeed in

forestalling any reforms that creates incentives to compete and perform better.

Now consider a contrasting model of school financing as is the case in the province of Alberta, Canada (and in most provinces in Canada and Australia). Both government and private schools receive financing through aggregation of the individual taxpayer’s selection of his contributions to the education mill rate of property tax. This selection, however, does not limit parental choice of schools – government or non-government. Such a financing regime introduces competition and places great premium on school performance, and as a result, government schools in Canada on average outperform private schools. Such a financing regime also limits large disparities in individual school performance.

The contrasting experiences of USA and Canada demonstrate the need for introducing results-based finance in industrial countries (see Table 2 for an overall framework of intergovernmental finance that is relevant to all countries). In a radical reform of its intergovernmental finance system, Australia has recently made significant moves to introduce a results-based intergovernmental finance system (see Shah, 2004 for a critique of the earlier Australian system that may have motivated recent reforms). In the next section, we will review recent attempts to introduce such reforms.

**Table 2. Principles and better practices in grant design**

Grant objective	Grant design	Examples of better practices	Examples of practices to avoid
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, tax-base sharing	Tax abatement and tax-base sharing (Canada)	Deficit grants, wage grants (China), tax by tax sharing (China, India)
Reduce regional fiscal disparities	General non-matching fiscal capacity equalization transfers	Fiscal equalization with explicit standard that determines total pool as well as allocation (Canada, Denmark, and	General revenue sharing with multiple factors (Brazil and India); fiscal equalization with a fixed pool

		Germany)	(Australia, China)
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spill-over of benefits	Grant for teaching hospitals (South Africa)	Closed-ended matching grants
Set national minimum standards	Conditional non-matching, output-based bloc transfers with conditions on standards of service and access	Road maintenance and primary education grants (Indonesia before 2000)  Education transfers (Brazil, Chile, Colombia) Health transfers (Brazil, Canada),	Conditional transfers with conditions on spending alone (most countries), pork barrel transfers (USA), ad hoc grants
	Conditional capital grants with matching rate that varies inversely with local fiscal capacity.	Capital grant for school construction (Indonesia before 2000), highway construction matching grants to states (United States)	Capital grants with no matching and no future upkeep requirements
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance (Canada before 2004)	Ad hoc grants
Provide stabilization and overcome infrastructure deficiencies	Capital grants, provided maintenance possible.	Capital grants with matching rates that vary inversely with local fiscal capacity	Stabilization grants with no future upkeep requirements

Source: Boadway and Shah, 2009.

## 2.4. Results -based intergovernmental finance - the practice

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Results-based finance can be used to influence sub-national priorities or to undertake partnership tasks. Practical examples of such practices are a few and far between. A few interesting examples of such an approach are listed below. These practices are grouped in two broad categories: (a) results-based intergovernmental finance to support broader reforms, and (b) assuring minimum standards in the provision of merit goods.

### *a. Furthering intersectoral reforms*

Only three noteworthy examples of this nature are available.

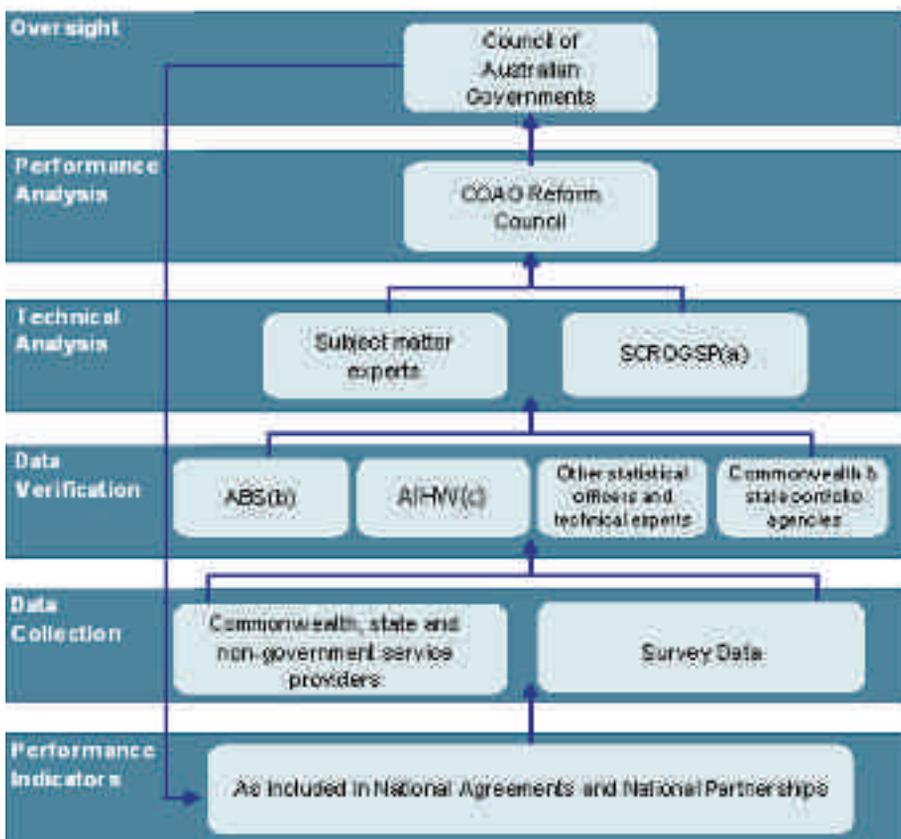
#### **Australia: National Partnership Payments, 2009**

These payments are intended to provide incentives to states either to (a) facilitate reforms, e.g. to implement the seamless national economy through reductions in unnecessary and inconsistent regulation across jurisdictions and to improve processes for regulation-making and review; or to reward those jurisdictions that deliver on nationally significant reforms – the National Partnership Reform Payments; or (b) to improve service delivery standards - National Partnership Project Payments.

The payments are based upon intergovernmental agreements that lay down mutually agreed performance benchmarks and are channelled through the Council of Australian Governments (COAG) Reform Fund. The States are free to use these funds as they choose provided they can demonstrate agreed-upon results. The results are to be verified on behalf of the COAG by an independent agency – the COAG Reform Council, reporting to the Prime Minister as Chair of COAG.

The Australian Government has also clarified performance reporting and accountability framework for such transfers (see Chart 1). The COAG Reform Council has been authorized to monitor performance against agreements and report the results to the COAG and the general public (see Australia, 2009).

**Chart 1: Performance reporting information flows**



Notes: ABS: Australian Bureau of Statistics,  
 Source: Australian Treasury (2009), Budget Paper no.3, p 169.

**“Performance Reserve Fund” of the European Union (EU) Structural Funds Program, 2000-2006**

The EU set aside 4% of the total structural funds transfers and made the distribution conditional on the achievement of specific, jointly agreed objectives. Following the EU agreement, Italy set aside 4% of the structural funds it received as a “community performance reserve” to be allocated to regions for improving effective utilization of structural funds. The indicators used for this evaluation included: (a) program implementation effectiveness; (b) quality of management based on control system,

selection criteria, monitoring and evaluation systems and evaluating employment impacts ; and (c) the existence of financial and project finance plans – later reflecting public-private partnerships.

Italy further augmented this program by setting aside 6% of the structural funds' budget transfer to regional governments as a “national performance reserve” to be distributed upon progress achieved in modernizing regional public administration. Performance indicators used emphasize (a) implementation of national legislation for public administration reforms, especially in systems of managerial selection and evaluation; (b) innovation in enhancing effectiveness of structural funds such as monitoring and evaluation systems; (c) implementation of integrated multiregional projects; and (d) focusing resources on a few priority areas (see Anselmo et al., 2006).

### **Russian Federation – Regional Fiscal Reform Fund**

This fund was established in 2007 and provides special supplemental grants to regions that agree with the federal government on implementing a package of fiscal reforms (Kaiser, 2009).

### **Uganda – Local Development Grant**

Eligibility for this grant is based upon compliance with three minimum conditions: (1) Availability of a council-approved district development plan and functional planning committees; (2) proper maintenance of accounts and adherence to procurement regulations; and (3) capacity to supervise engineering works. Those districts and sub-counties who comply with these conditions are further assessed against the following criteria to determine a reward (20% of the grant) or a punishment (20% of the grant funds).

The performance measures used are: (a) efforts made to improve the quality of the development plan; (b) allocation of the development grant in line with the national priority program areas – water, primary education, primary health, feeder roads, and agricultural extension; (c) timely accountability and expenditure decisions in line with actual allocation ; (d) capacity-building effort; (e) staff functional capacity; (f) tendering capacity and

performance; monitoring reports; mentoring plans and reports of a higher local government to a lower local government; and (g) 10% co-financing being provided (Barungi, 2003).

***b. Setting national minimum standards for merit goods***

Setting national minimum standards in regional-local services may be important for two reasons. The first is that there is an advantage to the nation as a whole from such standards as they contribute to the free flow of goods and services, labour and capital and reduce wasteful inter-jurisdictional expenditure competition, and thus improve the gains from trade in the internal common market.

Second, these standards serve national equity objectives. Many public services provided at the sub-national level such as education, health and social welfare are redistributive in their intent, providing in kind-redistribution to residents. In a federal system, lower-level provision of such services – while desirable for efficiency, preference matching and accountability – create difficulty in fulfilling federal equity objectives.

Factor mobility and tax competition provide strong incentives for lower level governments to under-provide such services and to restrict access of those most in need, such as the poor and the old. This is justified by their greater susceptibility to disease and potentially greater risks of cost curtailment. Such perverse incentives can be alleviated by conditional non-matching grants where the conditions reflect national efficiency and equity concerns, and where there is a financial penalty associated with failure to comply with any of the conditions.

Thus conditions will not be on the specific use of grant funds but on the attainment of standards in quality, access and level of services. Such output-based grants do not affect local government incentives for cost efficiency but do encourage compliance with nationally specified standards for access and level of services. Properly designed conditional non-matching, output-based transfers can create incentives for innovative and competitive approaches to improved service delivery. Input-based grants fail to create such accountability.

***Examples of output-based (performance-oriented) grants to achieve and sustain national minimum standards for merit goods***

Results-based financing has been used to sustain national minimum standards for merit goods in a handful of countries only. Most of these practices are found only in the fields of education and health, but in a limited number of cases such financing has been used in other public areas such as infrastructure. The following paragraphs highlight these examples.

**2.4.1. Results-based financing of education**

Several countries have launched innovative programs to create results based accountability in financing sub-national education programs. These are reviewed in the following paragraphs:

**Australia: National Schools Specific Purpose Payments, 2009**

The National Education Agreement specifies the following objectives for this grant program:

- ensuring that all children are engaged in and benefit from schooling, with a goal of lifting the year 12 attainment rate to 90% by 2015; and
- ensuring that children meet basic literacy and numeracy standards and continuing to improve overall literacy and numeracy achievements.

The grants consist of equal per capita payments for both government and non-government schooling to all States. Out of this, the government schools' component for each state is based upon each State's share of full-time equivalent student enrolments in government schools. The growth factor for the government school component is the product of growth in average government schools' recurrent costs and growth in full-time equivalents in government schools.

The grant funds are required to be spent on schooling, but states have full budget flexibility to allocate funds as they see fit to achieve mutually agreed objectives. The program has not set any benchmarks for performance, but as part of an overall reporting and accountability framework, states must provide performance data to the Commonwealth and to the general public. The COAG

Reform Council will collate data for all states and will publish such statistics and analytical reviews of performance for government and general public use (The Australian Treasury, 2009).

**United States: Race to the Top Competitive Grant Program, 2009**

This \$4.35 billion program was launched by President Obama on July 24, 2009 to mark a new federal partnership in education reform with states, districts and unions to accelerate change and boost improvements. The program invites states to apply for financing by undertaking to implement four core interconnected reforms as follows:

- Raising standards: Agreeing to adopt internationally benchmarked K-12 standards.
- Closing the data gap: Establish data bases to monitor advances in student achievement and identification of effective instructional practices.
- Improving quality of teachers and principals, especially in high poverty schools: Establish strategies for rewarding and retaining top-notch teachers and separation of non-performers.
- Turning around lower-performing schools: Introduce major reforms to change school culture and replace staff and principals.

As a part of its eligibility for financing, each state's record will be examined for its compatibility with provision of a progressive environment for improving education standards and access. For example, states that limit alternative routes to certification for teachers and principals or cap the number of charter schools will be at a competitive disadvantage. States that explicitly prohibit linking data on achievement or student growth to principal and teacher evaluations will be ineligible for the grant until they change their laws (see Duncan, 2009).

**United States No Child Left Behind (NCLB) Act of 2001**

The NCLB provides federal financing of elementary and secondary education (K-12 schooling) provided states agree to requirements for student testing and accountability and strive for improvements in achievement scores and equity in access to education by various income and ethnic groups. NCLB requires states to test students in

reading and mathematics annually in grades 3-8 and once in grades 10-12, and in science once in grades 3-5, 6-8, and 10-12. Individual schools, school districts and states must make public test results in the aggregate and for specific student subgroups, including low-income students, students with disabilities, students with English as a second language and major racial and ethnic groups.

NCLB requires that states, school districts, and schools ensure that all students are proficient in grade-level math and reading by 2014. States define grade-level performance. Schools must make “adequate yearly progress” towards this goal, whereby proficiency rates increase in the year leading up to 2014. The rate of increase required is chosen by each state. In order for a school to make adequate yearly progress (AYP), it must meet its targets for student reading and math proficiency each year.

Schools that fail to make adequate yearly progress for two consecutive years must draft a school improvement plan. A school failing to meet AYP for three consecutive years must initiate a performance improvement plan and also implement a public school choice, meaning that students are given the option to move to other public schools. A fourth year failure requires restructuring and supplemental education services – school financed special instruction. If a school fails to make AYP in the fifth year, it must implement restructuring, including changes in staff and management, or be converted into a charter school run by a private management company.

The NCLB Act also provides for a special education finance incentive grant to (i) reward “good school finance” states – those that spend more on public education and distribute funds equitably; and (ii) provide twice the amount of funds to high poverty school districts in “bad school finance states” – those which spend relatively less on education and distribute funds inequitably to school districts (see Foundation for New America, 2009).

Local governments in the Province of Alberta, Canada, use a novel approach to determine the allocation of taxpayers’ contributions to school finance. This is done by resident taxpayers by designating the education component of their property tax bill to either public

or parochial (religious, private) school boards. These declarations determine the total amounts of property tax finance available to public and parochial providers. Schools receive grants on a per pupil basis and parents retain the option to send their children to a school of their choosing regardless of their exercise of voting on school finance. Higher-education financing assigns weights to enrolments, giving different programs with medical and engineering education higher weights than the humanities.

### **Results-based financing of higher education in industrial countries**

A handful of countries use performance basis in funding universities. Commonly used criteria include: number of credits accumulated by students; number of graduates; research publications; and number of doctoral dissertations (see Jongbloed and Vossensteyn, 2001). The following paragraphs cite specific examples of such financing.

Most provinces in Canada provide university finance based upon enrolments/graduation by types and sciences; engineering and medicine receive higher weights than social sciences and humanities. A few provinces provide supplemental grants using performance-based criteria. The Province of Ontario provides 2% of the total funding based upon (a) six-months, and two-year employment rate for recent graduates; (b) degree completion by entrants. The Province of Alberta provides a special grant to recognize universities for their institutional performance on several indicators: enrolment growth; satisfaction of recent graduates; administrative expenditure efficiency; revenue generation by means other than fees; research grants; citation impact of research papers; and community and industry support of research.

Denmark provides 30-50% of higher-education financing based upon number of students passing specified examinations. The cost of each student is weighted on the basis of the major subject according to the so-called “taxi-meter” model that takes into account differential costs associated with education and equipment, joint costs (administration and buildings), and expenses for experimental sciences and practical training as in medicine and physics.

Finland finances higher education using three components – core

funding, performance funding and funding for specific initiatives. Performance funding is based upon: funding for research from external sources; assessed learning achievement, provision of adult education; graduation time; and participation in international cooperation. To calculate the amount of performance funding, target figures are multiplied by a field-specific cost factor, agreed for a three year contract period (Holttta and Rekila, 2003).

The Netherlands provides 50% of university financing based upon an output criterion. Each university's grant is based upon the number of students who completed their programs multiplied by the normative study duration (4.5 years) plus the number of students who drop out multiplied by an administratively determined study duration of these dropouts (1.35 years). The total amount of funding is then calculated by multiplying calculated graduation numbers by a fixed reimbursement per student with engineering receiving a higher amount per student compared to other programs.

Sweden specifies a minimum number of students in general and in science and technology in particular for each institution to receive financing. 40% of the financing is based on enrolments, and the remaining 60% on accumulated credits.

In the USA, most states provide a small amount of funding based upon performance. South Carolina is the only state where all university financing is based upon 37 specified indicators. The State of Tennessee provides 6% of university finances using four performance criteria: academic testing and accreditation with 60% weight; satisfaction surveys with 15% weight; planning and collaboration receiving 10% weight, and student outcomes in terms of retention, job placement and assessment implementation receiving 15% weight (Bogue and Hall, 2003).

### **Results-based education financing: Developing and transition country examples**

Conditional non-matching output-based transfers to ensure national minimum standard in merit goods or for fiscal need compensation are rarely used in DTEs. Nevertheless, one finds a few shining examples of programs that marry equity with performance orientation in grant allocation.

Brazil has a noteworthy national minimum standards grant programs for primary education. Under the 14th amendment to the federal constitution, the state and municipal government must contribute 15% each of their two principal revenue sources (state value added tax and state share of the federal revenue sharing transfers for states, and services tax and the municipal share of the state revenue sharing transfers for municipalities) to FUNDEF – a special fund for primary education.

If the sum of the state and municipal required contributions divided by the number of primary school students is less than the national standard, the federal government makes up the difference. The total amount of the FUNDEF is then distributed among the state and its municipal providers on the basis of school enrolments (see Gordon and Vegas, 2004 for a review of the FUNDEF program).

Chile's school grants (and those of the State of Michigan, USA) finance vouchers for school-age population giving parents a choice in sending their children to public or Catholic/private schools. An additional performance grant providing a 25% additional grant as a salary bonus for teachers in the best performing schools based upon a National System to Evaluate School Performance (SNED in Spanish, see Gonzalez, 2005). Central per capita transfers for education in Colombia and South Africa, and the capitation grant to Malaysian states, come close to the concept of such a transfer.

The operating grant for schools (became defunct in 2000) in Indonesia used school age population (ages 7-12) as criteria for distribution of funds to district governments. This was supplemented by a matching capital grant (local government to provide land for schools) to achieve minimum standards of access to primary schooling. These grants enabled Indonesia to achieve a remarkable success both in improved literacy as well as minimum standards of access across the nation.

#### **2.4.2. Results-based financing of healthcare**

Canada and Brazil lead the way in results-based inter-governmental financing of healthcare as discussed below.

### **Canada: Canadian Health Transfers Program (CHT)**

A good illustration of a simple yet effective design of such a grant system is the Canadian Health Transfers (CHT) program. Under this program, the federal government provides per capita transfers for health to the provinces with the rate of growth of these transfers tied to the rate of growth of the GDP. There are no conditions on spending, but there are strong conditions on the access to health care. As part of the agreement to receive these transfers from the federal government, the provinces undertake to abide by several access-related conditions and face penalties as specified below if there is a breach of any condition. The five conditions are:

- (1) **Universality:** To provide universal coverage;
- (2) **Portability:** Residents have the ability to move to another province and retain health coverage in the province of origin for a transition period. Residents and non-residents have equal access;
- (3) **Public insurance but public/private provision:** The province agrees to provide universal insurance to all, but finances public and private providers on an equal footing – both get reimbursed from the public insurance system using the same schedule of payments negotiated by the provincial medical association;
- (4) **Opting in and Opting out:** All healthcare providers have the option of opting out of the system and bill patients directly and not follow the prescribed fee schedule. The clients of these providers get reimbursed according to the government prescribed schedule of payments by submitting claims; and
- (5) **No extra billing:** All providers opting in the system are excluded from billing patients directly especially for charges in excess of the prescribed schedule.

Penalties include (a) threat of discontinuation of the grant program if conditions (1) through (4) are breached, and dollar for dollar reduction of grant funds for breach of condition (5).

The program has enabled Canadian provinces to ensure universal access to a high quality healthcare to all residents regardless of their income or place of residence.

### **Brazil: Unified Health System (SUS)**

Fiscal transfers in support of the Unified Health System – SUS that operationalizes the constitutional obligation of universal right to free health services - are administered under a federal program called annual budget ceilings – TGF. The TGF has two components. Equal per-capita financing from the central government to all municipalities is provided to cover basic health benefits. Funding of hospital admissions and high-cost ambulatory care is subject to a ceiling for each type of treatment. All registered healthcare providers – state, municipal, or private - are eligible for grant financing through their municipal government (World Bank, 2001, Shah 1991).

#### **2.4.3. Results-based intergovernmental financing of other services**

Only a handful of examples are available as noted below.

Indonesia - The District/Town Road Improvement Grant used length of roads, road condition, density (traffic use) and unit costs as criteria for distribution of funds. This grant program helped monitoring the health of the road network on a continuing basis and was successful in keeping roads in good working conditions in most jurisdictions (Shah, 1998).

Chile - Grants to municipal governments for water and sewer access by the poor cover 25-85% (means tested) of a household's water and sewer bill for up to 15 cubic meters a month with the client paying the rest (Gomez-Lobo, 2002).

Argentina – Federal transfers to provinces for social insurance are based upon number of poor women and children enrolled in social insurance and performance on key output measures (Eichler, 2008).

### **2.5. Implementing results-based grants (RBG): Practical considerations**

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In practice, RBGs are much simpler to design and implement due to less demanding requirements for data and self-enforcement mechanisms for monitoring and oversight. Implementation of RBG requires three types of data – for use in the allocation criteria, data on service population are needed, for accountability (continuation

or suspension of a grant) data on outputs or service delivery performance are required, and for long term evaluation of the program, data on the results-based chain are necessary. For administration of the program, it is absolutely critical to have reliable and timely statistics on service population and service delivery performance. Data on service population is typically readily available for most public services, including merit goods such as education, health, social welfare and infrastructure.

Data on service delivery performance would be required of grant recipients as a condition for future release of funds. Thus RBG enhances opportunities for both internal and external evaluation of providers and improved provider accountability to citizens. Incidentally, performance-based budgeting yields all the above data, but at the present time such data are not being used to their full potential. RBG would enhance the usefulness of such a tool. It should also be noted that traditional, input-based earmarked grants are more data intensive as the grantor requires detailed data on costs and disbursements.

The RBG paradigm, on the other hand, is not concerned with micro management and controls but focuses rather on results-based accountability. Given that the data needed for grant allocation under RBG are typically more accurate and less controversial, and the formula design much simpler and more objective, it offers an opportunity for wider political and social consensus due to the objectivity and fairness of such an allocation. Such a simpler grant design may nevertheless be unpopular with some bureaucrats who may perceive a move away from input-based conditionality as a threat to their bureaucratic powers. Since grant design is typically a bureaucratic responsibility, it is no wonder that politicians typically receive grant options engrained in complex designs.

Some politicians may also prefer such complex input-control financing alternatives in view of the discretionary powers they confer upon the grantors. Therefore the foremost impediment to the widespread acceptance of RBG is the lack of knowledge about the principles and practices of such transfers among bureaucrats and politicians. This paper has taken a small step to bridge this knowledge gap.

## 2.6. Conclusions

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In conclusion: while output-based (performance) oriented grants are best suited to the grantor's objectives and also simpler to administer than traditional, input-based, conditional transfers, they are rarely practiced. The reasons have to do with the incentives faced by politicians and bureaucrats. Such grants empower customers while weakening the sphere of opportunism and pork-barrel politics. The incentives they create serve to strengthen the accountability of the political and bureaucratic elite to citizens and weaken their ability for influence-peddling and building dream bureaucratic empires. Their focus on the value for money exposes corruption, inefficiency and waste, and expectedly their introduction is blocked by potential losers. Citizens' activism garnered by the information revolution offers new hope to overcome these obstacles to reform, as indicated by several recent reform initiatives in both industrial and developing countries.

## **Annex 1. United States No Child Left Behind Act**

With its enactment in 2001 of the No Child Left Behind Act (NCLB), Congress reauthorized the funding of the Elementary and Secondary Education Act (ESEA) but added significant accountability provisions and other conditions to federal education aid. Most aid is referred to as Title I aid and is allocated to school districts (rather than states) based on the number of poor children who reside in the district and on the average level of school spending in the state. The program is not fully funded, which means that the amount appropriated for the program does not equal the sum of its grant obligations as determined by the formula.

The current funding formula includes a “hold harmless” provision to prevent districts from experiencing declines in funding commensurate with any declines in the number of poor children, and also a “small state minimum” which ensures that the sum of district allocations in each state meets some minimum level. These provisions, in the context of the lack of full funding, disproportionately limit the amount of funds available for districts with growing poor populations, as districts with relatively shrinking poor populations are held harmless.

The stated goal of NCLB is to close the academic achievement gap that currently exists among students of different races and between those from economically disadvantaged and other families. NCLB as written requires states receiving Title I funds to implement annual standardized testing in grades three through eight in reading and math (and in science as well starting in 2007/2008) and to set state standards of proficiency on those tests. The law mandated that by 2005-06, all schools in Title I states must be staffed entirely by “highly qualified” teachers, with bachelor’s degrees, state certification and some proof of subject-level competency in each subject they teach.

Title I schools are monitored for their annual yearly progress (AYP) in working towards having 100 percent of students and all sufficiently large “subgroups” of students (defined by racial/ethnic category, free lunch eligibility, English proficiency, and disability) meet state standards by 2014. Various penalties exist for failing to

meet AYP with the severity of the penalty depending on the number of consecutive years of failing to meet the standards. Key sanctions include giving students the option to transfer to another public school and giving low-income students the opportunity to use part of the Title I funds previously allocated to the school on their behalf. Students can use these funds with the supplemental educational services (tutoring) provider of their choice, including a private provider. All Title I schools, regardless of progress in meeting state standards, must use federal funds only for programs grounded in “scientifically based research.” This requirement is both ambiguous and highly controversial.

While states retain authority over what constitutes proficiency on their own tests, the federally-determined sanctions for failure to make AYP provide an incentive for states to set lower proficiency thresholds that schools are more likely to attain (or, alternatively, to choose easier tests that yield higher scores).

There is wide agreement that NCLB has sparked significant changes in educational practice. The Center for Educational Policy has conducted one of the most comprehensive data collection efforts tracking the impact of NCLB since its implementation. Jennings and Rentner (2006) describe major findings from this tracking effort. These include changes in activities undertaken by state education agencies, ranging from adopting standards and creating corresponding standardized tests to establishing state-specific criteria of what constitutes a highly qualified teacher. The bulk of NCLB-induced changes, however, have been at the school level. Jennings and Rentner describe schools increasing time spent teaching tested reading and math, aligning their curricula to better match state standards and tests, and increasing attention to the subgroups of students most likely to cause schools to fail to meet AYP goals.

Source: Annex write-up provided by Andrew Reschovsky in a personal communication with the author, August 2009.

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# Chapter 3

## The fiscal federalism theory of grants: Some reflections from political science

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### 3.1. Introduction

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According to the theory of fiscal federalism, intergovernmental grants represent an effective control instrument for the central government. Through conditional grant schemes it may manipulate the incentive structure facing local governments and thus induce them to provide more local services that generate benefits for residents of other jurisdictions. Through unconditional grant schemes it may engage in revenue sharing with local governments or provide fiscal equalization without incentive effects for the local choice of service provision. Unconditional grants thus leave local governments with more local freedom and autonomy than conditional grants.

In this chapter I take issue with these basic notions. I raise three points. First, I discuss conditional and unconditional grants as a measure of local freedom. I find this measure flawed because it neglects the fact that the central government has other ways of manipulating local choices than using grant systems. Second, I question the behavioural assumption about the central government that is implicit in the theory of fiscal federalism. Specifically, I raise the problem of political self-interest that must be faced by any theory that wants to understand real world politics. Third, I discuss the behavioural assumption concerning local governments that is implicit in the theory of fiscal federalism. Moving beyond the theory's "black box", unitary actor assumption raises some intriguing questions about the effect of grants on local decisions.

I start out by reviewing the basic theory of grants inherent in the theory of fiscal federalism. I keep this review short because the basic notions are well known, and many excellent reviews already exist. I then move on to my three points. Throughout the paper, I illustrate my points by recent experience from intergovernmental relations in Denmark. I conclude by giving some thoughts about where my points might lead future research on grant systems.

### **3.2. Intergovernmental grants in the theory of fiscal federalism**

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According to the theory of fiscal federalism, intergovernmental grants constitute an important policy instrument for the central government that may serve a number of different functions. They may internalize spill-over effects to other jurisdictions, provide fiscal equalization across jurisdictions, and serve revenue-sharing purposes (Oates 1999; Smart & Bird 2010; Lotz 1990: 217-244; Mau Pedersen 2007: 240-253). Grants can take either of two general forms. They can be “conditional grants”— sometimes referred to as “earmarked grants”— that place various kinds of restriction on their use by the recipient, for instance a condition that the recipient matches the grant by own income sources. Or they can be “unconditional grants”— sometimes referred to as “general-purpose grants”— that is, lump-sum transfers to be used in any way the recipient wishes.

The theory prescribes that conditional grants be employed where the central government wants the recipient government to increase spending on local service provision because it generates benefits for residents of other jurisdictions. The rationale is that the grant subsidy induces the recipient government to incorporate the spill-over benefit into its local decision-making calculus. In contrast, unconditional grants are the appropriate instrument in situations where the central government does not want to interfere in the local decision-making process, but simply to provide fiscal equalization or revenue sharing. The more the central government wants to interfere in local decisions, the more conditional grants it should use. In contrast, if it values local autonomy, it should primarily rely on unconditional grants. From the recipient government’s perspective, conditional grants represent central control efforts, while unconditional grants respect local autonomy and freedom.

If the theory is correct, conditional grants should have the greatest effect on local decisions because they not only provide an income effect but also change relative prices. This is the central empirical prediction of the fiscal federalism view on intergovernmental grants. It has long been found to be true. In an early review of empirical studies, Gramlich (1977) found that the average result from a large number of empirical studies was that conditional grants lead to more local expenditure than unconditional grants. The variation around the mean result was considerable, however. Some studies found the impact of conditional grants to be large, while others found it to be close to zero. In other words, although the theory has it right on average, there seems to be some unexpected noise in the signal. In the following I speculate why. But first I want to raise the broader question of local autonomy. Do unconditional grants really give recipient governments more freedom? Should local governments welcome a change from conditional to unconditional grants?

### **3.3. Intergovernmental grants and local government autonomy**

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The fact that conditional grants give recipient governments less autonomy and more central government control than unconditional grants may seem so obvious that it is hardly worth questioning. This truism is widespread not only among believers in the theory of fiscal federalism, but also within norm-setting international bodies dealing with intergovernmental fiscal relations in practice. For instance, a recent paper from the OECD's Network on Fiscal Relations Across Levels of Government considers the distinction between conditional and unconditional grants "crucial for assessing subcentral fiscal autonomy" (OECD 2009: 15). In a similar vein, article 9 of the European Charter of Local Government by the Council of Europe states: "As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction."

Yet, I find this truism misleading. It paints a dangerously incomplete picture of intergovernmental relations. It overlooks the important fact that the central government has more than one tool box available when trying to control local governments. Besides the

grants tool box there is the tool box containing instruments of legal regulation. Both tool boxes may be used to achieve a given control purpose. But seen from the perspective of local governments, the grants tool box is often preferable. A conditional grant represents control by incentive manipulation. Local governments may choose to react to the stimulus, but they may also decide to ignore it if they are ready to pay the price of not receiving the grant. In contrast, legal regulation is control by coercion. If local governments ignore it, councillors go to prison. So if the choice is between control by conditional grants and control by unconditional grants combined with legal regulation, conditional grants may not be so unattractive after all.

Is this way of thinking about the choice between conditional and unconditional grants a far-fetched academic idea, or does it have some relevance to the real world? Let us take a closer look at the historical experience in Denmark, where the change from conditional to unconditional grants over the last 30-40 years is widely hailed by fiscal federalism theorists as a success story.

The Danish story begins in the 1960s, when a ministerial committee overhauled the system of conditional grants to local governments. The committee concluded that the system consisted of a bewildering array of about 90 conditional grant schemes that had been established in a largely incremental and uncoordinated process over the past 50-100 years. The committee found that the system made it difficult to prioritize across policy areas and left both local and central government without efficiency incentives (Det Økonomiske Sekretariat 1968). The report became a stepping stone to a profound reform of the intergovernmental grant system in the wake of the municipal reform in 1970 where approximately 1,300 local governments were amalgamated into less than 300 new units. The grant reform was carried through in a series of steps (Lotz 1998; 1990: 252-261; Mau Pedersen 1995: 195-204; 2007: 271-280). The first step was taken already in 1970 and resulted in a reduction of matching grants to local schools and roads. The second step was taken in 1973 when matching grants to local roads were abolished. The third step was taken in 1975 when matching grants to local schools were abolished. The fourth step was taken in 1976 and reduced a number of matching grants in the social area. The next major step was taken ten years later in 1987 when matching

grants in the areas of child care and old age care were abolished. In the 1990s, the trend continued with a series of changes of matching grants within the area of social transfer payments. Each time a matching grant has been reduced or abolished, it has been added to the central government's general-purpose block grant to local governments. In this way, the grant reforms since 1970 have resulted in a gradual change from conditional to unconditional grants.

From the perspective of the normative theory of fiscal federalism, local governments should welcome this development in Danish intergovernmental relations because it has increased local autonomy and freedom. My point is, however, that this presupposes that the central government has not touched the tool box containing instruments of legal regulation. The picture is incomplete until it has been established that the central government has not changed its control instruments from grants to legal instruments.

This is obviously a difficult question that requires in-depth research to be answered. Here, I can only indicate that the other tool box has not been locked away in this period. I will do this by a brief inspection of the school area, an important local government function in most countries. Until 1970, the Danish central government used conditional grants to control municipal primary schools. A matching grant reimbursed 85 per cent of local governments' expenditure on salaries to school teachers. In 1970, the grant was reduced to a reimbursement rate of only 60 per cent. Then in 1975 the matching grant was abolished, and since then there have been no conditional grants to local governments in the school area.

From the perspective of fiscal federalism this is a story of increasing local autonomy. However, this presupposes that the central government has not turned to the regulatory tool box. A rough answer to this question is provided in Figure 3.1, which shows three measures of legal regulation of municipal schools in Denmark 1966-2007 that is the period during which the conditional grants were abolished. The three measures are all quantitative indicators of the central government's legal regulation and are thus vulnerable to the criticism that the substance of the

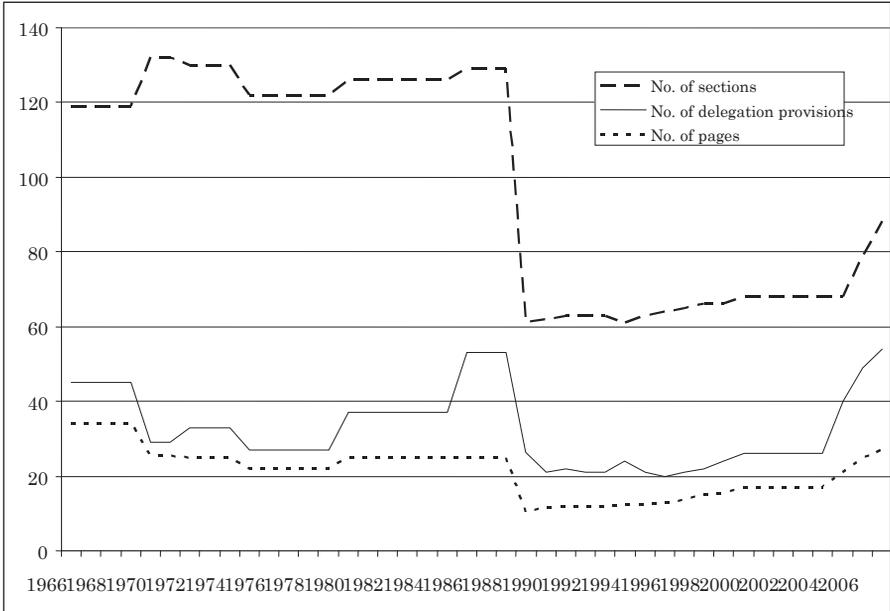
regulation may vary even though its quantity does not. However, there is general agreement that the length of regulation is not a bad measure of how detailed it is (see e.g. Huber & Shipan 2002: 44-78). The three measures are all indicators of the extent to which the Danish primary school act regulates the autonomy of local governments within the school area. The measures are all from consolidated versions of the act that have been published regularly during the period.<sup>43</sup> There are two measures of the length of the act. The first simply counts the number of sections in the act. The other counts the number of pages the act takes up in the Danish parliament's *Law Journal (Lovtidende)*, the official publication channel for all Danish parliamentary acts. The journal has had the same two-column format in the period under investigation. One page contains approximately 500 words. The third measure counts the number of provisions in the primary school act that deal with delegation. This is a measure of how much delegated power parliament allows the government in the school area. It indicates how much regulation the central government imposes on local government in addition to parliamentary rules.

A first glance at Figure 3.1 shows that the three measures are correlated, although not perfectly so. They all indicate that the abolishment of conditional grants in the first half of the 1970s was not accompanied by a corresponding change in legal regulation, which appears almost invariant during that period. A major change then took place in the late 1980s when the school government act was abolished and partially incorporated into the school act. This led to a considerable reduction in legal regulation and, by implication, an increase in local autonomy. However, this appears to be a temporary release for local governments, because the central government seems to have recaptured at least parts of the lost ground in the years since this major reform. This is especially the case for the years after the turn of the millennium where the central government's regulatory appetite has risen dramatically. What is surprising about this 40-year development is that it appears largely unrelated to the development in the grant area. The two tool boxes appear to lead separate lives.

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<sup>43</sup> Please note that the measures include the Danish school government act prior to 1989, see the explanation in the note to Figure 1.1.

**Figure 3.1. Legal regulation of municipalities: The Danish primary school act, 1966-2007**



Note: This figure is based on consolidated versions of the Danish primary school act (Folkeskoleloven) published in the following years: 1966, 1970, 1972, 1975, 1980, 1986, 1989, 1990, 1991, 1992, 1994, 1995, 1996, 1996, 1997, 1998, 1999, 2000, 2005, 2006, and 2007. Until 1989, the figures include consolidated versions of the Danish primary school government act (Skolestyrelsesloven), which was then partially abolished and partially incorporated into the primary school act. Number of sections includes all sections in the act. Number of pages measures the length in the Danish parliament’s *Law Journal (Lovtidende)* where all acts are officially published. The number of provisions on delegation has been identified by running word searches on the word “rules” (“regler”) in Word and PDF versions of the consolidated acts since delegation provisions typically allow the government to either make rules or make exemptions from rules.

Turning to a closer inspection of the three indicators of central government regulation, they tell a story of quite detailed central intervention in the running of local schools. The primary school act covers between nine and 34 pages in the parliament’s *Law Journal* and contains between 62 and 132 sections. This amounts to quite a lot of legal text. The act regulates issues like number of years in primary schools, subjects to be taught, number of weekly hours to be taught in the various subjects, types of examinations and

regular tests, maximum number of students in individual classes, school libraries, assistance to children with special needs, management structure of local schools, user boards, teacher councils, student councils, procedures for closing down a school, transportation of students between home and school, teachers' educational background, complaints procedures, and many other issues.

Further, the primary school act contains between 20 and 54 delegation provisions during the 40 years under investigation. In these provisions, parliament has delegated powers to the government to regulate by decrees issues like assistance to children with special needs, language lessons to children of refugees and immigrants, exemptions from classes in Christianity, possible extra subjects in addition to those required by the primary school act, definition of the purpose of the various subjects, pre-schooling, regular tests, special project lessons, individual education plans for each student, procedures for examinations, minimum and maximum number of lessons in the various subjects, purpose and functions of school libraries, procedural rules to follow when local authorities require students to follow special supporting teaching sessions, how to teach students with contagious diseases, possible co-management of several schools, transportation of students between home and school, students going to schools in neighbouring municipalities, requirements to ensure active student participation and good order in teaching sessions, elections to user boards and student councils, complaints procedures, and many more issues. In 2009 the government used its delegated powers to issue a total of 57 government decrees, orders, circulars and instructions ([www.retsinfo.dk](http://www.retsinfo.dk)).

As Figure 3.1 clearly shows, central regulation has been on the rise since the turn of the millennium. This is, among other things, due to the introduction of national tests, which local governments now must use as a regular evaluation tool in selected subjects. The results of these tests are publicized to enable the public and the central government to monitor local schools. The tests were introduced by parliamentary law and followed up by government decrees. If given the choice, local governments would no doubt have preferred voluntary tests made attractive by conditional grants.

All in all, the Danish central government's regulation of local schools has varied over the past 40 years, but has, by all indications, remained massive throughout the period. In this context the question of conditional and unconditional grants appears to be a minor detail in a large regulatory complex. The grants tool box simply pales in comparison with the central government's regulatory tool box. It would be highly misleading to conclude from the abolishment of conditional school grants in the early 1970s that this is an area where local autonomy has been on the rise.

Fiscal federalism theorists, of course, realize that there is more to intergovernmental relations than grants, but, as Bird (1986: 394) noted 20 years ago, "the temptation to focus on public finance data when measuring centralization appears to be overwhelming".

### **3.4. The central government in the theory of fiscal federalism: Benevolent dictator or a collection of self-interested actors?**

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Any theory of social phenomena is based on behavioural assumptions concerning decision-makers. This may be explicitly stated as part of the theory or it may be an implicit condition. In the case of the theory of fiscal federalism, the latter situation obviously prevails. The literature within this tradition speaks of "the central government" as not only a unitary, but also a benevolent actor. As Oates (1999: 1128) states on the theory's view on grant systems: "[The theory] ... leads to a vision of a system in which there exists a set of open-ended matching grants, where the matching rates reflect the extent of benefit spillovers across jurisdictional boundaries, and a set of unconditional grants for revenue sharing and, perhaps, equalization purposes." The central decision-maker behind such a system is a benevolent actor trying to maximize collective welfare.

Building social theories on this behavioural assumption has been increasingly challenged since the middle of the 20th century, and a number of theoretical schools based on individual self-interest have developed: public choice, rational choice, social choice, rational actor theory. These theories may not have ended up yielding the insights their advocates originally hoped for (Green & Shapiro 1994; Monroe 1991), but one legacy that is likely to endure is that

the problem of political self-interest needs to be taken seriously by any theory that wants to understand real world politics.

The increasing focus on political self-interest has also influenced studies of fiscal federalism. A growing number of 'second-generation' fiscal federalism studies are built on the assumption of rational self-interest maximization (Oates 2005; 2008). Here, I want to apply this perspective to the question of intergovernmental grants.

How do grant systems look from the perspective of a self-interested, central decision-maker? The first thing to note is that conditional and unconditional grants are different in one very important respect. Conditional grants are likely to generate supporters both within and outside the government apparatus. A recipient-bureaucratic complex is likely to evolve around conditional grants schemes (see Beer 1978), as conditional grants are often complex to administer in practice (read: government employees' jobs depend on their continued existence), and they provide important benefits for their recipients. Naturally, these actors support the schemes and are often willing to organise to oppose their abolishment. In contrast, those who benefit from abolishing conditional grants are the diffuse mass of general taxpayers to whom the benefit is so marginal that it is not worthwhile to organise to fight for the cause.

The central government is thus likely to face asymmetrical forces when trying to reduce or abolish conditional grants. It is an uphill battle because the opponents are better organised and more willing to fight than the supporters. This is no unusual situation in politics. In a range of policy areas, political decision-makers face an asymmetrically organised environment. This is likely to occur whenever most or all of the benefits of a programme serve some single, reasonably small interest, but most or all of the costs will be borne by a large number of people. Other examples include subsidies to private companies, support schemes to agriculture, and industrial policies that limit competition. Wilson (1989) speaks of "client politics" in these situations. As Figure 3.2 makes clear, client politics are different from "entrepreneurial politics", "interest-group politics" and "majoritarian politics".

The point is that it is a challenge to change client politics. Beneficiaries have vested interests and are ready to fight to protect them. Supporters are, at best, lukewarm. Is a self-interested government minister likely to be responsive to this asymmetrical pressure from the environment? The answer is yes, because the supporters often represent important parts of the minister’s constituency. And, from the minister’s perspective, conditional grants constitute an almost perfect way of cultivating constituency support. Apparently, you antagonize no-one.

**Figure 3.2. Typologies of policies according to their impact upon their environment**

		Concentrated benefits?	
		+	-
Concentrated costs?	+	Interest group politics (ex: labour market policies)	Entrepreneurial politics (ex: pollution control)
	-	Client politics (ex: conditional grants)	Majoritarian politics (ex: constitutional policies)

Source: Inspired by Wilson, J.Q., *Bureaucracy. What Government Agencies Do and Why They Do It*, New York: Basic Books, 1989, pp. 72-89.

So why do conditional grants not explode and eat up the entire government budget? The reason is that other political actors are held accountable for unsound government finances. So the politics of conditional grants is likely to be a matter of negotiation between different actors in the central government. Grant politics thus resemble budgetary politics within the government, which is well known from a comprehensive literature on this topic since Wildavsky’s path-breaking study (1964).

Let me give an idea of what a perspective building on political self-interest might imply for our understanding of real-world conditional grants by sketching a few testable empirical implications. A first and basic implication is that abolishing or reducing conditional grants is likely to generate asymmetrical reactions in the political system’s surroundings. Opponents organise and fight, supporters are silent. An example from recent Danish history is the government’s abolishment in 2002 of a number of conditional grants in the environmental area: the “Green Fund”, grants for “Green Employment” and “Water Grants”. The schemes financed different types of environmental

programmes, some of which were organized by local and regional governments. The reactions to this proposal in the political system's surroundings are listed in Table 3.1, which shows that less than half of those invited to comment on the bill chose to do so. Those who did were mostly environmental organizations, and they protested against the proposal. The supporters were, with only one exception, silent.

**Table 3.1. Reactions from external actors to the Danish government's proposal to abolish conditional grants within the environmental area**

	Against	Neutral	For
Association of County Councils		X	
The Danish Society for Nature Conservation	X		
Denmark's Private Water Works	X		
Danish Water Supply Association	X		
The Green Fund	X		
The Green Job Patrol	X		
The Ecological Council	X		
The Danish Outdoor Council	X		
Green Information	X		
The Association of Green Guides	X		
HK	X		
The Danish Society of Engineers	X		
The Danish Agricultural Council	X		
The Danish Society for a Living Sea	X		
The Network of Green Guide Steering Groups	X		
Eco-Net	X		
Friends of the Earth Denmark	X		
SID	X		
The Association of Danish Ship Builders			X
The Water Council	X		
Vestergør	X		
Ørestad Development Corporation		X	
The 92 Group	X		
Association of Local Governments		X	

Note: The consultation process on the government's bill in 2002 on the abolishment of various environmental grant programmes (LF 133/2002) involved 71 organizations and public authorities. 31 responded in writing. The table lists all written reactions from private and semi-private actors (i.e. not reactions from public authorities like individual local governments and ministries).

Source: Ministry of the Environment, *Høringsnotat vedrørende hørings svar til L 133*. Notat af 7. marts 2002, Copenhagen 2002.

A second implication is a constant pressure for conditional grants while the contrary pressure is more sporadic. The recipient-bureaucratic complex derives concentrated benefits from the conditional grant schemes, while the effects for actors favouring reductions or abolishment of the schemes are more diffuse. At the same time they have many other obligations than watching conditional grant schemes. Consequently, their energy is likely to be less persistent, and their attention is likely to quickly shift to other topics. Rolling back conditional grants is thus likely to come in waves where actors from the economic government ministries organize campaign-like attacks on the grant schemes. They may succeed, but their attention and energy are quickly captured by more urgent questions. But the recipient-bureaucratic complex is patient and persistent and likely to keep up the pressure once the energy of the economic ministries is spent. Conditional grants are thus likely to slowly creep back in once a central campaign has succeeded in rolling them back. In this way fighting conditional grants resembles deregulation offensives or campaigns to fight government red tape.

The Danish experience is an illustration of this phenomenon. On the one hand it is a success story of rolling back conditional grants and replacing them with unconditional grants. On the other hand several studies find that conditional grants are hard to get rid of and tend to somehow survive attempts to “streamline” local government finance, and even tend to grow in numbers over time. The Ministry of Interior (1998) conducted a study of conditional grants in Danish intergovernmental relations ten years ago. Its mapping showed that 54 conditional grant schemes existed that year. The ministry concluded that this was the result of “growth in the number of schemes in recent years” (1998: 169) and that there is “a growing tendency” (1998: 147) to use conditional grants. Ten years later Krevi, the Danish Evaluation Institute for Local Governments, conducted a new study of conditional grants (Krevi 2007). Its mapping showed that 98 conditional grants existed that year. This indicates considerable growth in just ten years, although comparison with the Ministry of Interior’s study should be done with caution because there is no agreed definition of what exactly constitutes a conditional grant scheme.<sup>44</sup> Furthermore, Krevi found

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<sup>44</sup> One definitional challenge is how to count government programmes that

it difficult to identify all conditional grant schemes and also found the responsible ministries somewhat protective and reluctant to reveal information on their schemes.

A third implication is that real-world grant schemes are likely to vary across nations depending on how the political system is organised at the central government level. Fragmented systems where policy-making tends to take place in subsystems – say, the US federal government – may leave more room for recipient-bureaucratic complexes to protect and expand their conditional grant programmes. In contrast, more concentrated systems – say, the UK central government – may strengthen the proponents of unconditional grants.

These implications are only initial thoughts, but hopefully they suggest that a perspective on grants that takes political self-interest at the central government level seriously raises questions that are quite different from those coming out of the traditional theory of fiscal federalism.

### **3.5. Local governments in the theory of fiscal federalism: Black boxes?**

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Fiscal federalism not only rests on a specific, although implicit, model of the central government; it is also based on an implicit model of local governments. The central empirical prediction is that conditional grants have a greater effect on local decisions than unconditional grants because they not only provide an income effect but also change relative prices. This hypothesis is actually a simple stimulus-response model. Local governments receive a stimulus, a grant, and a predictable response, an expenditure decision, is provoked. All theories simplify the real world in order to understand it, but this model may be too simple. It rests on the assumption that local governments are passive systems that need external stimuli to be activated. Local governments are implicitly treated as not only unitary actors, but actors without independent decision-making ambitions. In the perspective of fiscal federalism, local governments are “black boxes”.

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allocate subsidies not only to local governments, but also to private organizations and individual institutions.

This is an incomplete picture of real-world local governments. In reality they are political systems in their own right. Just like the central government, local government consists of a set of political institutions populated by actors pursuing different interests. Like central government actors, actors at the local level are not likely to be only benevolent, but also care about private goals. The problem of political self-interest pops up again. Furthermore, like the central government, local governments do not exist in a vacuum, but are surrounded by actors in the pursuit of improved local services, lower taxes, building rights, lenient zoning restrictions, pollution permits, and so on. Like the central government, local governments are confronted with rent-seeking behaviour by actors in their environment.

To understand how intergovernmental grants are translated into expenditure decisions by the receiving local government, we need a better understanding of the local decision-making process. I can only provide a starting point for such an exercise. The basic point would be to question the implicit unitary actor assumption and the equally implicit behavioural assumption. If we accept that local governments really are not unitary, but composite actors, and if we accept that local actors are primarily motivated by political self-interest, how do intergovernmental grants look?

Any local government incorporates different local interests, and at any given point it represents a certain balance of these interests. When a grant is transferred by the central government, it affects this balance. It is turned into a political instrument that empowers some actors and weakens others. For instance, a conditional grant to, say, local environmental protection strengthens expenditure advocates within this policy area and makes the pursuit of low expenditures or lenient environmental standards more difficult. Does it affect the local balance of powers enough to make increased expenditure possible? This depends on the relative position of the actors, which in turn depends on the local political-institutional setting.

Opening up the black box quickly complicates matters. But it also makes it possible to improve our understanding of how grants affect local governments. Let me again give an idea of what a perspective building on composite actor assumptions and realistic

behavioural assumptions might imply for our understanding of grants by sketching a few testable empirical implications and illustrating them with recent Danish experience.

A first implication is that a given grant in a given area may be received differently by local governments with similar institutional arrangements but varying preferences. The reason is that the grant will empower some local actors and provide them with an extra instrument to pursue their interests. Local governments with a pre-existing preference for following the grant stimulus should thus be more responsive. The Danish experience is an example of this phenomenon. In 2006 the central government changed the matching grant scheme for local governments' social security expenses to unemployed citizens. Before the change the central government reimbursed 50 per cent of local expenditure. The reform introduced an incentive to "activate" recipients of social security (i.e. to provide local labour market training). If recipients were "activated", the central government would reimburse 65 per cent of local expenditure, otherwise only 35 per cent.

According to the theory of fiscal federalism, this should provide local government with an incentive to "activate" social security recipients. However, a study by Krevi (2008) showed that, on average, the reform had no behavioural impact on local governments. On average they did not activate social security recipients to any higher degree after the reform. However, activation varied considerably across local governments depending on their local socio-economic situation. Krevi's quantitative study showed that local governments with a low tax base, high local unemployment and many social security recipients appeared to respond to the incentive in the new grant scheme while local authorities in a more comfortable economic situation did not react. To investigate the causal mechanism behind this result, Krevi conducted a follow-up study to the quantitative analysis. It was a comparative case analysis of eight local governments and showed that the socio-economic situation was not the only decisive factor, but that local preferences also mattered. Local governments under economic pressure and with a pre-existing preference for activation as an employment instrument responded to the incentive in the new grant scheme. The grant reform made it easier for actors who

held this preference to pursue this employment strategy. But they only succeeded in areas in economic distress.

A second implication is that a given grant scheme may have different effects in different policy areas in similar local governments. The reason is that local governments, like central governments, do not exist in a vacuum but are surrounded by actors with interests in local government affairs. The strength of these actors varies across areas. If the central government abolishes or reduces a conditional grant, these actors have an interest in preventing the local government from reacting to the incentive to reduce local expenditure.

Again, the Danish experience serves as an example. Pallesen (2003: 62-104) investigates the local expenditure reaction to the abolishment of matching grants to local governments in the road area in 1973, the school areas in 1975, the library area in 1984, and the child care and old age care areas in 1986. Fiscal federalism's grant theory would predict that local governments would react by reducing local expenditure, but this only happened in the road and library area. Local expenditure was not reduced in the other areas. According to Pallesen, the reason is that these areas are characterised by strong producer interests (local government employees in strong trade unions), strong user interests and popularity in the electorate. The study thus shows that actors in the local government's environment may succeed in forming effective coalitions to prevent the local government from responding to incentives in grant changes.

A third implication is that a given grant scheme may have different effects in different local government systems. The reason is that the local political systems may offer different institutional positions for actors with different interests in local expenditure to pursue their interests. Comparisons could be made between aldermen systems, committee systems, strong/weak mayor systems, and so on. For unitary nations this would probably require cross-national comparisons, since they seldom have different local government systems within their borders. In federal systems it should be possible to compare different local government systems across state boundaries. Inspiration might be drawn from numerous investigations of the "reformism hypothesis" in the USA.

According to this hypothesis, institutional arrangements associated with municipal reformism, such as the council-manager form of government and at-large city council elections, produce smaller and more efficient local governments than traditional institutions with a mayor-council form of government and council elections by constituency. The reason is that these different institutional contexts provide different opportunities and incentives for officials to engage in rent seeking and distributive politics (see e.g. Craw 2008). It seems plausible that grants might also work differently in these different systems.

### 3.6 Conclusion

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Fiscal federalism explores in both normative and positive terms the use and effects of intergovernmental grants. It has generated a number of important insights. However, like most theories, it also suffers from limitations, some of which I have discussed here. First, fiscal federalism tends to place a somewhat narrow focus on grants as instruments of intergovernmental control and thus may overlook regulatory means of controlling local governments. As the Danish experience shows, regulatory control instruments may be far more important than economic incentive manipulation through grants. Second, fiscal federalism builds on inaccurate behavioural assumptions concerning both central and local governments. In particular, the theory pays insufficient attention to unitary actor assumptions and the problem of political self-interest. Taking these issues seriously opens a Pandora's Box of problems. But it may also provide the basis for a better understanding of grants and intergovernmental relations. It is time for political scientists to take a deeper interest in intergovernmental grants.

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# Chapter 4

## Conditional vs. unconditional grants: The case of developing countries

Roy Bahl

### 4.1. Introduction

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Because subnational government taxation is not a viable option in many low-income countries, the financing of decentralized services often comes down to the choice between an unrestricted grant and one with conditions laid down by the higher level government. The central policy question that arises, and is explored in this paper, is how this choice does or does not compromise the success of fiscal decentralization.

We begin with some definitional issues and with empirical evidence about the revenue dependence on transfers in low income vs. OECD countries. Then we discuss the theoretical and practical advantage of conditional grants vs. unconditional grants in developing countries and give an illustrative review of the practice<sup>45</sup>.

### 4.2. Definition and measurement

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The term “transfer” refers to the case when money is raised at a higher level of government and passed to the lower level by some formula or ad hoc approach. We distinguish transfers from local taxes. The latter refer to the case where the subnational government is empowered to at least set the tax rate, and thereby has power at the margin to determine its revenue budget.

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There are a number of different kinds of public financing instruments in the transfer category: “grants”, “shared taxes”, “subsidies”, and “subventions” are but a few. Some of these are designed to be centralizing in nature because they allow for control of the use of these funds by the higher level government, while others are decentralizing in that they pass significant discretion to subnational governments. Intergovernmental fiscal systems in developing and transition countries are more centralizing than those in industrial countries. On the financing side, this centralization is accomplished by giving little taxing power to the local governments, and on the expenditure side it is done with mandates and conditions in the grant system.

### **4.3. Revenue importance**

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The importance of transfers in national financing systems might be evaluated in several different ways. First, we may note that transfers average about 6 percent of GDP in transition countries, compared with only about 2 to 3 percent in developing and industrialized economies (Table 1). Because of their higher level of economic development, many industrial countries have been able to adopt a more decentralized approach to governance (Bahl and Wallace, 2005). That transfers are a greater share of GDP in transition economies is not a reflection of their decentralized expenditure approach but their general unwillingness to decentralize revenue raising powers. In general, the share of transfers in GDP will be larger if the overall level of government revenue mobilization is greater and if lower level governments are relied on more heavily for service delivery and smaller if subnational governments are given more taxing powers.

Another way to make comparisons of the revenue importance of intergovernmental transfers, and one that is independent of the overall level of revenue mobilization, is to consider the share of the central government budget that is allocated to transfers. As may be seen from Table 1,

**Table 1. The revenue importance of intergovernmental transfers**

	As a percentage of GDP	As a percentage of central government expenditures	As a percentage of subnational government Expenditures
Developing countries (33) <sup>a</sup>	2.18	11.52	59.47
Transition countries (15)	6.42	15.80	44.09
Industrialized countries (24)	2.78	27.13	50.30

Source: International Monetary Fund (various years), *Government Finance Statistics Yearbook*; International Monetary Fund.

<sup>a</sup> Number of countries compared is shown in parentheses.

the industrialized countries allocate about twice as large a share of their central government budgets to intergovernmental transfers as do either developing or transition countries. Again, this reflects the much greater commitment to fiscal decentralization in the OECD countries.

Finally, we might compare the importance of transfers by noting that subnational governments in developing countries are more dependent on transfers than are subnational governments in industrialized countries (Table 1). It will surprise few who study these matters to see that transfers finance nearly 60 percent of subnational government expenditures in developing countries, though in fact it might surprise some that this share is not larger. The share is smaller in the industrialized countries because they have devolved more revenue-raising authority to their subnational governments<sup>46</sup>

#### 4.4. Conditionality and the objectives of transfer systems

Higher-level governments make use of intergovernmental transfers

<sup>46</sup> Note, however, that there is a very great disparity between federal and unitary countries in this regard. For a discussion of tax assignment in industrial countries see Bahl (2009).

for good economic reasons, and for understandable political reasons. The role of conditionality in a transfer system is bound up with this economic and political rationale. The first principles of fiscal federalism, where this rationale is laid out, are by now well developed and have been taught to several generations of students of public finance (Musgrave 1983, Bahl and Linn, 1992; Bird and Ebel, 2007). But while these principles provide good general guidance for industrialized countries, some important amendments are needed to take account of the economic setting and the particular institutional arrangements that often characterize low-income and transition countries.

The theory behind the use of conditional grants is straightforward, but implementation raises a number of issues. The problem lies mostly in the design and management of the grant system. There is almost always a disconnect between the goals the government has for an intergovernmental transfer, the design of the transfer instrument, and the implementation. Sometimes the disconnect between them is so great that the objectives of the transfer are not realized.

#### **4.5. Vertical balance**

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Arguably, the principal reason for intergovernmental transfers in LDCs is to redress the imbalance between the expenditure responsibilities of subnational governments and their revenue raising powers. While economic development has led to growth in the expenditure budgets of provincial and local governments, it has not led to a decentralization of taxing powers. The result in developing countries is almost always an inability of subnational governments to finance adequate levels of public services from their own sources (Bahl and Wallace, 2005; Bahl, 2009).

The resulting financing gap (the vertical imbalance) for less developed countries and for transition countries is usually filled by intergovernmental transfers. As countries develop, there is a shift toward asking subnational governments to raise more of their own resources. In the U.S., for example, transfers finance less than one-fourth of all state and local government expenditures, mostly because the state and local governments have access to a wide variety of consumption and income taxes. The same is true in most

OECD countries where there is extensive use of subnational government income taxes. Denmark, Spain and Switzerland are cases in point. Among developing and transition countries, however, most have not reached a threshold of comfort with subnational government taxes. Subnational government taxes in OECD countries are about five times higher than in low income countries even after adjustment for GDP. There are notable exceptions, of course, such as Argentina and Brazil (Rezende and Afonso, 2006; Tommasi, et. al. 2001).

In theory, the vertical gap could be filled by either a conditional or an unconditional grant. Those who advocate fiscal decentralization will prefer an unconditional grant because the funds may be used to either address expenditure needs in general or to lower taxes. In the case of a conditional grant, the focus would be more on closing the gap in particular sectors. The question of which is the best choice will come back to the extent to which the goal is central control of the use of the grant funds vs. addressing local expenditure needs based on local preferences.

#### **4.6. Equalization**

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Developing and transition countries are characterized by wide inter-regional disparities in economic well-being. It is not unusual for the average income in the richest provinces to be 10 times higher than that in the poorest places. These income disparities are directly reflected in differences in revenue-raising power. To the extent that subnational governments are given more independent revenue raising powers, these disparities will widen because the more urbanized local governments have the greatest taxable capacities and the strongest administrative infrastructures.

Countries do acknowledge the need for equalization of inter-regional differences in fiscal capacity in a decentralized system, and they must rely on intergovernmental transfers to accomplish this. Otherwise, the gap between subnational governments in the quality of public services provided would be out of step with social equity goals, and could be politically unacceptable. The design principles for an equalizing transfer system are simple enough: measure the extent of fiscal disparities, decide how much of the

gap will be eliminated, and develop a formula that will produce the desired equalization. This is easier said than done, apparently, because the implementation of a successful equalizing grant system is a challenge that few developing countries have met.

Most countries design equalization grants as general support programs to reduce disparities in the capacity to finance local services (Hull and Searle, 2007). This approach leaves it to the recipient government to decide whether it will spend the money on pro-poor services or tax reduction.

Conditional grants also are used for equalization purposes, but the grant design is tricky. Much depends on the grant conditions that are laid down. If the restriction is expenditure on a specific (pro-poor) function, and if eligibility is limited to poorer local governments, equalization might be accomplished. If the conditions have to do with matches from local funds, or preparation of acceptable expenditure plans, lower income governments may not be able to buy into the program.

#### **4.7. Externalities**

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Another rationale for the use of intergovernmental transfers is to stimulate the provision of adequate levels of local public services when externalities are present. Left to make their own decisions, without any incentives or penalties, local governments will underspend (overspend) on services where there are substantial external benefits (costs). This situation is well known in the industrialized countries, and it also holds true in the developing countries. Conditional grants are an instrument that can be used as an incentive to encourage local governments to increase their spending on functions with external benefits.

Central governments sometimes read the externality justification quite broadly to include both the need to take spillover effects into account and to stimulate spending to support national economic development or equity objectives. Sometimes the conditionality may involve earmarking a transfer for a specific purpose. However, it may also involve a local revenue matching condition or a requirement that services be delivered in a particular way. Or, the condition may be more general, as in a required mandate to

limit spending on personnel or to cover only capital activities. The condition may not even be on the expenditure side, for example, the case of a grant that is conditional upon increased revenue mobilization.

The design of an intergovernmental transfer system to address externalities requires policymakers to decide on the size of the grant required. In the case of a subsidy that reduces the unit cost of a particular service, the question is, what is the amount of subsidy required to induce the local government to expand public output to the target level? Government fiscal planners in developing countries mostly guess at what the right level of output might be. In fact, these underlying issues -- the size of the external effect and the price elasticity of demand for the service -- are usually ignored by fiscal planners. More often than not, the size of the grant is determined on the basis of affordability. The resulting expansion in output for the targeted function may or may not achieve efficient levels.

A major drawback of cost reimbursement grants is that the recipient governments may not spend the money for the dedicated purpose. "Money is fungible." If a subnational government receives a grant of \$1000 for primary education, will spending for primary education be \$1000 higher than it would have been in the absence of the grant? Because these transfer funds and other revenues are substitutes, the true impact of a grant may be hidden. Monitoring becomes all but impossible. There is no easy way around the fungibility problem. Higher level governments in developing countries usually try to address this issue by either limiting earmarked grants to functions where the unmet demand is great and there is no sentiment for displacement, by placing a minimum amount of expenditures on the functions in question, or by limiting local expenditures on such items as salary increases, new hires or general administration.

#### **4.8. Administrative justification**

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Intergovernmental transfers are thought to be a less costly way to finance government because the central government can assess and collect taxes more cheaply than can subnational governments. Another often-made argument is that subnational governments are

more corrupt than the central government, and therefore a shift of responsibility to subnational governments will lead to a waste of revenues. For these reasons, it is more efficient for the central (state) government to collect the taxes and then allocate some portion of the revenues to the lower level of government in the form of transfers.

There are counterarguments against both of these propositions. In fact, all taxes are not more efficiently administered by higher level governments. The property tax, user charges, motor vehicle licenses, and local business licenses are examples. The comparative advantage of subnational governments in all of these areas is their more intimate familiarity with the local tax base and with local taxpayers.

The charge that subnational government tax administrations are more corrupt than central government tax administrations is more accurately stated as a hypothesis. Some researchers have pointed out that corruption may be even greater at the central level because of less transparency and because the amounts involved are so much larger (Martinez-Vazquez, Arze del Granado and Boex, 2007).

The connection to conditional grants here is only indirect. If the real reason for constraining subnational government taxation is to resist local government expenditure autonomy, then the central government is likely to focus on conditional grants so that it can control subnational government budget allocations. An unconditional grant, by contrast, could give lower level governments the same discretion as would an equal amount of local tax revenue.

#### **4.9. Political justifications**

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Governments also adopt (or reject) intergovernmental transfers for political reasons. These reasons fall into three categories. The first is that the central government is resistant to giving up the control over governance that would come with giving revenue-raising powers to subnational governments, because authority to make decisions about the service delivery financed with these revenues would be passed from central bureaucrats to provincial and local

bureaucrats, and this would significantly dilute the power of the former. An alternative to giving up this power, while not fully rejecting the decentralization initiative, is to provide local governments with intergovernmental transfers that carry stringent conditions.

A second political reason for advocating intergovernmental transfers is the goal of enforcing uniformity in the expenditure mix and the revenue structure chosen. One way to restrain local governments from making fiscal choices is to structure intergovernmental transfers to limit local discretion. Third, a transfer system may be put in place as part of a political strategy to hold open the option of offloading the budget deficit on to subnational governments. The Philippines is an example where this strategy was used for a number of years.

All this said, the politics may also swing back and forth between preferences for fiscal centralization and conditional transfers and for decentralized taxing powers and unconditional grants. This was the case in Russia where the Yeltsin years were a time of advocating more power for the regional governments, whereas the Putin years have seen more pushback toward fiscal centralization. (Martinez-Vazquez, Rider and Wallace, 2008, chapter 7).

#### **4.10. The practice: Conditional vs. unconditional grants**

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Every intergovernmental transfer has two dimensions: the first is the *vertical share*, the distribution of revenues between the central government and all of the subnational governments. The second is the *horizontal sharing*, the allocation of the total grant fund among the recipient units. The design of a grant system requires deciding on *both* a structure of vertical sharing and a structure of horizontal sharing. There are elements of conditionality in both vertical sharing and horizontal sharing.

This paper expands on an approach developed by Bahl and Linn (1992) to describe and distinguish among the different types of transfers commonly found in developing and transition countries (See Table 2). Clearly this simple two-way classification is an oversimplification, because countries tweak the vertical and horizontal sharing arrangements in many ways. Still, this

description of the architecture is good enough to make the point that different combinations of vertical and horizontal sharing choices can lead to fundamentally different types of intergovernmental transfers.

**4.11. The architecture of vertical sharing**

As suggested by the columns in Table 2, there are three more or less common approaches to determining the size of the total grant pool (i.e. the vertical dimension). The total to be allocated may be determined as a share of some central or state government revenue source, it may be determined on an ad hoc basis, or it may be determined on a basis of cost reimbursement.

**Table 2. Alternative forms of intergovernmental grant programs**

	Method of determining the total divisible pool		
Method of allocating the divisible pool among eligible units	Specified share of national or state government tax	Ad hoc decision	Reimbursement of approved expenditures
Origin of collection of the tax	A	n.a.	n.a.
Formula	B	F	I
Total or partial reimbursement of costs	C	G	K
Ad hoc	D	H	J

n.a. Not applicable.  
 Note: For definitions of forms A-K, see text.

The shared tax. Arguably the form of vertical revenue sharing that is most in step with the goals of fiscal decentralization is the *shared tax* approach (the first column in Table 2). In this case, the central government allocates a share of national collections of some tax (or of all taxes) to the provincial/local government sector. In effect, this gives subnational governments an entitlement to a share of national revenues and makes them partners in the central

tax system. It provides some degree of certainty to the revenue flow to subnational governments, and it could give local governments access to broad-based and income-elastic taxes.

The choice of a shared tax, and the rate of sharing, will depend on the commitment of the central government to fiscal decentralization. Countries that are pushing subnational governments to be important players in the public service delivery system will choose major revenue sources with income-elastic tax bases, or will share collections from all taxes with their local governments. The cornerstone of the Indonesian decentralization program that took effect in 2001 was a 25 percent sharing of all domestic revenues. The Philippines allocates 40 percent of the total internal tax collection (in the third preceding year) to local governments. The proceeds from all central government taxes are assigned to the divisible pool in India, and in 2003, the state government share was 30 percent. In Pakistan, the provincial share is 41.5 percent of central taxes. This approach is not an uncommon choice for many developing and transition countries.

Tax sharing is nearly always distributed in the form of unconditional transfers. The basic idea is to channel more funds to subnational governments and not to provide an incentive to make any adjustment to spending patterns. Central governments that would like to impose stringent conditions on recipient local governments would not usually follow the tax sharing approach to vertical sharing, though there are some exceptions.

*Ad hoc transfers.* A second approach to vertical sharing is for the central government to decide on a total allocation to the subnational government sector. Whereas the shared tax approach gives subnational governments an ownership of some share of central revenues, the ad hoc approach sends an opposite message: the center owns all of its revenues and may or may not choose to grant some share to the subnational government sector. This approach to determining the vertical share often involves more negotiation and political consideration than subjective analysis of vertical imbalance, and both the approach taken and the amounts agreed upon may vary from year-to-year.

Obviously, there are great drawbacks to such a subjective

determination of the sharing pool. Because it is not transparent, and it is subject to political manipulation, this approach leads to uncertainties on the part of the subnational government sector and impedes fiscal planning and effective budgeting. Rezende and Afonso (2006) report that between 1996 and 2000, the amount of ad hoc transfers to subnational governments for social services in Brazil doubled. The ad hoc approach sends a signal that the central government may treat the subnational government sector as a lower priority use of resources.

In some ways, an ad hoc system of vertical sharing gives the central government more control over local spending than any other approach, because the full program may be terminated (or expanded) at central discretion. Moreover, the national government can change its spending priorities and delivery methods without changing the expenditure assignments of each level of government. Finally, the ad hoc approach allows for a reduction in the subnational government claim on revenues as the situation in the country changes.

In sum, the ad hoc approach to determining the size of the distributable pool is the most centralizing approach to designing an intergovernmental transfer system. It can feature conditional grants, but there is an option to close down funding for a program without concern for an entitlement of subnational governments to a particular amount of funding. This approach is widely used, even in countries such as Brazil that feature decentralization as part of their development plan.

One would expect a centralizing ad hoc approach to vertical sharing to be used in conjunction with conditional grants. In fact, this often is the case. Examples abound of the ad hoc approach to vertical sharing, as is described in Bahl and Wallace, (2007, Table 4). The most common type is a voted annual allocation to conditional grant programs as is done in Tanzania and in Brazil for health and education programs. The Autonomous Region of Muslim Mindanao in the Philippines is funded primarily by an annual ad hoc grant program (Manasan, 2009).

*Cost Reimbursement.* Under a reimbursement approach, the higher level government defines a service for which it will

guarantee to cover some portion of the cost incurred by subnational governments in delivering that service. The major difference between the reimbursement and the ad hoc approaches are that the former are more established programs that are based on a law and are not regularly redefined. Functions that are often targeted are teachers' salaries, health supplies, highway construction and maintenance, and infrastructure projects. Most developing countries include some form of conditional grant in their transfer system. (Bahl and Wallace, 2007, Table 5).

Once the eligibility and reimbursement rules are established, the vertical share can be determined by simply adding up the entitlements of the eligible units, i.e. the grant could be open-ended. But probably the more common approach is to first determine the vertical share based on affordability, then "cut the cloth" in terms of reimbursement and eligibility. In effect, this makes the grant closed-ended. The cost reimbursement approach is likely to involve a large number of conditional grants that are controlled by the line ministries and are continued from year-to-year. Before 2004, Tanzania's conditional grants were contained in 21 budget votes (Boex and Martinez-Vazquez, 2006). In Australia, about 40 percent of transfers are made up of 90 conditional grants for both current and capital purposes (Hull and Searle, 2007). In India there are more than 50 expenditure heads for conditional grants to rural local governments (Sethi, editor, 2004).

Cost reimbursement grants can take many forms. They may directly cover a percent of cost, e.g. 80 percent of the cost of road construction and maintenance. Or, they may be implicit cost reimbursement, as in the case of a conditional grant for primary education where no specific cost share is stated. In the latter case the tax price for primary education spending is lowered because of the grant.<sup>47</sup>

The great advantage, and disadvantage, of the cost reimbursement approach to vertical sharing is its conditional nature. On the one

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<sup>47</sup> If the grant money is not fungible, then there is no effect on the tax price since the total amount of the grant is additional spending on that function.

hand it allows the higher level government to specify those public service areas where it would like to see increased subnational government expenditures. So long as these transfers are targeted on public functions where there are significant externalities, conditional grants have the potential to be efficiency enhancing. It also allows the granting government to impose certain standards on service delivery and public facility construction, and thereby helps to impose uniformity and minimum standards in the delivery of some services. Conditional grants of this type might be seen as moving the fiscal system part of the way toward decentralization: it gives the subnational governments more discretion than if they were simply spending agents of the center, but it gives the higher level government some control over the use of the funds.

On the other hand, there are also important disadvantages to conditional grants. From the point of view of subnational governments, such grants limit budgetary discretion and can lead to “unwanted” public investments. Examples abound of local governments being unwilling to maintain capital facilities that were heavily financed by central government cost reimbursement grants.

So, central fiscal planners are caught on the horns of an efficiency dilemma. They can stay with the conditional grant and trust that they can guess correctly on the external benefits, or they can give an unconditional grant to subnational governments and then deliver functions with big externalities through vertical programs. As we discuss below, this is perhaps the major policy choice that surrounds the use of conditional grants in developing countries.

Finally, the cost reimbursement approach imposes an administrative cost on the higher level government, which must monitor the program, and a compliance cost on the subnational governments that must do significant reporting on their use of funds and their adherence to standards. It is more cumbersome, and more costly to administer, than is either the shared tax or the ad hoc approach to vertical sharing.

## 4.12. The architecture of horizontal sharing

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### **The architecture of horizontal sharing**

Four methods of horizontal sharing are commonly observed: a derivation approach, a formula approach, a cost reimbursement approach and an ad hoc approach. Following our argument that the impact of a grant system depends on both the vertical and horizontal dimensions of grant design, we note 10 possible options for designing a transfer, as reported in Table 2. Eight of these ten types of transfer could be structured as conditional grants.

*The derivation approach* A Type A transfer, as shown in Table 2, is the “derivation approach” to revenue sharing. Under this approach, the total grant pool is determined as a share of a national tax, and each subnational government receives an amount based on collections of that tax within their geographic boundaries. For example, 25 percent of value-added tax collections in China are allocated to the subnational government sector, and the allocation is made according to amounts collected inside the boundaries of each regional government. It is important to note that this is an intergovernmental transfer and not a local tax, because the subnational government has no control over the tax rate or the tax base.

The derivation approach is practiced widely among developing and transition countries, and there is much variation in the practice. Derivation-based sharing is a way for subnational governments with a stronger economic base to gain access to the more productive central taxes. In this regard, it might be thought of as an approach that is friendly to the economic development goals of decentralization. VAT, company income taxes, individual income taxes, and some of the productive excises are included in the sharing base in various countries. In other cases, the taxes shared on a derivation basis are more narrow-based and less productive. It would be hard to say that there is a “common” practice.

This approach to distributing intergovernmental transfers has some features that can be seen as positive or negative, depending on where one sits. First, derivation-based shared taxes are counterequalizing because the richer regions have the stronger tax bases and probably the strongest administrative machinery for

collection. The result is that, *cet. par.*, the disparities in taxable capacity between rich and poor regions will be widened under a program of derivation – based tax sharing. For example, Zhang and Martinez (2006) point out that 9 of China's 28 provinces collect 70 percent of income taxes.

Second, derivation-based transfers usually are unconditional and carry relatively few strings. Subnational governments do not get much choice about the level of revenue they receive, but they do have freedom in deciding on the expenditure of this money (unless expenditure mandates are also present in the intergovernmental financing system). On balance, derivation-based shared taxes probably lead to more accountability to local voters for the quality of local government expenditures than do conditional grants.

Third, derivation-based shared taxes might stimulate some increase in subnational government tax effort, because there is a link between the amount of tax collection in the local area and revenue accruing to the local government. The basic issue here is whether the subnational government has some discretion to affect the level of tax collections.

Fourth, derivation-based sharing should produce more certainty in local budgeting and fiscal planning than would most other forms of intergovernmental transfer. Subnational governments are in a position to forecast, with some accuracy, the year to year movements in revenue, and unless the central government changes the sharing rates, this enables a proper budget planning process to take place.

The administrative costs associated with derivation-based sharing are low relative to most other forms of transfer. Moreover, there usually are not significant compliance costs imposed on the subnational governments, because there are few strings attached. Nor does the central government need to monitor the use of the funds by the local government.

*Formula grants* A second common approach to the allocation of intergovernmental transfers among local governments is the formula grant. A formula grant uses some objective, quantitative criteria to allocate the pool of revenues among the eligible

subnational government units. The most common reason why governments move to a formulae-based distribution is to gain transparency in the distribution of grants. This creates a sense of fairness in that all know the exact criteria by which distributions are made. In short, formulas are meant to limit the higher level government's discretion in deciding how much revenue will be allocated to each local government unit.

Three types of formula grants are described in the schemes in Table 2: B, F, and I type grants. The *Type B* formula grants could be the most in step with the goals of decentralization, if the vertical shares are adequate in size and tied to growing tax bases. This would give subnational governments a dedicated claim on central revenues for an unconditional grant. Indonesia, the Philippines and Pakistan are examples of countries that adopted this form of revenue sharing, and in all three countries the base for sharing is total tax revenues. The transfers in these cases and under most similar systems are unconditional.

The other two types of formula grants are more limiting to subnational government discretion. *Type F* grants (ad hoc vertical sharing) give the higher level government maximum discretion in setting a high or low vertical share and determining whether the grant will be conditional or unconditional. *Type I* formula grants will be conditional and are likely to reflect central government priorities and standards for local public services. Certain social service grants in Latin America are structural in this fashion (Diaz-Cayeros, Gonzales, and Rojas (2006).

#### **4.13. Cost reimbursement - conditional grants**

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Arguably the most common form of conditional grant is a cost reimbursement grant (*Type C, G, K*). Irrespective of the way that the vertical sharing is arranged, these grants imply some action by the subnational government as a condition of receiving the funding. In most cases, they are structured to reduce the cost of providing a particular service, though there are other forms of conditions as well.

A Type C grant would fix the vertical share as an entitlement, based on a share of national tax collections, and then specify the

use of the grant money. For example, in some Latin American countries, a specified share of natural resource taxes are shared with subnational governments but distributed on a conditional basis (World Bank, 2005). The vertical share for earmarked education grants in Argentina is a fixed percentage of national taxes, and distribution is made by subnational government payrolls in the education sector. The major advantage of this approach is the strong guarantee that the grant money will flow and that it will grow with the economy.

The K-type conditional grant (entitlement programs) may be protected by statute in terms of the vertical share, whereas the G-type conditional grants (ad hoc vertical sharing) rely on an annual allocation from the budget. In both cases, however, these can be thought of as sectoral ministry programs in terms of the objectives, conditionalities and monitoring.

The horizontal sharing arrangement for conditional grants typically has three features. First, the higher level government specifies the functions on which the money will be spent, i.e. the grants are conditional. Hence the local tax price associated with delivering that function is lowered vs. a situation where there is no grant support. Second, the degree of cost sharing may be specified, i.e. the grant may carry a matching requirement. Third, standards of performance, construction, employee qualifications, etc., may be part of the conditionality in these grants.

Conditional grants raise two more general problems. First, they can impose quite large compliance costs on recipients in the form of reporting on the disposition of the funds. At its simplest level, this might involve no more than reporting that the grant money was spent under certain budget heads. At its more difficult level, compliance may require reporting and verifying that expenditures were made on specific budget subheads, certifying that expenditures were made only on eligible projects within the local government area, providing information on contractual arrangements, etc.

Second, conditional grants can be problematic if they are not coordinated. Most conditional grants are the responsibility of a particular sectoral ministry, and in many cases there is insufficient

communication across ministries. Sometimes, regional and local (elected and or appointed) bodies are formally established to plan and coordinate, but the success record here is variable.

The use of conditional cost reimbursement grants, and their rate of success in achieving their objectives, varies widely around the world. Countries seem to tailor their conditional grants to control subnational government spending patterns in a way that satisfies national priorities and political objectives. There is also some evidence of regional copycat patterns.

In Latin America, many countries dedicate a portion of national taxes to specific expenditure categories. More recently, there are calls in many of the countries to loosen the conditions so that subnational governments can have more discretion to meet particular local needs. Among the industrial countries, Japan uses a system where national disbursements are earmarked for a number of specific expenditure categories.

Some conditional grants are designed with numerous conditions, over and above earmarking, to assure the achievement of specific objectives. India's rural employment program has the twin goals of providing wages to the rural poor and implementing public infrastructure projects in these areas. The grants are matching, earmarked for this program, and the services are delivered by rural local governments. However, there are some stringent conditions, such as the eligibility requirements for workers and the prohibitions against using contractors and capital equipment.

#### **4.14. Ad hoc distributions**

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The horizontal sharing of the total grant pool for conditional grants may be ad hoc (*Types H, J*). That is, each year the higher level government will decide how it will distribute grants among eligible local governments. This is not an uncommon method for allocating capital grants among local governments. The most centralizing version of this form of grant is when both the grant pool and the distribution are determined on an ad hoc basis. A popular method of making ad hoc allocations is for subnational governments to "request" projects and for the higher level government to choose those that will be funded. This is a variant on the cost

reimbursement approach. Whereas conditional grants distributed under a reimbursement approach tend to be programmatic and have defined entitlements, those distributed under an ad hoc approach do not. Under a reimbursement program, parliament would appropriate a pool of funds to be spent on specified projects, but would distribute the funds on some subjective basis or would direct that the line ministries do so.

By almost all standards of a “good” intergovernmental transfer, ad hoc grants fail. They are not transparent, compromise local fiscal planning because they fluctuate significantly from year to year, and probably would not be driven by clearly stated objectives such as revenue mobilization or equalization.

One can point to some advantages of ad hoc transfers. From a point of view of the central government, these grants are “controllable” and are flexible enough to reflect the changing priorities of the center. They might also allow the government to move through a transition period from one grant system to another without disrupting service delivery. Moreover, they might be structured to impose little administrative costs, i.e. no formulae, no conditions, etc.

There are many examples of the use of ad hoc methods of distribution, though no two approaches seem to be the same. In Brazil, social contribution grants are distributed among subnational governments by ad hoc negotiations, but conditions are attached to the use of these funds (Rezende and Afonso, 2006). All annual grants to local governments in Thailand are distributed on an ad hoc basis (Weist, 2003). Both current and capital grants are distributed on an ad hoc basis in Nigeria (1999). Ad hoc grant programs tend to be popular in smaller countries where the central government feels that it has a good sense of needs at the local level or where data to support a formula approach are not available. Jordan and Malawi are examples.

#### **4.15. Conclusions and summary**

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Conditional vs. unconditional grants from higher to lower level governments is a choice that is driven by a nation’s vision about its governance. The more the vision includes subnational

governments as being responsible for delivery of basic services, and for the allocation of public financing activities, the more the choice will tilt toward local government taxation or unconditional grants as financing instruments.

The case of developing countries is different, and the conditional/unconditional grant choice is arguably more difficult than in the industrial countries. Administrative constraints of subnational governments in low-income countries limit the possibilities for general taxation and raise questions about the service delivery capabilities of these subnational governments. Moreover, there are macroeconomic considerations, i.e. central government misgivings about increased revenue mobilization powers at the local level and a fear that subnational governments would direct expenditures away from high priority national goals. By comparison with most of the OECD member countries, developing countries have an unfinished public infrastructure, a low rate of revenue mobilization, and a high level of inter-regional fiscal disparities. The problems of designing an intergovernmental transfer system are qualitatively different.

There is no comprehensive survey available to help identify an international trend toward one or another form of transfer. Moreover, “conditional” and “unconditional” grants are general terms that refer to a variety of different approaches to intergovernmental transfers. The vertical and horizontal arrangements that are used to share central revenues result in a number of grant types with different impacts. This makes it very difficult to generalize about the advantages and disadvantages of conditional vs. unconditional grants.

Many countries have adopted revenue sharing arrangements that feature unconditional transfers where the subnational governments have discretion over how the funds will be spent. These systems feature an entitlement to a share of national tax collections and often are distributed on a formula basis.

At the other extreme are various forms of conditional grants with earmarks and matching provisions laid down at the central level. In some cases, the conditional grants give the subnational governments an entitlement in terms of both guaranteed funding

and a formula distribution. In other cases the funding and the distribution among recipients is ad hoc.

The conditionality provisions vary greatly across countries. In some cases, it is a cost recovery and earmarked for a particular function. In other cases the restrictions that go with the grant are detailed and involve significant compliance costs. Central governments argue that the conditions are necessary to ensure efficient expenditure of the funds, but subnational governments often see it as a harmful encroachment on local autonomy and a challenge to the objective of fiscal decentralization.

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# Chapter 5

## General grants vs. earmarked grants: Does practice meet theory?

Junghun Kim

### 5.1. Introduction

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Intergovernmental grants are important revenue sources for local governments. In many OECD member countries, the amount of intergovernmental grants makes up more than 40 per cent of local government revenue. Even for countries that rely less on intergovernmental grants, the economic and political effects of intergovernmental grants are significant. As a result, the optimal design of intergovernmental grants has been an important issue in the field of fiscal federalism. Especially the choice between general grants and earmarked grants has long been an important practical and theoretical issue.

In the economic literature, the theoretical view on this issue is not clear-cut, but it can be said that both general grants and earmarked grants play their own roles in efficient and equitable resource allocation. Generally speaking, an earmarked matching grant is desirable in the case where a local government's activity generates spillover benefits for other local governments. On the other hand, the principle of subsidiarity supports the use of general grants to allow local governments to have as much an independent decision-making power as possible. Also, general grants are more appropriate than earmarked grants for filling the fiscal gap between the spending responsibilities and taxing powers of subnational governments. In short, theoretical studies on the design of intergovernmental grants imply that general grants and earmarked grants are necessary for both efficient resource allocation and redistribution.

Despite the theoretical results, however, there is a general tendency in policy debates to favor general grants over earmarked grants. The European Charter of Local Self-Government (the European Charter) is a well-known example of this, as Article 9 of the Charter stipulates that earmarked grants should be avoided as much as possible. Given the status of the European Charter, the outright advocacy of general grants over earmarked grants has significant policy implications not only in the EU member countries but also outside the European region. However, it is also worthwhile to note that there is a distinctive discrepancy between the position of the European Charter and the implication of the fiscal federalism literature.

In the policy field, the influence of the European Charter seems strong in many countries. The Nordic countries launched reforms to transform many earmarked grants into block grants (general grants) during the 1980s and 1990s. In the UK, the size of general grants was predominantly larger than that of earmarked grants (ring-fenced grants) until 2007.<sup>48</sup> In Italy, the 2001 constitutional reform of intergovernmental fiscal relations clearly shows the country's preference for tax sharing and general grants over specific grants. Federal countries such as Germany, Austria, Australia, and Belgium have a system of tax sharing as a major source of subnational government revenue, which is a kind of formula-based general grant in the sense that it contains equalization components. In Korea and Japan, although both general grants and specific grants are important revenue sources for local governments, there has always been a tendency to try to transform specific grants into general grants or tax sharing.

This apparent trend, however, needs to be interpreted with caution. The size of earmarked grants in Sweden is almost as large as that of general grants despite the fiscal reforms in the 1990s. In Norway, the size of earmarked grants is about 50 per cent of general grants, but still plays an important role as a central government fiscal tool in controlling local tax rates (Borge, 2004). In Korea and Japan, the size and number of specific grants are

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<sup>48</sup> In 2007, a ring-fenced education grant, the Dedicated Schools Grant, was introduced, and the balance between general and earmarked grants shifted significantly toward the latter.

large despite extensive efforts to reduce them. In the United States, federal revenue sharing was abolished long ago, but specific grants are widely used. In the UK, the amount of ring-fenced grants is now larger than that of general grants, as a result of the introduction of education block grants in 2007.

To conclude, general grants are a preferred type of intergovernmental grants in many countries, but it is also true that earmarked grants play an important role as well. The question is then why we have contradicting attitudes in the choice of intergovernmental grants: on the one hand, general-purpose grants are advocated as a better form of intergovernmental grants; on the other hand, earmarked grants are widely used.

In this paper, practical and theoretical factors that affect the form of intergovernmental grants are discussed based on international comparison studies and a literature survey. In general, the principle of subsidiarity supports simple and transparent formula-based general grants. However, there is a trade-off between the principle of subsidiarity and equitable and efficient redistribution. As a result, earmarked grants are used in many countries to provide redistributive public services and efficient redistribution. Also, since standard levels of redistributive public services are monitored or guaranteed by the central government even in cases where such services are financed by general grants, the dividing line between general grants and earmarked grants is not very clear.

The paper is organized as follows: in the following section, the history and the institutions that affect the design of intergovernmental grants are discussed. In section 3, I review the key literature on the choice between general grants and earmarked grants. The theoretical implications on the balance between general grants and earmarked grants are also discussed. Section 4 concludes.

## **5.2. Evolution of intergovernmental grants systems**

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### **5.2.1 Sweden**

As discussed in Schwarz (2001) and Hermansson (this volume), the size of specific grants in Sweden was much larger than that of

general grants up until 1993. That year, a major reform was introduced to transform many specific grants into general grants. As a result, the share of specific grants in local government revenue fell from 19 per cent in 1992 to 7 per cent in 1993. By the late 1990s, however, the number of specific grants rapidly grew again. As a result, the average share of specific grants in local government revenue was larger than that of general grants during the early part of this decade. Only very recently, the size of general grants has become larger than that of specific grants.

Another interesting feature of intergovernmental grants in Sweden is that according to Schwarz (2001), the general grant before the 1990s was an open-ended matching grant. This is because general grants in Sweden before the 1990s were determined as the product of the local tax rate and the 'guaranteed tax base', which was larger than the actual tax base. This was due to the fact that an increase in the local tax rate accompanied by a reduced tax base was subsidized by the central government which, for the purpose of the distribution of general grants, used a guaranteed tax base that was above the average tax capacity. Naturally, the rapid expansion of the local public sector continued until major fiscal consolidation reforms took place in the 1990s.

The historical observation of the Swedish intergovernmental grants system can be summarized as follows: Firstly, contrary to the general expectation, the role of specific grants has never been negligible even after the 1993 local finance reform that consolidated specific grants into block grants. Secondly, the reforms that transformed specific grants into block grants were prompted by the need to consolidate the fiscal position of the central government rather than the need to enhance local government fiscal decision-making power. Thirdly, the fact that the general grant was a kind of open-ended matching grant does not quite fit the textbook definition of intergovernmental grants. In Sweden, general grants before the 1990s not only had an income effect but also a price effect that stimulated local taxation and spending.

The fact that Sweden's general grants had the characteristics of an open-ended matching grant raises a question as to the role of general grants. As Boadway (2001) notes, major public services in

areas such as health, education and welfare constitute a substantial component of public sector budgets and are highly decentralized in many countries. In this case, even if the provision of such public services is financially assisted by general grants, it is unlikely that, given the redistributive nature of such public services, the central government does not control local budgets for such public services. If minimum standards of public services are mandated, as would be very likely in the case of health care, education and welfare programs, the dividing line between general grants and earmarked grants becomes quite blurred.

### **5.2.2 United Kingdom**

In the case where redistributive public services are jointly provided by central and local governments, general grants that support the provision of such services often take the characteristics of categorical block grants. The case of education in the UK is a good example. The UK's standard cost of local education was one component of a general grant (Revenue Support Grant) until 2007. But the question whether local governments actually spend the full amount of education RSG has been controversial for a long time, and a so-called "named and shamed" policy was applied to make general grants have an effect similar to that of earmarked grants.<sup>49</sup> Concerning the area of education, however, England has decided that the strategy of "named and shamed" is not sufficient to align central government grants with local government expenditure, and an earmarked grant for education (Dedicated Schools Grant) was introduced in 2007.

The historical observation of the evolution of England's education grants shows that there is a fundamental trade-off between local choice and the center's desire to control a minimum level of important public services. On this matter, Lyon's report (2007, p. 84) takes a critical view of earmarked education grants by stating that it reduced the scope of local authorities to prioritize and

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<sup>49</sup> "... recent trend has been for at least some Government Departments and their Ministers to make it absolutely clear that they expect the full amount of any increase in SSA for "their" service area to be passed on in full to that service. Councils which have failed to do this have been "named and shamed" by Government Departments in some cases. There is therefore a good deal of pressure to pass on SSA service increases in full to their respective service areas." (North Yorkshire County Council, Corporate Policy Committee, 2000).

manage pressures between different public services. But that is exactly the intention of the central government, which criticized local governments for not spending enough fiscal resources on education. Given that the central government had monitored the level of local education expenditures tightly even under the system of general grants, there might not be much difference between the old and new systems. But the example indicates that the choice between general grants and earmarked grants depends on a society's value judgment on the level of merit goods such as education, and it changes with the political environment.

### **5.2.3. Italy**

In 2001 a major fiscal reform took place in Italy that replaced most intergovernmental grants with local tax revenue, especially VAT tax sharing. This implied that the provision of public services in Italy became much more decentralized than before. However, the provision of healthcare, the most comprehensive and important subnational expenditure item, was largely an exception since the revised constitution designated healthcare as an "essential" public service (Brosio and Piperno, 2008; Arachi and Zanardi, 2004). With respect to essential public services, subnational governments are required to provide those up to a specified level in terms of quality and quantity. According to Arachi and Zanardi (2004, p. 345), the VAT sharing rate was adjusted in 2001 to guarantee fiscal resources to finance the sum of all regions' standardized health needs. Thus in the case of healthcare in Italy, tax sharing essentially plays the role of categorical block grants since the main responsibility of regional governments is healthcare, and their main revenue comes from VAT sharing.

### **5.2.4 United States and Canada**

The case of the United States is quite different from the countries discussed above. As is well-known in the local public finance literature, the US does not have general grants or tax sharing, and specific grants are widely used to financially support subnational governments.<sup>50</sup> Therefore, the US takes a position completely opposite to that of the European Charter with regard to the balance between general and earmarked grants. In principle there

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<sup>50</sup> According to the Catalogue of Federal Domestic Assistance (CFDA), the number of federal assistance grants was close to 2,000 in 2008.

may be a good economic reason for this, but, as Inman (1988) notes, only a part of the US system of federal grants can be explained by the standard efficiency and equity arguments provided by the fiscal federalism literature.

Some efforts have been made in the US to transform specific grants into categorical block grants. In the early 1980s, several block grants were created by combining similar types of specific grants.<sup>51</sup> An important recent case of this type of change was the transformation of the Aid to Families with Dependent Children (AFDC), an open-ended matching grant, into the Temporary Assistance to Needy Families (TANF), which is a categorical block grant. As discussed in Baker, Payne and Smart (1999), a similar change took place in Canada where the Canada Assistance Plan (CAP), originally an open-ended matching grant, was changed into a closed-ended matching grant and then finally into a block grant. It should be noted that the purpose of these transformations of specific grants into block grants was not to increase subnational governments' decision-making power. As is criticized in Quigley and Rubinfeld (1997), the main reason for introducing the TANF as a block grant was to reduce the fiscal burden of the federal government.

### **5.2.5. Implications of international experience**

The history and institutions of intergovernmental grants systems of European and North American countries suggest the following implications. First, in the area of redistributive public services, explicit or implicit categorical block grants are widely used as a means to financially support subnational governments that provide such services. Second, the textbook definition of intergovernmental grants often does not match the implementation in practice. In the case of general grants and tax sharing, many implicit controls make such grants virtual earmarked grants. As for specific grants, matching grants are very often closed-ended rather than open-ended, as pointed out by Oates (1999). Therefore, in many cases, price effects are absent in the system of specific matching grants. Third, because of the blurred dividing line between different types of intergovernmental grants, the statistical data on

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<sup>51</sup> In the US, block grants mean categorical block grants, while in the Nordic countries block grants mean general-purpose grants.

intergovernmental grants used for international comparison have limitations. In particular, there is a limitation in understanding the exact nature of the balance between general and earmarked grants from the cross-country statistical data.

### **5.3. Balance between general and earmarked grants: literature review**

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#### **5.3.1 Efficiency argument for matching grants**

In the literature on fiscal federalism, the optimal design of intergovernmental grants has been studied for a long time, but it is still an evolving subject, as can be seen from recent studies such as those of Oates (2005, 2008) and Weingast (2009). The seminal works that have established the traditional view of intergovernmental grants are Buchanan (1950, 1952), Oates (1972), Flatters et al. (1974), and Boadway and Flatters (1982). These works have developed the concepts of fiscal equity and fiscal externality and has laid the theoretical foundation of intergovernmental grants.

In Boadway (2004, 2007), the cases where intergovernmental grants make inter-regional resource allocation efficient are well explained. The reason why intergovernmental grants can be efficiency-enhancing is basically because the migration of labor and capital across local governments creates fiscal externalities. In such cases, inter-regional transfers that internalize such externalities are efficient. For example, in the model considered by Boadway and Flatters (1982) and Boadway (2004), fiscal externality arises as a result of the difference between a migrant's tax payment and the marginal cost of public goods provision. If there is no congestion effect in the provision of public goods, the difference in fiscal externality depends on the difference in the migrant's tax payment, which in turn depends on, for example, the amount of resource rent in local governments. In such cases, intergovernmental grants that neutralize the differences in resource rent across local governments prevent inefficient fiscal migration. It should be noted that the type of intergovernmental grants that internalize fiscal externalities is general grants, since the objective is to equalize fiscal capacities of local governments rather than to stimulate provision of a particular type of public good.

Another classic model that deals with efficiency-enhancing intergovernmental grants is that of Wildasin (1991). In this model, redistribution is a local public good that arises because the rich in a locality (state) are altruistic toward the poor living in their state. Since it is assumed that the poor are mobile across states, redistribution toward the poor in a state attracts welfare migration from outside. This means an additional burden of redistribution to the rich. As a result, the level of welfare benefits chosen by the rich in each state is lower than the optimal level that would be chosen without the fiscal externality. In this situation, federal matching grants that support the state's welfare program enhances efficiency by raising the level of welfare benefits in each state to the optimal level.

The type of intergovernmental grants in Wildasin's model is open-ended matching grants that provide a subsidy to raise the level of benefits per mobile household, but also increase in proportion to the number of beneficiaries (Wildasin, 1991, footnote 14). The AFDC welfare program in the US, cited in Wildasin (1991), did have this property, so at that time the US welfare policy was in conformity with Wildasin's model. However, the AFDC was changed to the TANF, a categorical block grant, during the 1990s. From an economic theoretical point of view, this change is undesirable since it will lead to a race to the bottom, or more accurately a downward bias in welfare benefits. So although the Wildasin model has attracted much attention in the theoretical literature<sup>52</sup>, it does not seem to have as much impact on the design of intergovernmental grants in the real world.

The key mechanism that makes a block grant undesirable in the Wildasin model is welfare migration. Brueckner (2000) addresses this issue and finds empirical evidence that a state's perception of welfare migration creates a downward bias in benefits. So he concludes that the demise of matching grants may be undesirable from a policy perspective. Brueckner makes several qualifications, however, that suggest that the switch from open-ended matching grants to a block grant might not be too problematic. First, a block grant can induce more flexibility and innovation at the state level.

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<sup>52</sup> See Dreze et al. (2007).

Second, the magnitude of fiscal externality and the matching rates of the matching grants can be negligible. More fundamentally, they are too difficult to estimate to be implemented in a policy. Third, due to the flypaper effect, block grants can have a stimulative effect. Fourth, institutional constraints such as eligibility have much stronger effects than the form of intergovernmental grants. Bruecker also notes an important disadvantage of a block grant for welfare programs, which is that it is insensitive to a recession-induced rise in unemployment.

### **5.3.2. Local redistribution: general grants vs. earmarked grants**

Having an efficient system of intergovernmental grants is not just a theoretical issue since it has an important impact on the real economy. However, as discussed in Oates (1999) and Boadway (2004, 2007), interregional transfers in the real world are primarily justified on equity grounds. Since vertical equity can be more effectively addressed by the central government, the notion of equity that has relevance for intergovernmental grants is mainly about horizontal equity, which is defined as the equal treatment of equals by the public sector throughout the nation. A difficult issue, however, arises when the central government tries to apply the concept of horizontal equity on a nationwide basis. According to Boadway (2004), horizontal equity implies that "all regions must not only have the resources to apply national standards of redistribution, but they must actually apply them." As a similar but more practical concept, Boadway suggests the notion of *fiscal equity* under which "the role of equalization transfers is to provide regions with the resources that would enable them to meet national standards of redistributive equity if they so chose, but does not compel them to do so."

Since the main reason intergovernmental grants exist in the real world is redistribution, the concept of fiscal equity suggested by Boadway has an important implication for the type of intergovernmental grants. Intergovernmental grants that fiscally support but do not compel local governments to meet national standards of redistributive equity are clearly general-purpose grants. But as Boadway (2001, 2004) recognizes, there is a fundamental conflict between the notion of horizontal equity that emphasizes the nationwide standard of redistribution, and that of fiscal equity under which the ultimate decision-making on

redistribution is left to local governments.

In a sense, the evolution of intergovernmental grants systems in many countries discussed in the previous section reflects the fundamental conflict between horizontal equity and fiscal equity. In deciding the method to finance important redistributive public services such as education, healthcare and welfare programs, the pendulum has historically swung back and forth between these two concepts in most of the countries. In the UK, the recent introduction of the Dedicated Schools Grant, a ring-fenced education grant, was the result of a long conflict between fiscal equity and horizontal equity. Similarly, the tension between the two concepts is affecting the way healthcare is financed in Italy. In Korea, there was an effort in 2005 to decentralize the provision of welfare programs, and specific grants for some of these programs were transformed into categorical block grants. But this has been met with strong criticism that such a change has considerably weakened welfare programs.

In evaluating the roles of general grants and earmarked grants in the provision of public services, another issue that needs to be noted is that in some countries like Italy and Denmark, the main responsibility of regional governments is healthcare. In this case the difference between tax sharing, block grants, and earmarked grants is quite small since there is not much competition between different types of public services at the regional level. That is, no matter whether the major financial resource for healthcare is VAT tax sharing as in Italy or block grants as in Denmark, they are not much different from earmarked grants to the states in the US and Canada. Given that money is fungible, there is a possibility that categorical block grants for healthcare provided to the states in the US or Canada are used to provide other types of public services. On the other hand, regional governments in Italy or Denmark use the revenue from tax sharing or general grants as if it is earmarked to healthcare. In this sense, the division between earmarked and general grants is very much blurred when subnational governments provide very few or a single type of public service.

### **5.3.3 Political economy**

In the previous discussion on general and earmarked grants, the focus of the analysis was on redistributive public services such as

health, education and welfare programs that are provided by subnational governments. As Boadway (2007, p. 57) argues, this approach is distinguished from the classical view of fiscal federalism, in which the central government has sole responsibility for redistribution and subnational governments provide local public goods.<sup>53</sup> Therefore, in the classical view, the main role of intergovernmental grants is to internalize spillover effects of local public goods, which in turn implies that matching grants are needed for such a purpose.

As Boadway explains, this classical view does not accurately depict the actual role of subnational governments in many advanced countries. The local governments in most OECD countries share the responsibilities of providing redistributive public services with the central government. Since the expenditure on redistributive public services dominates that on public goods in these countries, the classical view of the role of local governments has a narrow range of application in understanding the intergovernmental fiscal relations of many advanced countries. As Boadway argues, the spillover managing role of grants is of limited relevance in a mature, decentralized system.

Even if the main role of intergovernmental grants is to provide redistributive public services rather than to internalize externalities, this does not, however, fully explain the reason why the European Charter one-sidedly advocates general grants over specific grants. The recent literature on political economy of fiscal federalism seems to provide some answers to this question.<sup>54</sup> The main issue relevant to our discussion is how political economy factors affect the balance between general and earmarked grants. According to the political economy literature, pork barrel politics and rent seeking lobbying activities seem to have important implications for the desirability of specific grants. Pork barrel politics refer to the efforts of politicians to use central government grants to strengthen their own political positions. As a result of

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<sup>53</sup> According to Bewley (1981), local public services refer to publicly provided private goods, and local public goods refer to public goods that exhibit economies of scale.

<sup>54</sup> In Sato (2007), many political economy aspects that influence the system of intergovernmental grants are discussed.

pork barrel politics, a disproportionately large amount of central government grants can be provided to swing districts or used to build cohesion within governing legislative coalitions (Milligan and Smart, 2005). Therefore, grants distribution affected by pork barrel politics is neither efficient nor fair. Lobbying activities by local governments to gain more grants from the central government have the same implication since they reinforce pork barrel politics.

If pork barrel politics and rent seeking are important issues in designing the system of intergovernmental grants, it seems reasonable to make an effort to minimize specific grants, which are usually discretionary and therefore more susceptible to pork barrel politics than are formula-based general purpose grants. Recent studies on this issue seem to provide some empirical evidence to support this view. Solé-Ollé and Sorribas (2008) find evidence of pork barrel politics in the distribution of specific project grants in Spain; Leigh (2008) finds evidence of pork barrel politics in the distribution of discretionary programs in Australia; and Cadot et al. (2006) find that lobbying activities influence the regional distribution of infrastructure spending in France.

Although the evidence found seems to support the European Charter's position that favors general grants over earmarked grants, it should be noted that there are views, especially in the Nordic countries, that formula-based block grants are also susceptible to distributive politics. In empirically investigating the influence of distributive politics on intergovernmental grants in Norway, Sorensen (2003) implicitly assumes that the distribution of the total amount of both block grants and specific grants is influenced by distributive politics. Johansson (2003) is more explicit about this approach. In Sweden, the largest share of intergovernmental grants is distributed by civil servants to municipalities according to detailed regulations. Therefore, political parties lack the opportunity to distribute grants according to tactical considerations. However, Johansson argues that parties can influence the rules of grants distribution, and therefore formula-based block grants are also susceptible to distributive politics.

### **5.3.4. Budget Control**

Casual observation of the changes in the intergovernmental grants systems in many countries indicates that one of the reasons for such changes was the center's effort to reduce the budgetary burden of intergovernmental grants. As was criticized by Quigley and Rubinfeld (1997), the main motivation for transforming the AFDC, an open-ended matching grant, into the TANF, a categorical block grant, was to reduce the budgetary burden of the federal government. Also, the fiscal reforms in the Nordic countries that transformed specific grants into general grants took place during the 1990s, when the economic crisis hit the Nordic countries.

As Oates (1999) observes, most matching grants are in practice closed-ended rather than open-ended. Since the effect of closed-ended matching grants is similar to that of categorical block grants, this aspect is not easily explained by traditional economic theory. In Huber and Runkel (2006), the issue is investigated, and it is argued that the use of categorical block grants is a second-best policy required by the self-selection constraint of contributing regions under the environment of asymmetric information. Intuitively, the closed-ended matching grants, which induce receiving regions to oversupply a certain type of public service, make interregional redistribution unattractive enough for contributing regions not to have an incentive to mimic the receiving regions.

The analysis by Huber and Runkel seems to have an interesting implication for the balance between general block grants and categorical block grants. As a budgetary device to control the central government's fiscal burden, categorical block grants can be a better choice than general grants from the second-best point of view, since the former make interregional redistribution not too attractive. If fiscal decentralization in a country relies too much on general-purpose grants or tax sharing with strong equalization components, an increased use of categorical block grants can be efficiency-enhancing as well as desirable on equity grounds.

## **5.4. Conclusion**

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In this paper, the intergovernmental grants system has been evaluated with a focus on the balance between general grants and

earmarked grants. The comparison of intergovernmental grants systems on an international level shows that, although the general grant is a favored type of intergovernmental grants, categorical block grants play an important role, if not the major role in financing subnational public goods and services.

In countries with mature, decentralized systems, subnational governments share the fiscal burden of financing redistributive public services such as healthcare, education and welfare programs with the central government. In terms of expenditure size, the subnational government's responsibility of providing such services dominates that of providing public goods that generate spillover effects. Because of this there is a fundamental conflict between a political demand for a standard level of redistributive public services and the principle of subsidiarity emphasized in the European Charter. There is no clear-cut answer to this question, but in many countries, explicit and implicit types of categorical block grants are used to strike the balance between standardized redistribution and the principle of subsidiarity.

The literature on political economy of fiscal federalism, on the other hand, seems to provide good reason to favor general grants. The theoretical and empirical literature on pork barrel politics and rent seeking activities shows that specific grants are both inefficient and inequitable. Since specific grants are arguably more susceptible than formula-based general grants to lobbying activities, advocacy of general grants can be interpreted as an effort to minimize pork barrel politics and rent seeking. But it needs to be noted that in some literature on distributive politics in the Nordic countries, general grants as well as specific grants are regarded as susceptible to distributive politics.

Among the many factors that affect the form of intergovernmental grants, the central government's budgetary concern appears to be an important reason that has caused open-ended matching grants to be transformed into general grants or categorical block grants. Then there is the question whether general grants or tax sharing with equalization is a better device for budget control than are categorical block grants. Since the latter make interregional redistribution reasonably unattractive to contributing regions, categorical block grants can be the second-best efficient and

equitable alternative. This view has important implications for the countries in which interregional redistribution is based on a large amount of general grants or tax sharing.

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# Chapter 6

## Intergovernmental grants in OECD countries: Trends and some policy issues

Hansjörg Blöchliger and Camila Vammalle

### Introduction

Intergovernmental grants make up around one half of total tax-plus-grants revenue of sub-central governments (SCG) in OECD countries on average. Earmarked grants in turn represent around 50 per cent of total grants. The first section of this paper describes the grant systems and the grant structure in OECD countries and analyses how they have evolved between 1995 and 2005. The second section analyses the distinction between earmarked and non-earmarked grants in OECD countries and how they have evolved over the last decade. The third section deals with a number of policy issues related to the intergovernmental grants system: their different purposes and potential side effects<sup>55</sup>.

### 6.1. Intergovernmental transfers: level and evolution

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*The system of intergovernmental grants has grown in more than half of the OECD countries over the last decade...*

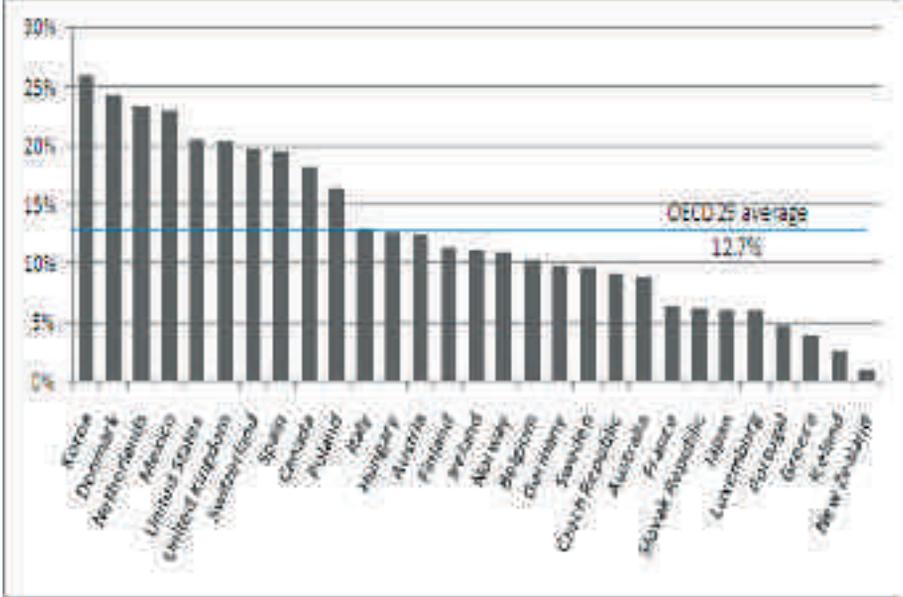
Between 1995 and 2005, the average ratio of transfers to total government spending grew steadily and regularly in around two-thirds of the OECD member countries. Year-on-year increases of the transfer share were much more frequent than reductions. Today, the share of sub-central transfers in total government expenditure varies between 26% (Korea) and 1% (New Zealand), with an average of around 13%. Federal countries have a higher

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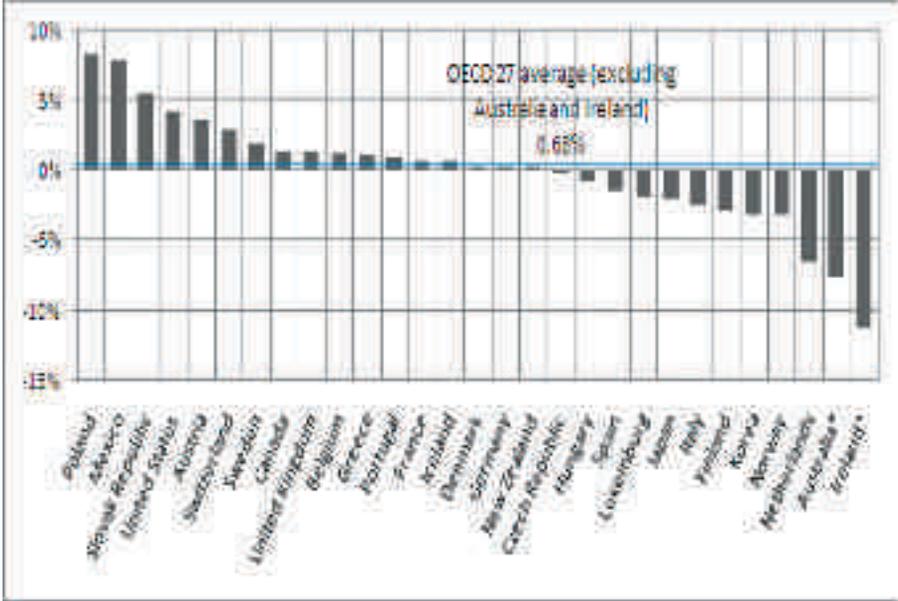
transfer-to-government expenditure ratio than unitary countries, partly because there are more government levels disbursing grants. Grants have largely covered the growing fiscal gap of the 1995 to 2005 decade, acting as a main policy lever in the decentralisation process and determining the balance between the two SCG fiscal resources.

**Figure 1. Share of transfers in total government expenditure, 2005**



Source: OECD National Accounts

**Figure 2. Change in transfers to total government expenditure, 1995-2005**



Source: OECD National Accounts, \* the apparently strong reduction in Australia’s and Ireland’s transfer systems is mostly due to a change in accounting practices.

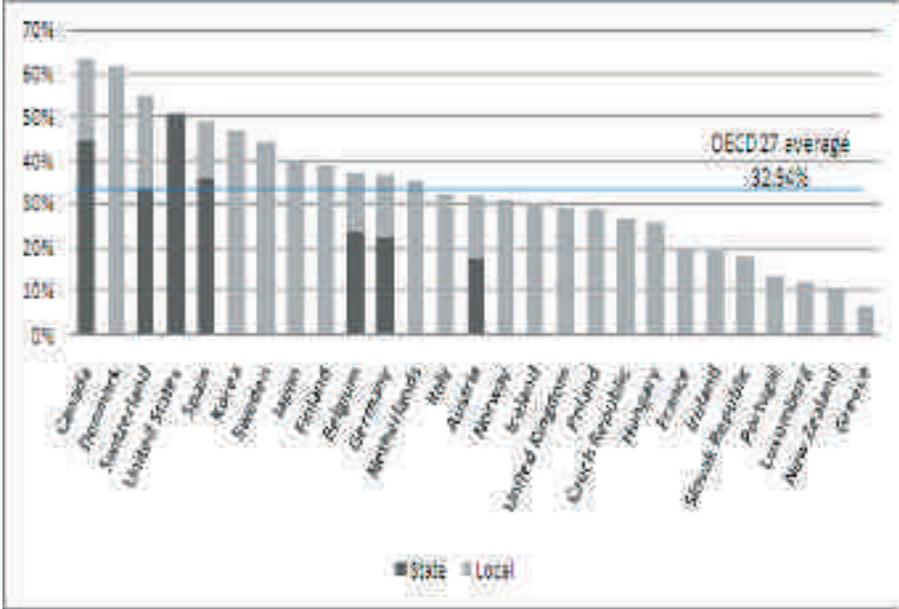
*... due to a clear decentralisation trend in spending ...*

While the ratio of SCG to total expenditure varies strongly across OECD countries (61% for Canada, 5% for Greece), between 1995 and 2005 the average ratio increased from less than 31 to almost 33%. Only in Ireland, Japan, the Netherlands and Norway did the sub-central spending share decrease significantly. In most countries, SCG spending growth was regular and steady, with some countries showing sharp increases close to or above 10 percentage points – such as the Czech Republic, Finland, Poland, the Slovak Republic, and Spain.

On average, federal countries have a higher SCG expenditure share (figure 3) and an above average growth rate (figure 4), even though the constitutional framework (federal or unitary) does not fully explain the pattern, as some unitary countries also show very high shares, and some federal countries have seen this share

decrease since 1995. Actually, simple expenditure ratios do not take into account the spending power, *i.e.* the capacity of SCGs to choose the level and composition of their spending.<sup>56</sup>

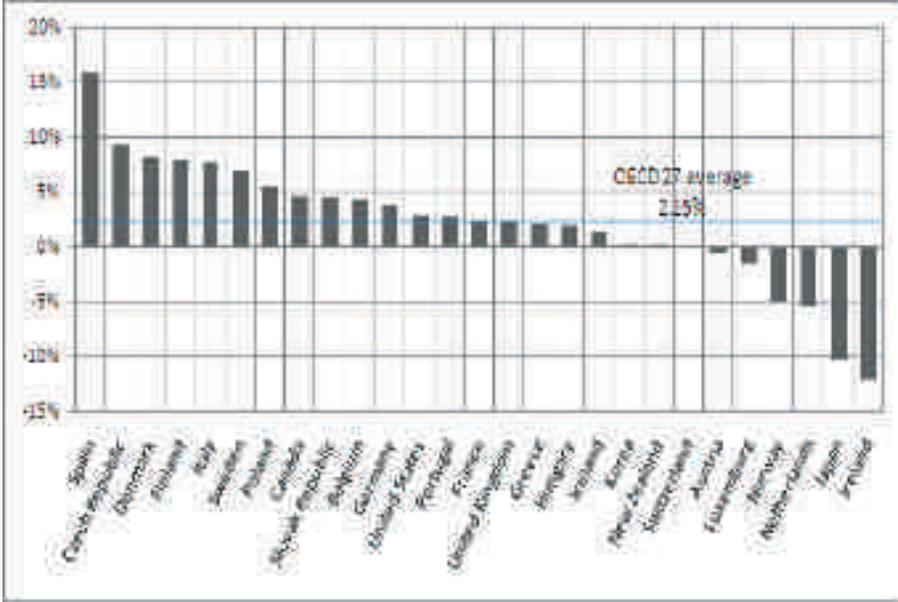
**Figure 3. SCG expenditure ratios, 2005**



Source: OECD National Accounts

<sup>56</sup> On the measurement of true spending power using institutional indicators, see Bach, Blöchliger and Wallau. (2009).

**Figure 4. SCG expenditure ratios, 1995-2005**



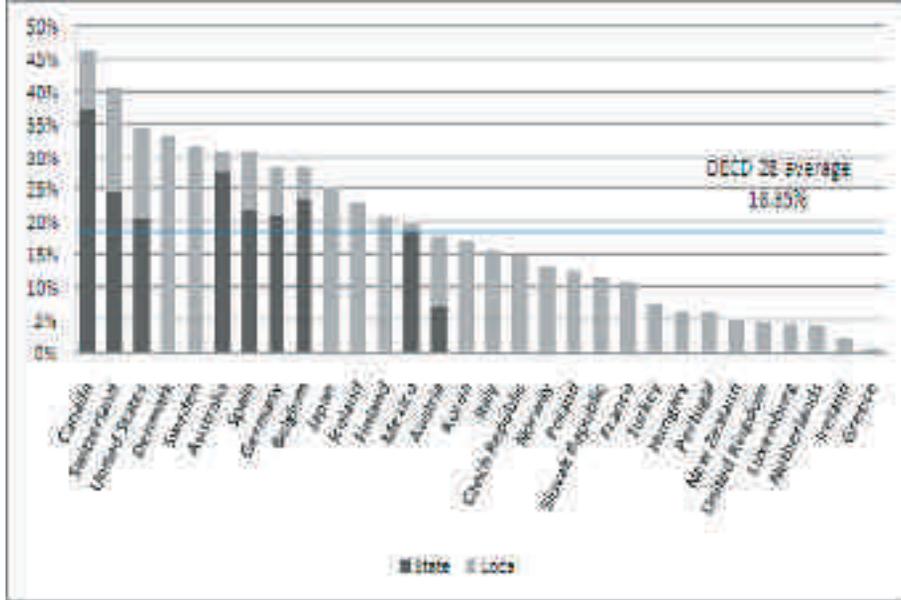
Source: OECD National Accounts

**... while tax decentralisation remained relatively limited.**

Unlike spending, tax revenues have almost not been decentralised to lower-level governments over the last decade (figure 6). The SCG to total tax share varies between 46% (Canada) and 1% (Greece), with an average tax share of 17% (figure 5). Federal countries grant a significantly higher SCG tax share than unitary countries (28 *versus* 13%). Between 1995 and 2005, the tax share rose slightly from 17 to 18% of total tax revenue, but this increase is mainly due to a few countries involved in secular decentralisation such as Hungary, Italy and Spain.<sup>57</sup> In all other countries, the sub-central tax share remained roughly stable or even decreased.

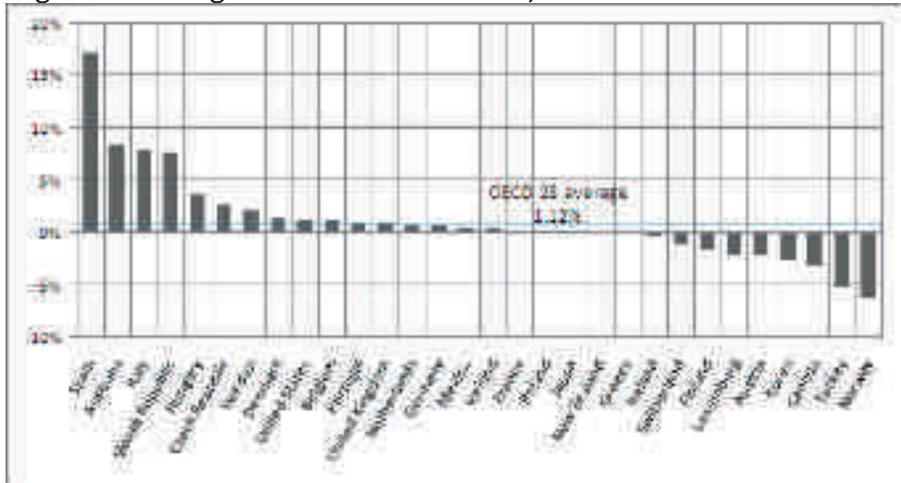
<sup>57</sup> Australia also shows a strong increase around the year 2000, but these numbers reflect a change in accounting methods following the introduction of the GST (Australian VAT) rather than a true expansion of SCG taxing power.

Figure 5. Tax revenue ratios, 2005



Source: OECD National Accounts

Figure 6. Change in tax revenue ratios, 1995-2005



Source: OECD National Accounts

Sub-central taxation appears to be a very stable feature of fiscal policy in general and in fiscal federalism in particular, with the taxing power of each government level often anchored in

constitutional provisions or fundamental laws on sub-central autonomy. While stable fiscal frameworks make potential tax revenue more predictable, the widening gap between sub-central spending and sub-central tax revenue requires finding additional SCG resources such as transfers.

## **6. 2. Earmarked versus non-earmarked grants**

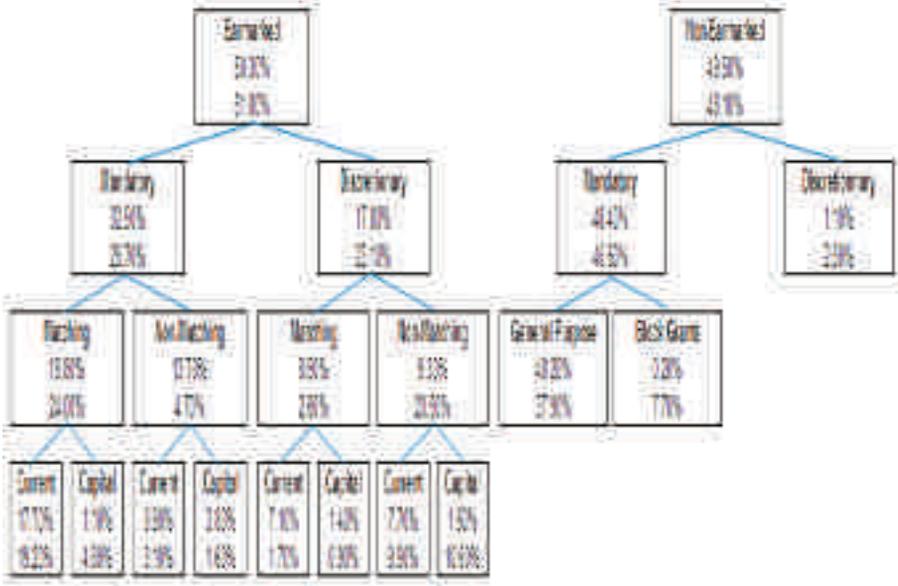
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Grants can be divided into many different categories, each type of grants serving different purposes and having different advantages and drawbacks. The main distinction in the assessment of sub-central fiscal autonomy is the division between earmarked and non-earmarked grants. The two categories can be further subdivided into mandatory and discretionary grants, which has different implications in terms of predictability of revenues for SCGs. Earmarked grants may be further subdivided into matching and non-matching grants, according to whether the transfer is linked to SCG own expenditure or not. This distinction has important consequences on sub-central incentives to spend. Finally, earmarked grants can also be subdivided between grants for capital expenditure and grants for current expenditure. Non-earmarked grants consist of block and general purpose grants, where the latter provide more freedom of use; but as both forms are unconditional, the distinction often collapses<sup>58</sup>. This taxonomy is also used by the Council of Europe.

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<sup>58</sup> Details on how block grants are distinguished from general purpose grants can be found in Bergvall, Charbit, Merk and Kraan (2006).

Figure 7: Composition of grants, 2006

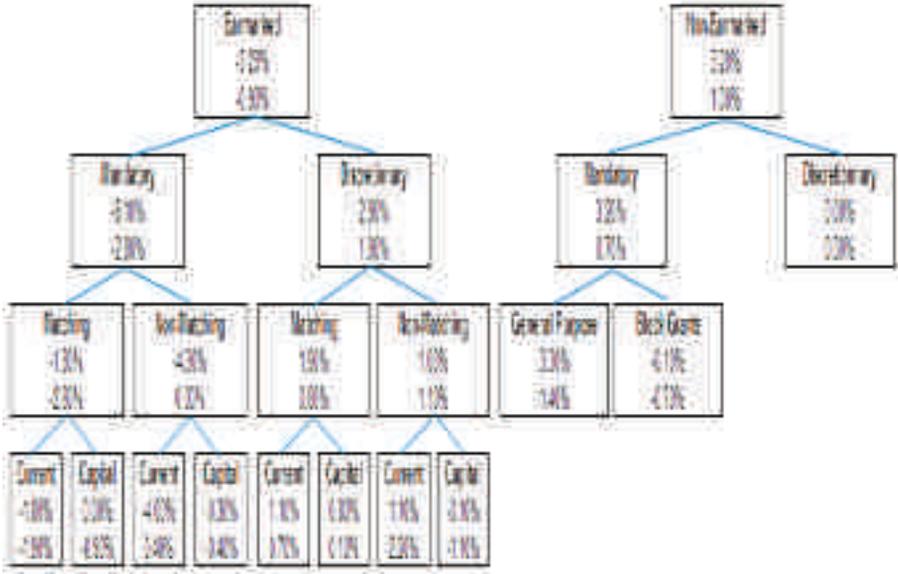


Note: The first line corresponds to state averages, the second line to local averages.

Source: OECD Fiscal Decentralisation Database

On average, earmarked and non-earmarked grants account for around identical shares of intergovernmental grants in 2007 (Figure 7, table 1 in the annex for country details). Almost 30 per cent of earmarked grants are matching, *i.e.* linked to SCG own expenditure. Matching grants lower the cost for SCGs of providing public services, as CGs bear part of the cost. This therefore tends to foster SCG spending, but as will be discussed further in this report, this may put some pressure on both central and sub-central budgets. Around two-thirds of all earmarked grants are mandatory, giving SCGs more revenue security but leaving less scope for central governments to adjust expenditures rapidly to overall fiscal conditions. Only around one third of earmarked transfers are discretionary and can thus – at least from a legal, if not political, point of view – be reduced at short notice. Whether discretionary transfers fluctuate more than mandatory grants, remains to be analysed once data for a longer time period are available.

**Figure 8: Evolution of the composition of grants, 2000-2006**



*Note:* The first line corresponds to state averages, the second line to local averages.

Source: OECD Fiscal Decentralisation Database

Overall grant design has evolved little between 2000 and 2006 (Figure 8, table 2 in the annex for country details). Some earmarked grants have been replaced by non-earmarked grants, which increased by around 3 percentage points, indicating more fiscal leeway for SCGs. A recent report by the Council of Europe also concludes that earmarked grants are still widely used. The strongest decline was in the category of mandatory earmarked non-matching grants. Again, structural change varies widely across countries, pointing at some path-dependency of the intergovernmental transfer system.

### 6.3. Some policy issues

The following section deals with a number of policy issues related to the grant system. Grants are usually used for equalisation purposes, or to take account of externalities, but they can also be used to fund specific policies. Grants often have unintended side effects, which can be reduced by carefully designing the grant formulas, or by combining grants with other types of measures,

such as performance indicators, regulatory standards, contracts, etc.

### ***Grants have an equalisation role***

While a higher sub-central tax share is preferable on grounds of efficiency and accountability, it is likely to raise equity concerns. Indeed, tax raising capacity is unevenly distributed across jurisdictions and likely to entail an uneven provision of public services under sub-central responsibility. Intergovernmental grants can be used to reduce differences in tax raising capacity and public service needs across jurisdictions (Boadway, 2007). This section gives a short overview of fiscal equalisation in OECD countries, the importance of equalising grants, and the role such grants would have to play if SCGs got a higher tax share.

Fiscal equalisation is a central policy driver in intergovernmental fiscal relations and accounts on average for more than half of total grants. Most countries have introduced explicit or implicit equalisation systems using either vertical grants to financially weak SCGs or horizontal grants from financially strong to financially weak SCGs. An overview of fiscal equalisation indicators is given in Table 2. For the countries that provided data in 2007, equalisation covers around 2.3% of GDP, 4.8% of total government expenditure and 55% of total intergovernmental grants on average (but can represent more than 80% of total grants in countries such as Switzerland, Portugal or Turkey).<sup>59</sup> On average, fiscal equalisation diminishes disparities in revenue raising capacity – as measured by the Gini coefficient or the variation coefficient – by almost two thirds, from 29% to 10% and to virtually zero in some countries. After equalisation, fiscal disparities are clearly below economic disparities as measured by regional GDP, *i.e.* the potential to provide public services is more evenly distributed than economic wealth (OECD, 2007).

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<sup>59</sup> Since some equalisation systems work via tax sharing not reported as inter-governmental grants, the share of equalising grants in total grants is likely to be lower than 55 %. Moreover, many grants reported in the fiscal equalisation exercise as “equalising” consist of both an equalising and a neutral part, with the neutral part often being larger than the equalising part.

**Table 1. A snapshot of fiscal equalisation, 2007**  
 Equalising grants and their fiscal disparity-reducing effect

	Size of the equalisation system (in percent)			Effect on fiscal disparities (variation coefficient)		
	Percent of GDP	Percent of government expenditure	Percent of intergovernmental grants	Disparities before equalisation	Disparities after equalisation	Difference
Federal/regional countries						
Australia	0.5	1.4	19	16.8	0.0	16.8
Austria	3.8	7.6	69	-	4.2	-
Canada	1.0	2.5	24	29.8	20.1	9.7
Germany	2.0	4.2	45	13.0	2.7	10.3
Italy	3.0	6.3	48	39.0	6.0	33.0
Mexico	3.7	-	78	-	-	-
Spain	3.0	7.6	67	26.5	10.1	16.4
Switzerland	3.0	8.2	80	31.8	23.2	8.7
Unitary countries						
Denmark	2.8	5.1	23	16.0	6.0	10.0
Finland	3.8	7.4	71	17.7	4.2	13.4
Greece	1.2	2.4	75	-	-	-
Japan	4.0	11.0	-	36.0	-	-
Norway	0.5	1.2	11	23.0	8.0	15.0
Portugal	1.8	4.0	81	90.0	28.0	62.0
Sweden	2.6	4.6	50	10.0	0.0	10.0
Turkey	1.1	-	82	39.0	14.0	25.0
Unweighted average	2.3	4.8	55	29.9	9.7	19.2

*Source:* Blöchliger and Charbit (2008).

A widely held view is that higher sub-central tax autonomy is associated with higher fiscal disparities and hence with more need for equalisation (*e.g.* for Germany: Seitz, 2008). In policy terms, a country wishing to increase sub-central taxing power could be interested to know whether – and to what extent – equalisation should be strengthened in order to keep fiscal disparities at bay. A simple cross-section analysis suggests that countries with a higher SCG tax share tend to have more comprehensive equalisation systems (annex 3). A 10 percentage *point* increase in the sub-central tax share is associated with an increase of the share of equalising grants in GDP by 0.6 percentage *point*. In relative terms: a 10% increase of the sub-central tax share is associated with a 15% increase of equalising grants.

Equalising grants will therefore play a central role in the decentralisation process: The empirical evidence shows that more sub-central tax autonomy is associated with larger fiscal disparities, potentially requiring larger fiscal equalisation systems. Therefore, political economy considerations will most probably force countries wishing to increase sub-central tax autonomy to increase the share of transfers dedicated to fiscal equalisation. There is some consensus that fiscal equalisation is a necessary companion to tax decentralisation and that the latter's success is likely to depend on a well-functioning equalisation system.

***Grants may reduce externalities***

Horizontal and vertical fiscal externalities or “spill-overs” often serve to justify intergovernmental grants on efficiency grounds. Fiscal externalities can arise if the fiscal policy of one jurisdiction or government level affects outcomes in other jurisdictions, or, more technically, if governments do not fully perceive the social marginal cost and benefits of their taxing and spending decisions. Intergovernmental grants can compensate jurisdictions that are affected by such externalities.

Matching or subsidisation grants may also provide incentives to SCGs to experiment, by compensating an SCG who takes innovation risks from which other SCGs could benefit. Fiscal externalities may be rooted both in the spending and the revenue side of decentralised budgets and can be either horizontal (between jurisdictions of the same level) or vertical (across different government levels) (table 2).

**Table 2. Taxonomy of externalities**

	<i>Horizontal</i>	<i>Vertical</i>
<i>Spending externalities</i> May lead to undersupply of the concerned public services.	Arise if an SCG’s spending policy affects the residents of other jurisdictions. Examples include public services funded by one jurisdiction – <i>e.g.</i> infrastructure – benefiting the residents of neighbouring jurisdictions.	Arise when the spending decisions of an upper government level <i>e.g.</i> for tertiary education – depend on spending of a lower government level, <i>i.e.</i> for primary and secondary education.
<i>Tax externalities</i> May lead to a distorted tax structure, excessive or too low tax rates or distorted spatial allocation decisions of firms and residents.	Arise if an SCG’s tax policy affects the residents of other jurisdictions. Examples include tax exporting, <i>i.e.</i> local and regional taxes borne by non-residents, or strategic tax rate setting affecting tax revenues in other jurisdictions.	Arise if different government levels tax the same tax base.

Intergovernmental grants – particularly matching grants – might correct for such externalities, to give incentives for SCGs to provide adequate levels of public services for non-residents or to compensate them for the tax policies of other jurisdictions. However, the rationale for grants as an anti-externality device is not always clear-cut and seems to be relevant only in a limited number of countries with a specific institutional and fiscal background.

- Horizontal tax externalities could play a role if SCGs have high taxing power *and* rely significantly on sales taxes. This is the case mainly in the United States, where autonomous sales taxes account for 50% of state and 20% of local tax revenue. The many studies seeking to quantify the externalities associated with these taxes conclude that both lead to considerable sub-central tax exporting and sub-central tax erosion (for a – somewhat outdated – overview, see Hall and Smith, 1995), and a US report estimates the losses due to out-of-state-purchases at 0.5 to 5% of the total tax revenue (OECD, 2005). However, policy proposals to cope with tax exporting and tax erosion hardly ever favour grants over straightforward

reforms of the tax system (Bird, 1993). Reform proposals include: replacing SCG sales taxes by a sub-central Value Added Tax (McLure, 2000 or Marè, 2007) – despite sub-central VATs having drawbacks – or integrating SCG indirect taxes into a tax sharing system, as was done in Australia in 2000 or Mexico in the 1980s, although that reduces the fiscal autonomy of SCGs.

- Horizontal spending externalities could be relevant in countries with large SCG spending power. Tertiary education could be particularly relevant, since geographical mobility of students could generate a disincentive for SCGs to invest in universities (OECD, 2008a and 2008b). Transport infrastructure is another example, where inter-jurisdictional externalities (or spill-overs) could lead to underinvestment by sub-central governments (Sutherland, 2008). A number of Swiss studies estimate spill-overs for various municipal services at 8 to 15% of total municipal expenditure, reaching 30% for some specific services such as road infrastructure (OECD, 2002). Since Switzerland is a likely benchmark in terms of both jurisdictional fragmentation and spending decentralisation, these percentages could hold as an upper limit for spill-overs. In the case of Canada, spending externalities appear to be of little significance (Smart, 2005). Moreover, some spill-overs tend to cancel each other out, which give affected jurisdictions an incentive to mutually compensate them (Rauscher, 2000).<sup>60</sup> As a consequence, rather than relying on central government, SCGs have often reached agreements on service use across jurisdictional borders.<sup>61</sup>
- Finally, vertical externalities could arise in countries where responsibilities overlap or where central and sub-central governments tap the same tax base. Central government may subsidise sub-central services like primary and secondary

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<sup>60</sup> Service provision across jurisdictional borders can be seen as a repeated game. If the stakes of each jurisdiction are roughly symmetrical, the outcome is likely that all jurisdictions provide services taking into account the effect of their actions on others.

<sup>61</sup> Around 3% of SCG spending is covered by grants from other jurisdictions of the same government level. This type of grants usually reflects horizontal compensation agreements.

education or healthcare on the assumption that SCGs do not invest sufficiently there. However, the few empirical studies suggest that SCGs provide adequate levels of core services and in some cases even tend to overspend (OECD, 2005).<sup>62</sup> Vertical tax overlap, *i.e.* concurrent taxation of the same tax base is quite pervasive in many OECD countries, and tax externalities – particularly excessive tax rates – could arise if one government level does not allow for the impact of its tax policy on another government level (Dahlby, 1996). Vertical externalities tend to be relevant if both government levels tax a mobile base such as personal or corporate income (Keen and Kotsogiannis, 2002; Esteller-Moré and Solé-Ollé, 2001). However, since it is not clear which government level is actually responsible for vertical externalities, the question of who has to compensate whom remains open, and grants could as well flow from the sub-central to the central level (Keen, 1997). If governments feel that taxing a common tax base leads to externalities, changes to the tax framework rather than to the grant system may be the appropriate solution.

It appears that the size and structure of intergovernmental grants, particularly matching grants, can be better explained by political economy factors and constraints – such as the role and power of SCGs in the multilevel framework – than by purely fiscal considerations (Brennan and Pincus, 1990).<sup>63</sup> Indeed, with their limited scope, actual fiscal externalities are likely to be smaller than the matching grants invented to tackle them. Earmarked matching grants plus discretionary earmarked grants – the latter often having a matching character – account for around 37 % of intergovernmental grants and around 18 % of total sub-central spending for both SCG levels taken together. These percentages are well above the size of externalities identified in OECD member countries (for a summary see Joumard and Kongsrud, 2003). Moreover, matching rates in most countries are typically much larger than justifiable by any plausible level of externalities (see for the US: Inman, 1988 and for Switzerland: Blöchliger and

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<sup>62</sup> Swiss cantons seem to provide excessive hospital care compared to what the federal level would do if it was responsible for this service (Steinmann et al., 2003). Some regions in Spain appear to overspend in transport infrastructure in order to attract economic activity (e.g. Delgado and Alvarez, 2007).

<sup>63</sup> For a summary of recent empirical studies see Blöchliger and Charbit (2008).

Herrmann, 2001).

***Earmarked grants may be used to fund specific policies***

From a theoretical perspective, non-earmarked grants are considered to be a more effective tool for financing SCGs, especially with respect to equalisation purposes. However, there are specific cases where earmarked grants might be an appropriate policy instrument. Such cases consist of addressing risk-sharing concerns (such as supporting innovation), supporting experimentation in public service delivery, and co-funding projects. In addition, temporarily using earmarked grants can help building capacity at the SCG level during decentralisation processes, when new tasks are assigned to SCGs, or finance recovery policies after crises or natural disasters. Recently, the financial and economic crisis has triggered a surge in the use of discretionary earmarked grants in national stimulus packages, as these have proven to be a very flexible and fast instrument to address exceptional situations which require timely, geographically targeted responses (box 1).

**Box 1. Using earmarked grants to address exceptional situations**

Grants can be used by central government as an instrument to take fast and geographically targeted action to tackle emergency situations such as natural disasters or economic downturns. In the present financial and economic crisis, grants to SCGs have been widely used to distribute and manage national stimulus packages, as they represent on average almost 30 % of national stimulus plans (table 3). A very small fraction of these grants is directly targeted at helping out SCGs (general purpose grants and current expenditure grants represent less than 5 % of total national stimulus packages), and most of these grants are earmarked to finance capital expenditure, thus serving the national purpose of sustaining demand and employment through investment.<sup>64</sup>

*Table 3. Example of share of grants to SNGs as a percentage of total national stimulus spending<sup>65</sup>*

<sup>64</sup> As SCGs are responsible for about 50% of general government capital expenditure in OECD countries, increasing use of earmarked grants to support investment is hardly surprising.

<sup>65</sup> In OECD (2009), fiscal packages are registered according to the type of investment they are targeted at, and not according to the level of government that receives and manages the funds. This is why the “transfers to SCGs” displayed in this work are not consistent with the answers to the questionnaires, as these reflect the share of the national stimulus packages channelled through SCGs (even if they are earmarked for specific purposes, and thus consolidated under other items in national figures).

	General Purpose Grants	Earmarked Grants		TOTAL
		Current Expenditure	Capital Expenditure	
Australia	-	0%	56%	<b>56%</b>
Canada	-	6%	78%	<b>84%</b>
France	-	-	27%	<b>27%</b>
Germany	-	-	29%	<b>29%</b>
Japan	33%	-	18%	<b>51%</b>
Korea	-	-	28%	<b>28%</b>
Norway	7%	2%	30%	<b>39%</b>
Portugal	-	-	22%	<b>22%</b>
Spain	-	1%	72%	<b>73%</b>
United States*	-	-	13%	<b>13%</b>
<b>average (16)</b>	<b>2%</b>	<b>1%</b>	<b>23%</b>	<b>26%</b>

Source: Country responses to a questionnaire prepared by OECD's Network on Fiscal Relations Across Levels of Government; and OECD (2009). Fiscal Packages Across OECD Countries: Overview and Country Details. \*Various government reports.

This national fiscal stimulus effort is aimed at increasing investment levels, but bears a moral hazard risk, as SCGs could be tempted to cut their own expenses and investment programs, knowing that they will receive funds from CGs. Central governments must therefore be careful to create mechanisms to ensure that the grants given to SCGs do not crowd out investment programs that SCGs would have carried out anyway. Several mechanisms have been used to achieve this goal: the grants can for example be conditional on SCGs maintaining a minimum level of investment (e.g. in France, the early disbursement of the "Fonds de Compensation de la TVA" is conditional on SCGs investing at least as much as the average over the years 2004-2007; in Australia, States are required to maintain their own pre-plan level of spending in areas receiving Commonwealth funds).

These stimulus funds might also trigger unnecessary investments, as those bearing the benefits (SCGs) do not bear the costs (CGs). This risk is usually addressed by requiring SCGs to co-finance the investments (matching grants).

Source: OECD (2009). Sub-national Dimension and Policy Responses to the Crisis, OECD Network of Fiscal Relations across Levels of Government, Paris.

### ***Grants may have unintended side effects***

Intergovernmental grants constitute a "common pool" resource for an individual SCG and can alter sub-central fiscal behaviour and bring about moral hazard, as shown above. This is due to the

asymmetry between benefits and costs for SCGs, as SCGs receiving a grant or an increase in grant allocation enjoy its full benefits while bearing only a fraction of the cost in terms of the additional tax revenue or borrowing needed for the central government to finance these grants.

Depending on the formulas that determine the grant allocation and depending on the political economy of fiscal relations in a country – especially SCGs’ influence on central government budget allocations and their interest in a higher tax autonomy – intergovernmental grants can soften the sub-central budget constraint and deteriorate the fiscal stance of both central and sub-central governments. There are several channels through which moral hazard can work, affecting not only fiscal outcomes such as SCGs’ own tax revenue, expenditure, deficits, and debts, but eventually the size of the transfer system itself.

Equalisation grants may reduce sub-central tax effort, as in most countries they ensure a minimal fiscal endowment to low-income jurisdictions, which is achieved by disbursing grants inversely related to an SCG's fiscal capacity. While such equalising grants are well justified on equity grounds, they tend to discourage SCGs from raising their own tax revenue, since an SCG increasing its tax capacity must inevitably accept a reduction in grant entitlements. This “compensation rate”, “equalisation tax” or “tax on tax revenue” can reach up to 80 or 90% of additional tax revenue, thereby undermining an SCG’s tax effort and willingness to strengthen its fiscal base.

Grants may also put pressure on spending: if they are linked to the actual cost of producing the services (education, health, infrastructure, etc.) and not to standard costs, SCGs do not have incentives for increasing efficiency. Matching grants allow for a reduction in the cost of service provision for SCGs and can thus be justified on externality grounds, but they also invite overspending, as the allocation received by SCGs increases the more they spend on the matched service. The grant system may also cause self-propelling growth of deficits and debts when SCGs face soft budget constraints and expect central government to automatically increase the level of transfers in case of a deficit, or bailout excessive debts.

The variety of disincentives can be reduced through a skilful grant design, described in more detail in earlier Fiscal Network papers (e.g. Bergvall *et al.*, 2006). A summary is provided in Box 2. The negative side effects of grants can also be remedied by combining grants with complementary instruments. For example, incentives for increasing efficiency can be provided by combining general purpose grants with performance indicators or imposing automatic productivity cuts (also called “efficiency dividends”), and the overspending bias can be mitigated by using co-funding mechanisms, as SCGs must bear part of the cost of the investment (this is being very widely used in the stimulus packages in countries such as Canada).

### **Box 2. Well-designed grants: a summary**

Countries have developed several approaches to contain the negative side effects of their intergovernmental transfer system (Bergvall *et al.*, 2006; Blöchliger and Charbit, 2008). Their various approaches can be divided into 1) measures on the tax revenue side, 2) measures on the grant side, and 3) institutional measures, with the three groups sometimes overlapping. The approaches can be summarised as follows:

1. Tax effort can be increased if the potential tax base rather than actual tax revenue is used to assess SCG tax capacity. Many countries use a representative tax system (RTS), where potential revenue from each sub-central tax is determined by multiplying a standard tax base with a standard tax rate, or they use the revenues from a central government tax to assess sub-central tax capacity. An RTS should cover all major sub-central taxes and their bases. Alternative indicators for assessing potential tax capacity include sub-central GDP or household income (macroeconomic approach). RTS can help reduce strategic behaviour and prevent SCGs from manipulating tax capacity indicators in order to obtain more grants.
2. Spending pressure can be reduced if grant allocation is based on a few broad-based geographic, demographic or socio-economic need indicators. Having few indicators covering principal sub-central needs tends to be more transparent and produces less statistical headaches in the allocation of entitlements. Indicators should be outside sub-central control to ensure that SCGs cannot manipulate them. Most countries today use standard or norm cost approaches whereby grant allocation is independent of actual expenditure incurred by SCGs. Also, spending performance can be increased if grants serving several purposes – e.g. simultaneously to subsidise SCG services and to equalise SCG disparities – are disentangled and separate grant systems developed.
3. Finally, institutional reforms can help contain grant-related budget drift. Some countries set transfer caps irrespective of sub-central financial needs.

Establishing agencies and other arms'-length independent bodies responsible for grant distribution can help channel transfer increases and reduce the pressure from special interests. Also, an adequate set of budget management rules can improve fiscal discipline. In several countries intergovernmental grants are shown as a single and separate budget item, thereby increasing transparency. A two-stage budget procedure, whereby the overall grant budget is negotiated separately from the distribution formula, can also contain pressure from special interests.

## ANNEX

Table 4. Grant revenue by type of grant, 2006

As percentage of total grant revenue

	Earmarked								Non earmarked			Total
	Mandatory				Discretionary				Mandatory		Discretionary	
	Matching		Non-Matching		Matching		Non-Matching		General purpose	Block grants		
	Current	Capital	Current	Capital	Current	Capital	Current	Capital				
<b>Australia</b>												
State	-	-	-	-	47.5	9.2	32.4	4.9	5.9	-	-	100.0
Local	-	-	-	-	15.6	-	2.8	0.0	81.6	-	-	100.0
<b>Austria</b>												
State	48.4	2.4	12.1	17.3	0.9	-	0.3	-	10.9	0.2	7.5	100.0
Local	36.5	3.3	11.5	28.7	1.8	-	0.2	-	18.0	0.1	0.0	100.0
<b>Belgium</b>												
State	1.0	0.3	-	-	-	0.0	-	-	97.1	1.6	-	100.0
Local	45.0	5.0	-	-	-	-	-	-	49.9	-	-	100.0
<b>Canada</b>												
State												
Local												
<b>Czech Republic</b>												
Local	12.4	-	-	-	-	-	72.3	15.3	-	-	-	100.0
<b>Denmark</b>												
Local	0.1	71.8	-	0.0	0.3	0.6	0.0	0.1	26.8	-	0.2	100.0
<b>Finland</b>												
Local	5.8	-	-	-	-	-	1.9	1.7	14.2	75.8	0.6	100.0
<b>France</b>												
Local	6.8	-	0.1	-	-	2.0	1.7	1.8	80.9	6.7	-	100.0
<b>Germany</b>												
State												
Local												
<b>Greece</b>												
Local	40.9	36.1	-	-	-	-	-	-	23.0	-	-	100.0
<b>Hungary</b>												
Local	36.2	10.5	-	-	-	-	5.3	10.6	36.2	-	1.1	100.0
<b>Iceland</b>												
Local												
<b>Ireland</b>												
Local	-	-	-	-	-	-	14.8	73.5	11.7	-	-	100.0
<b>Italy</b>												
State	-	4.5	-	5.1	-	-	14.7	5.6	70.2	-	-	100.0
Local	-	-	-	-	-	-	30.5	31.5	38.0	-	-	100.0
<b>Japan</b>												
Local												
<b>Korea</b>												
Local	-	-	-	-	12.7	14.7	-	-	72.6	-	-	100.0
<b>Luxembourg</b>												
Local	86.3	13.6	-	-	-	-	-	-	-	-	-	100.0
<b>Mexico</b>												
State	-	-	49.0	-	-	-	5.7	-	45.4	-	-	100.0
Local	-	-	42.3	-	-	-	-	-	57.7	-	-	100.0
<b>Netherlands</b>												
Local	48.4	-	-	-	-	-	-	-	51.6	-	-	100.0
<b>New Zealand</b>												
Local												
<b>Norway</b>												
Local	9.6	0.0	-	-	-	-	33.5	-	-	56.9	-	100.0
<b>Poland</b>												
Local												
<b>Portugal</b>												
Local	-	-	-	-	-	-	16.1	-	83.9	-	-	100.0
<b>Slovak Republic</b>												
Local												
<b>Spain</b>												
State	0.3	0.4	8.5	4.4	1.3	0.8	1.1	0.9	82.4	-	-	100.0
Local	17.1	17.8	2.1	-	-	-	-	-	62.9	-	-	100.0
<b>Sweden</b>												
Local												
<b>Switzerland</b>												
State	74.3	-	-	-	-	-	-	-	25.7	-	-	100.0
<b>Turkey</b>												
Local	-	-	-	-	-	-	-	57.0	-	-	43.0	100.0
<b>United Kingdom</b>												
Local												
<b>United States</b>												
State												
Local												
<i>Unweighted average</i>												
State	17.7	1.1	9.9	3.8	7.1	1.4	7.7	1.6	48.2	0.2	1.1	100.0
Local	18.2	8.3	2.9	1.5	1.6	0.9	9.4	10.1	37.3	7.3	2.4	100.0

**Table 5. Evolution of grant revenue by type of grant**  
Change from 2000-2006, percentage points

	Earmarked								Non earmarked		
	Mandatory				Discretionary				Mandatory		Discretionary
	Matching		Non-Matching		Matching		Non-Matching		General purpose	Block grants	
	Current	Capital	Current	Capital	Current	Capital	Current	Capital			
<b>Australia</b>											
State	-	-	-	-	5.9	4.6	5.4	-1.2	-14.6	-	-
Local	-	-	-	-	8.6	-0.1	2.7	-0.4	-10.8	-	-
<b>Austria</b>											
State	-6.3	-0.2	9.2	-2.2	0.4	-	0.1	-	-0.8	0.0	-0.1
Local	-2.2	-5.6	6.5	-6.3	0.5	-	0.0	-	7.1	0.0	0.0
<b>Belgium</b>											
State	-0.7	-0.1	-	-	-0.1	0.0	-	-	1.1	-0.3	-
Local											
<b>Canada</b>											
State											
Local											
<b>Czech Republic</b>											
Local	-16.7	-	-	-	-	-	31.9	-15.2	-	-	-
<b>Denmark<sup>1</sup></b>											
Local	-39.699	71.8	-0.6	0.0	0.3	0.6	-0.1	-4.0	-28.4	-	0.1
<b>Finland</b>											
Local	-3.9	-	-	-	-	-	0.2	-1.5	14.2	-8.2	-0.8
<b>France</b>											
Local	-0.9	-	0.0	-	-	-0.5	-0.9	-0.7	5.9	-2.9	-
<b>Germany</b>											
State											
Local											
<b>Greece</b>											
Local	7.7	-7.7	-	-	-	-	-	-	0.0	-	-
<b>Hungary</b>											
Local	-4.3	1.4	-	-	-	-	0.2	5.6	0.3	-	-3.2
<b>Iceland</b>											
Local											
<b>Ireland</b>											
Local	-	-	-	-	-	-	-1.2	2.8	-1.6	-	-
<b>Italy</b>											
State											
Local											
<b>Japan</b>											
Local											
<b>Korea</b>											
Local	-	-9.3	-	-	1.5	2.6	-	-	5.1	-	-
<b>Luxembourg</b>											
Local	-4.0	3.9	-	-	-	-	-	-	-	-	-
<b>Mexico</b>											
State	-	-	-1.0	-	-	-	-0.1	-	1.1	-	-
Local	-	-	0.3	-	-	-	-	-	-0.3	-	-
<b>Netherlands</b>											
Local	-5.0	-	-	-	-	-	-	-	5.0	-	-
<b>New Zealand</b>											
Local											
<b>Norway</b>											
Local	-11.2	0.0	-1.0	0.0		0.0	16.3	-3.2	0.0	-0.8	-
<b>Poland</b>											
Local											
<b>Portugal</b>											
Local	-	-	-	-	-	-	-0.4	-	0.4	-	-
<b>Slovak Republic</b>											
Local											
<b>Spain</b>											
State	0.0	0.3	-32.1	0.2	0.4	0.2	1.0	0.8	29.2	-	-
Local	0.8	4.1	-0.4	-	-	-	-	-	-4.4	-	-
<b>Sweden</b>											
Local											
<b>Switzerland</b>											
State	-4.0	-	-	-	-	-	-	-	4.0	-	-
Local											
<b>Turkey</b>											
Local	-	-	-	-	-	-	-	-8.0	-	-	8.0
<b>United Kingdom</b>											
Local											
<b>United States</b>											
State											
Local											
<i>Unweighted average</i>											
State <sup>2</sup>	-1.8	0.0	-4.0	-0.3	1.1	0.8	1.1	-0.1	3.3	-0.1	0.0
Local	-4.7	3.4	0.3	-0.4	0.6	0.2	2.9	-1.4	-0.4	-0.7	0.2

1) The years 2000 and 2006 are not comparable because of the change in the methodology.

### Annex 3: Testing for the link between SCG tax autonomy and equalisation needs

The empirical investigation on the sub-central tax share and equalising transfers is based on the assumption that a higher sub-central tax share is associated with higher fiscal disparities. In this line of reasoning, if the SCG tax share is to rise, more equalising grants would be needed to keep disparities constant. Since equalising transfers depend not only on the SCG tax share but also on country-specific features such as the sub-central tax mix, sub-central tax autonomy or preferences for disparity reduction, some control variables have to be introduced. To keep the equation simple and also to take the low degree of freedom into account, an empirical model of the type

$$transfer_i = \beta_0 + \beta_1 \cdot taxshare_i + \beta_2 \cdot taxstructure_i + \beta_3 \cdot reduction_i + \varepsilon_i$$

is chosen, where for each country “transfer” stands for the share of revenue-equalising grants in GDP, “tax share” alternatively stands for the sub-central share in total tax revenue (for federal countries the share of the state level was used since equalisation only concerns the state level) or the share in *autonomous* taxes, *i.e.* taxes of the “a”, “b” and “c” type in the taxing power classification (OECD, 1999), “tax structure” for, alternatively, the share of income taxes, immovable property taxes and consumption taxes, and “reduction” for the difference in pre- and post-equalisation disparities (measured through the variation coefficient). Data are available for 12 countries and for the year 2005. The model was estimated both in its linear and log-linear form.

Regression results for the main specification are shown below, with the linear form in the left-hand panel and the log-linear form in the right-hand panel of table 2. Coefficients for both the SCG tax share and the disparity reduction achieved are positive and statistically significant at the 5 or 10 percent level, suggesting that a higher sub-central tax share is associated with a higher transfer to GDP share, if disparities are to remain equal. The coefficient for the tax structure – represented here as the share of immovable property taxes in total SCG tax revenue – tends to be negative but is not significant. In various alternative specifications, higher tax

autonomy tends to have little influence on the need for equalising grants, the share of income taxes in the sub-central tax mix also tends to have little influence, and a higher share of consumption taxes in the SCG tax mix tends to be associated with a lower need for equalising grants, but none of these coefficients is significant.

**Table: Estimated effects of the SCG tax share on the need for equalisation grants**

Linear regression			Log-linear regression		
Variable	Coefficient	Std. Error	Variable	Coefficient	Std. Error
C	-1.22	0.84	C	-9.10*	3.94
TAXSHARE	0.06**	0.02	LOG(TAXSHARE)	1.49*	0.64
REDUCTION	0.09***	0.02	LOG(REDUCTION)	1.72*	0.95
PROPERTYTAX	-0.08	0.05	LOG(PROPERTYTAX)	0.00	0.40
Number of observations	12		Number of observations	12	
Adjusted R-squared	0.51		Adjusted R-squared	0.34	
Prob(F-statistic)	0.03		Prob(F-statistic)	0.22	

*Note:* \*\*\*significant at the 1-% level, \*\*significant at the 5-% level. For explanations see Box 1.

*Source:* Fiscal Network database.

The results have to be interpreted with great care. First, only a limited number of countries participated to this exercise. The data is likely to suffer from sample bias, especially with respect to the tax structure, as countries with a high sub-central property tax share are under-represented. Second, coefficients may be biased for reasons of endogeneity. Disparity reduction – i.e. the variable reflecting preferences - could actually hold as another variable for the amount of equalisation transfers, making the relationship between transfers and disparity reduction circular. Third, a cross-sectional analysis does not say anything about a possible evolution over time. Differences in tax raising capacity may evolve quite differently across countries once the sub-central tax share starts rising. To the extent that countries made or make reforms to the sub-central revenue composition, more detailed time series analysis should be carried out

# Chapter 7

## General grants and earmarked grants in Norway

Lars-Erik Borge and Grete Lilleschulstad

### 7A. Growth and design of earmarked grants: the Norwegian experience by Lars-Erik Borge<sup>66</sup>

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#### Abstract

The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivation for the reform was to establish a simpler and more transparent grant system and a fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency. Ever since its introduction, the block grant system has been under pressure, and the level of earmarking has steadily increased. The purpose of this paper is to tell a story of how the design of earmarked grants has evolved over the last 25 years. There has been a trend towards more targeted earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of prioritized services without leaking into other services. The new schemes have reduced political frustration at the central level by increasing the correspondence between intentions and results, but have led to a more complicated system that in the longer term may lead to less local innovation and initiative.<sup>67</sup>

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<sup>67</sup> This a revised version of a paper presented at the Copenhagen Workshop on Intergovernmental Grants September 17-18, 2009 under the title "Block grants and earmarked grants: The Norwegian experience". I am grateful for comments and suggestions from the participants.

## 7A.1. Introduction

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The introduction of the block grant system in 1986 was a major reform in the financing of the local public sector in Norway. Around 50 earmarked grants were replaced by block grants based on objective criteria. The main motivation for the reform was to establish a simpler and more transparent grant system and fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency by giving local governments more discretion in the allocation of resources across services.

The block grant reform was considered a first step to further reduce earmarking. The main idea was to abolish many of the remaining earmarked grants and to increase the amount of resources distributed through the block grant system. Local government priorities should, if necessary, be regulated through legislation. In a larger picture, the block grant reform was one of several attempts of decentralization. The Local Government Act was revised in 1992 to give local governments more freedom to organize their decision-making and production. The liberalization of the credit market during the 1980s meant that the control of local public investments through public banks was reduced.

The intention to further reduce the level of earmarking after 1986 has not been realized. Conversely, there has been a strong trend in the opposite direction. The purpose of this part of the chapter is to tell a story of the growth and design of earmarking since the introduction of the block grant system in 1986. Section 7A.2 presents the empirical background and demonstrates that the block grant system has been under pressure ever since it was introduced. The increased reliance on earmarked grants can be understood as the outcome of a blame game between the central and the local governments. Sections 7A.3-7A.5 are devoted to describing how the design of earmarked grants has changed over time; from ineffective earmarking, through earmarking with leakages, and finally to earmarking without leakages. Finally, section 7A.6 contains some concluding remarks.

## 7A.2. Empirical background

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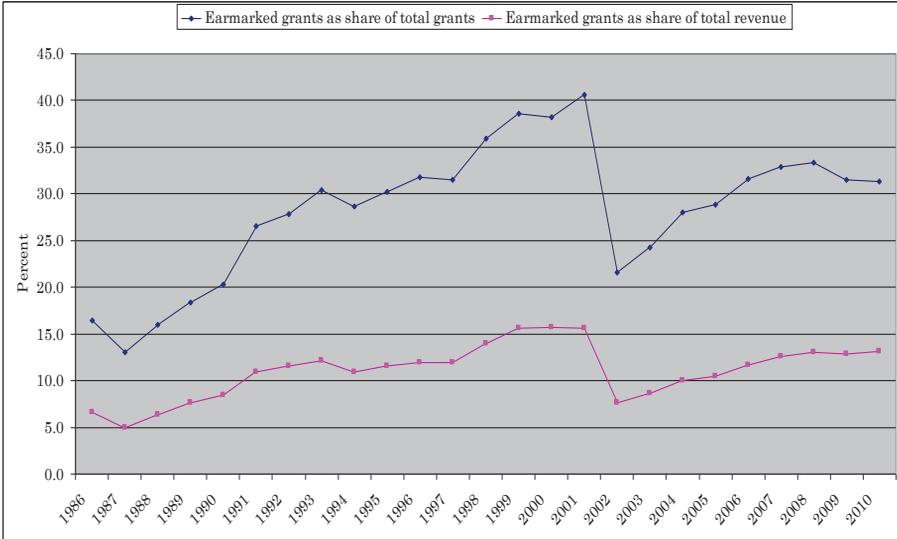
In Norway, as in the other Nordic countries, local governments<sup>68</sup> are the main providers of welfare services, i.e. education, health and social services. Norwegian local governments have substantial discretion in the allocation of resources across service sectors, but are heavily regulated on the revenue side. The main revenue sources are local taxes and block grants from the central government, and total local government revenue amounts to 16-17% of mainland GDP (excluding the petroleum sector). Most taxes are of the revenue-sharing type, where effective limits on tax rates have been in place for the last 30 years. The main elements of the block grant system are tax equalization, spending needs equalization, and a discretionary grant (to take account of specific local conditions not captured by the objective criteria). A more detailed description of local government financing in Norway is provided in part B of this chapter.

In the Norwegian context, all grants that are not included in the block grant systems are labeled earmarked grants, and the same definition is applied here. All earmarked grants are conditional in the sense that they must be spent on a specific program or for a specific purpose. Most of them are either of the matching type or categorical block grants. This corresponds to the definition of earmarked grants suggested by Smart and Bird (2010). Compared to the OECD terminology (Blöchliger and Vammalle 2010), I make no distinction between block grants and general-purpose grants. I use the term general block grant (or simply block grant) for the grants included in the block grant system.

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<sup>68</sup> The local public sector consists of two tiers, municipalities and counties. In the following the term local government covers both municipal and county governments.

**Figure 1. The development of earmarking, 1986-2010**



Note: Earmarked grants related to refugees and labor market policies are excluded as they vary substantially from year to year. VAT compensation (introduced in 2003) is treated as a block grant.

Figure 1 illustrates the development of earmarking since 1986. Two indicators are reported, i.e. earmarked grants as a share of total grants and earmarked grants as a share of total revenue. It appears that earmarked grants as a share of total grants have nearly doubled since the introduction of the block grant system, from 17% in 1986 to 31% in 2010. An increase in earmarked grants as a share of total grants does not necessarily mean more earmarked financing of local public services. It could rather reflect a shift from block grants to tax financing. However, this has not been the case in Norway during the period under study. Earmarked grants have nearly doubled also when measured as a share of total revenue.

The year 2002 represents a main exception to the trend towards more earmarking. That year, earmarked grants increased sharply both as a share of block grants and as a share of total revenue. However, the shift does not reflect less earmarking of particular services, but is rather the result of a shift in the division of labor between the counties and central government. The central government took over the responsibility for hospitals, a service

where the level of earmarking was relatively high.

In 2003, the Parliament adopted a major childcare reform the main goals of which were lower user charges and an increased capacity to achieve full coverage. The reform is financed by earmarked grants, and these grants account for much of the increase in the level of earmarking in recent years. Starting in 2011, childcare will be included in the block grant system, and consequently the level of earmarking will be substantially reduced. Based on data for 2010, earmarked grants would be reduced from 17% to 5% as share of total revenue.<sup>69</sup> In other words, the inclusion of child care in the block grant system will bring the level of earmarking back to the 1987 level. The purpose of this paper however, is to discuss how the design of earmarked grants has evolved since the introduction of the block grant system and until 2010.

The standard theory<sup>70</sup> of fiscal federalism argues that earmarked grants should be used in situations with positive spillovers across jurisdictions. However, it is hard to argue that spillovers may account for the steady growth of earmarking in Norway over the last 25 years. The responsibilities of local governments have not changed much and consist for a large part of welfare services where spillovers are of little relevance. Smart and Bird (2010) draw the same conclusion and argue that imperfect information, incentives, and political considerations are important to understand the widespread use of earmarked grants. In the following discussion, I will focus on political considerations.

The steady increase in the level of earmarking means that the block grant system, and its underlying logic, has been under constant pressure. In the Norwegian context with limited local tax discretion, the logic of the block grant system is that central government is responsible for the total revenues of the local public sector (correspondence between revenues and responsibilities), while the local governments are responsible for the allocation of resources between different services. In practice the leads to

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<sup>69</sup> More updated calculations from the Ministry of Local Government and Regional Development indicates that the level off earmarking (measured as share of total revenue) will be further reduced to 4% in 2011, see also part B of this chapter.

<sup>70</sup> The standard theory corresponds to “the first generation theory of fiscal federalism” in the terminology of Oates (2005).

unclear responsibilities. When local politicians are confronted with a “crisis” in service provision, they immediately blame the central government which sets the financial constraints. On the other hand, central government will try to shift responsibility back to local governments, arguing that they should get more value for their money or give higher priority to the service concerned. If the “crisis” grows large and include a large number of local governments, it may be difficult to avoid supplementary grant increases. From the point of view of central government, earmarking can be seen as a way to limit the blame game as well as supplementary grant increases. A formal analysis of this argument can be found in Carlsen (1998).

### **7A.3. Ineffective earmarking: Sectoral block grants and categorical block grants**

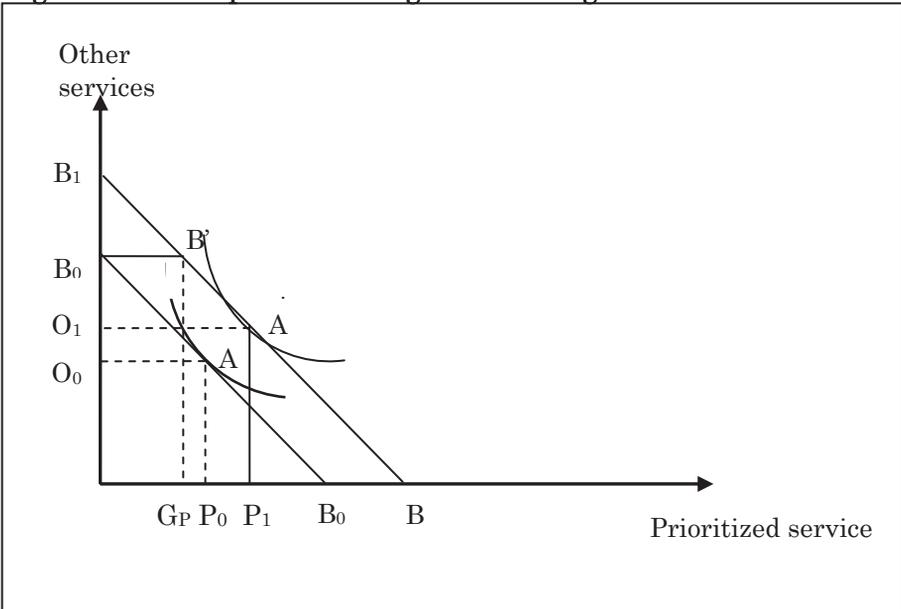
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Until 1994 the spending needs equalization in the block grant system consisted of sectoral block grants, i.e. one grant for each major service sector (education, healthcare, etc). Central government used these sectoral grants to signal its priorities. If it wanted higher spending on education, the sectoral grant for education was increased by more than were other sectoral grants. However, indications from central government did not impose any formal restrictions on the use of the grants. As part of the block grant system, the sectoral block grants were unconditional. Since local governments were free to spend the grants as they liked, it is no surprise that the indications made through sectoral block grants turned out to be ineffective. At best the sectoral grants gave the central government a short-term political gain when the budget was proposed, but this backfired during the fiscal year if local governments did not give priority to the sectors with the highest growth in grants.

At a later stage the central government introduced categorical block grants. These grants are allocated according to objective criteria (like a block grant), but are earmarked in the sense that the money has to be spent on a particular service or activity. The purpose of figure 2 is to illustrate that also categorical block grants tend to be ineffective. The local government provides two services;

the prioritized service (P) and other services (O).<sup>71</sup> Initially there is no earmarking, and the budget constraint is  $B_0B_0$ . The actual allocation is in point  $A_0$  with spending  $P_0$  on the prioritized service and  $O_0$  on other services. Then the central government introduces a categorical block grant of size  $G_P$ . Since the amount  $G_P$  has to be spent on the prioritized services, the budget constraint shifts to  $B_0B'B_1$ . The optimal response for the local government is to increase provision of both services, to  $P_1$  and  $O_1$  respectively. However, this is exactly the same response it would have made if the amount  $G_P$  was given as a general block grant (with no strings attached), in which case the budget constraint would be  $B_1B_1$ .

**Figure 2. The impact of a categorical block grant**



The key point is that categorical block grants are likely to work as a general block grant as long as the amount ( $G_P$ ) is smaller than the amount the local government would have spent on the prioritized service anyway ( $P_1$ ). The local government is then able to neutralize the effect of earmarking by reallocating non-

<sup>71</sup> In the Norwegian setting with limited local tax discretion it is reasonable to interpret O as other services provided by the local government. In a more general setup with local tax discretion, other services would also include private consumption.

earmarked revenues (general block grants and taxes) from the prioritized service to other services. An implication of this result is that categorical block grants are likely to work as general block grants when they are wide (in the sense that the earmarking applies to large service sectors such as education and care for the elderly), but may be effective when they are narrow (school books, cultural activities for the elderly, etc).

Moreover, it should be noticed that sectoral block grants and categorical block grants may have some short-term impact on local priorities even if they are wide. In the short term, the reallocation of non-earmarked revenues from the prioritized service to other services may be too visible. In the longer term, however, it is difficult for the central authorities to detect the counterfactual allocation.

Sectoral block grants and categorical block grants must be understood in a political context, and more precisely as a response to a general “crisis” description in the media. Borge and Rattsø (1998, p. 35) argue that ministers can gain positive publicity in the press by granting a relatively small amount to solve problems raised in the tabloid press. In the short term, the ministers appear energetic, vigorous, and able to solve problems. In the longer term, however, the ministers (if still in office) may have a hard time explaining why the policy does not result in better services. It is my understanding that sectoral block grants and categorical block grants lead to much political frustration at the central level. Because of this frustration, ministers started looking for more effective (or targeted) grant schemes.

#### **7A.4. Effective earmarking with leakages: Open-ended matching grants**

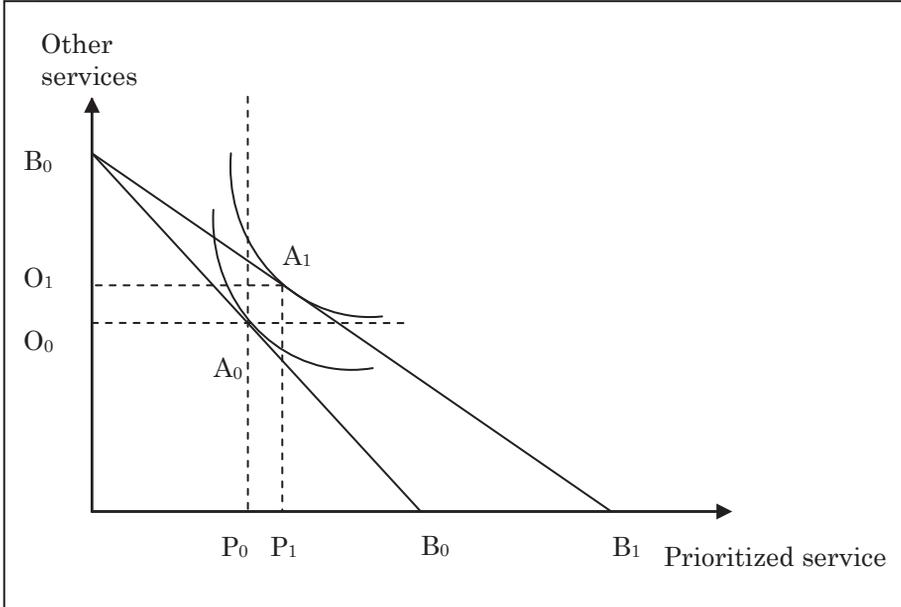
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In the economics literature on intergovernmental grants (e.g. Rubinfeld 1987, section 6.2) it is emphasized that effective earmarking should affect relative prices, i.e. they should be of the matching type. The impact of an open-ended matching grant is illustrated in figure 3. The initial budget constraint is  $B_0B_0$ , and the actual allocation is in point  $A_0$ . The introduction of an open-ended matching grant reduces the relative price of the prioritized service and shifts the budget line to  $B_0B_1$ . The matching grant has

a price effect that reduces the cost of providing the prioritized service, and a positive income effect because total revenue increases (given the initial allocation). Both the substitution effect and the income effect leads to increased provision of the prioritized service. Because of the substitution effect, the matching grant is more stimulative than sectoral and categorical block grants. The matching grant is therefore more effective in terms of affecting local priorities.

The effect on other services is more unclear, and depends on how much the prioritized service is expanded. If the expansion is large (the new allocation is southeast of the crossing between  $O_0$  and  $B_0B_1$ ), the impact on other services is negative. But if the expansion is small (the new allocation is between the crossing  $P_0$ - $B_0B_1$  and the crossing  $O_0$ - $B_0B_1$ ), other services are expanded as well. It can be demonstrated that provision of other services will increase (decrease) if the demand for the prioritized service is inelastic (elastic) with respect to price. Much empirical literature (summarized by Oates 1996) documents that demand for local public services tends to be inelastic with respect to price. Consequently, the typical outcome will be that an open-ended matching grant to some extent will leak out to other services. This is the case in figure 3, where the new allocation  $A_1$  implies increased provision of both services.

**Figure 3. The impact of an open-ended matching grant**



For the local government the leakage to other services is an optimal response, but for central government the leakage may be problematic politically.<sup>72</sup> In the budget process, central government specifies the (expected) amount of money to be distributed through the matching grant, and the minister must argue that this amount of money is needed to improve the prioritized service. But if it turns out that the local spending increase on the prioritized service is lower than the grant increase, it becomes the minister’s job to explain why. He can to some extent blame the local governments for not being loyal to the intentions of the grant program, but it is difficult to evade responsibility for an improper grant design that explains the lack of correspondence between intentions and outcomes.

The matching grant for childcare, which has been in place for several decades, is a prime example. In the late 1990s, the matching rate was increased to enhance coverage and to lower user

<sup>72</sup> A conflict of interest between the two tiers of government is a premise of the discussion, but I do not take a stand on whether a social optimum should be guided by local or central preferences. That (highly interesting) issue is beyond the scope of this chapter.

charges. It turned out that the impact on coverage and user charges was modest, and that the increased spending on childcare was much lower than the grant increase. The discrepancy between intentions and actual policy change received much media attention. This resulted in a blame game between central government and local governments. The local governments argued that they had obeyed the rules, since total spending on childcare amply exceeded grants received for childcare, while central government emphasized that the spending increase was lower than the grant increase. Again the frustration led to a search for more effective ways of affecting local priorities.

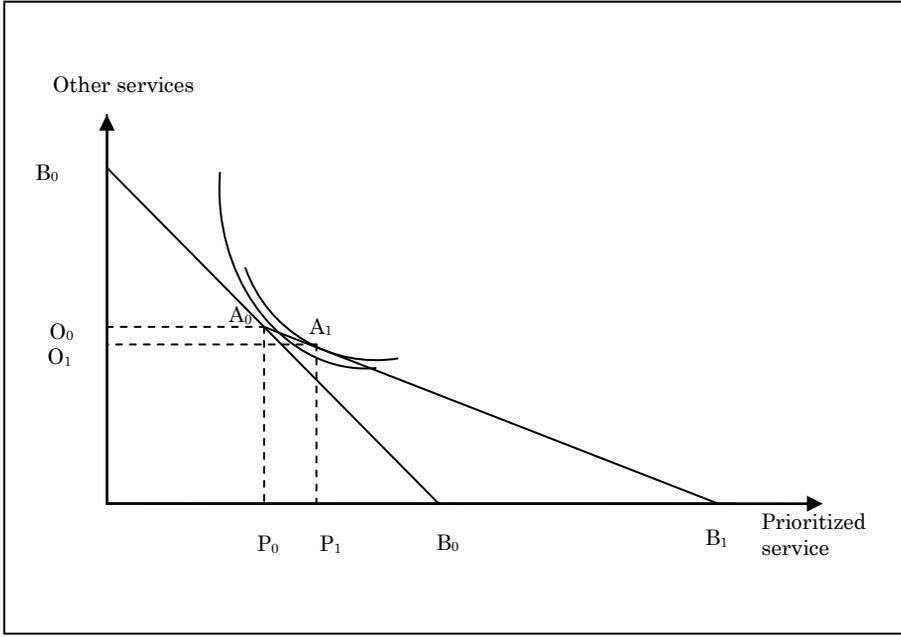
### **7A.5. Effective earmarking without leakages: Matching grants related to expansion of services**

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In recent years the central government has used so-called action plans to stimulate provision of particular services. Action plans are explicitly announced to be in place for a limited number of years, and they include temporary, earmarked grants as financial means. In order to reduce the probability of leakages, many of the grants are related to expansion of services or investment in new capacity. Action plans have been used in e.g. elderly care, education, and childcare.

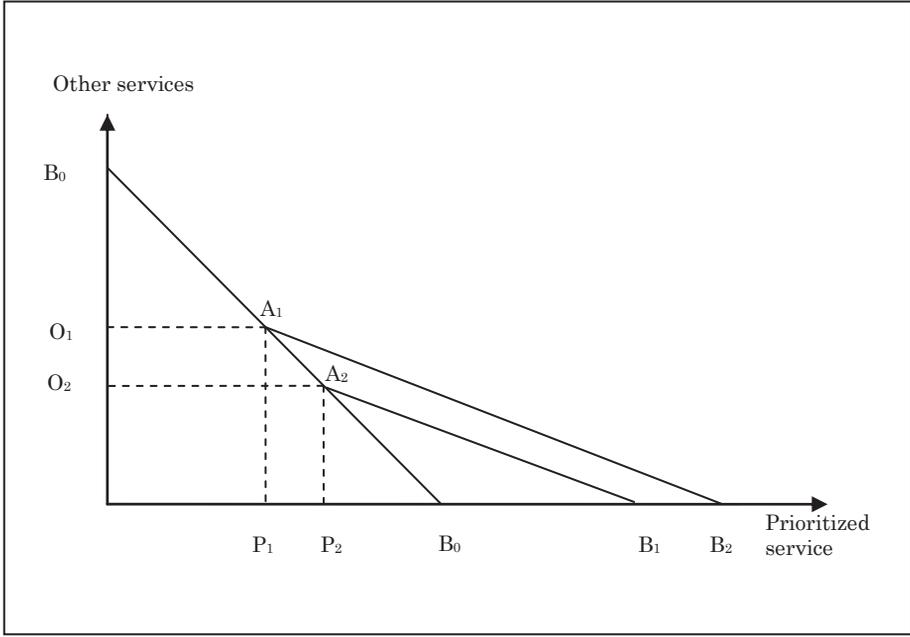
Figure 4 illustrates the case of a matching grant related to expansion of services. This could be either an investment grant or a grant for current expenditures related to increased spending. Again the initial budget line is  $B_0B_0$  and the initial allocation is in  $A_0$ . The matching grant related to expansion of service P shifts the budget line to  $B_0A_0B_1$ , and the new allocation is in  $A_1$ . Since the new allocation has to be on the segment  $A_0B_1$  of the new budget line, it is obvious that the matching grant increases the provision of the prioritized service and reduces the provision of other services. The leakage is eliminated. The outcome is rather the opposite, i.e. a reallocation of non-earmarked revenues from other services to the prioritized service. The larger the expansion of the prioritized service, the larger is the cutback of other services.

**Figure 4. The impact of a matching grant related to expansion of services**



The amount of grants received will vary across local governments depending on the initial service provision level. This is illustrated in figure 5, where I consider two local governments (1 and 2). The two local governments have the same initial budget constraint  $B_0B_0$ , but different initial allocations ( $A_1$  and  $A_2$  respectively). Because of the different initial allocations, the new budget constraint will also differ. The new budget constraint is  $B_0A_1B_1$  for local government 1 and  $B_0A_2B_2$  for local government 2. It is clear that the outward shift in the budget constraint is largest for local government 1, with lowest spending on the prioritized service. This is an attractive feature of the grant program since more resources are allocated towards local governments that are lagging behind in the provision of the prioritized service. However, local governments that have given high priority to the prioritized service will be “punished” since they are less able to take advantage of the new grant program. This is likely to have severe negative consequences in the longer term. Local governments will be reluctant to develop the services if they fear to lose out when the next central government action plan is implemented.

**Figure 5. A matching grant for “new” service provision with different initial allocations**



Borge and Rattsø (2008) present a more formal theoretical analysis of action plans and temporary matching grant programs. The intertemporal model distinguishes between three periods – before, during and after a matching grant program. Given a benchmark of block grant financing, three types of matching grants are analyzed – a matching grant for current expenditure, an announced investment grant, and an unexpected investment grant. A matching grant for current expenditure is the conventional way of handling matching grants and includes the standard price and income effects. Investments to expand capacity are largely neglected in the standard grant analysis, but matching grants to stimulate investments are important in practice. The inclusion of the investment decision also highlights the possibilities that local governments have of shifting resource use over time and the importance of expectations.

The analysis shows how an announced investment grant, due to an expectation effect, leads local governments to reduce their investments before the implementation of the grant program. This is avoided by introducing unexpected investment programs, which

will, however, have the effect that local governments giving priority to the relevant service will be “punished” since they are less able to take advantage of the grant (as in figure 5 above). Investment grants imply large changes in service provision, while matching of current expenditure offers more stability.

Borge and Haraldsvik (2008) provide an empirical analysis of the action plan for elderly care that was implemented in 1997 to increase capacity and improve service standards within the elderly-care sector. The main financial element in the action plan for elderly care was a temporary investment grant for nursing homes. Consistent with figure 4, Borge and Haraldsvik find that the elderly-care sector is expanded at the expense of other services, and particularly childcare. For the local government with the largest utilization of the action plan, the predicted increase in childcare coverage (during 1997-2005) is 7-8 percentage points lower than for a local government that did not implement the action plan.

Given the temporary nature of action plans, it is interesting to analyze whether they have any impact on the budgetary balance. It may be assumed that a temporary grant program leads to a “spend now” attitude that may reduce fiscal discipline. Consistent with this view, Borge and Haraldsvik (2008) find that high implementation of the action plan for elderly care is associated with a reduction in the operating surplus.

## **7A.6. Concluding remarks**

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The introduction of the block grant system in 1986 was a major reform in the financing of Norwegian local governments. The main motivations for the reform were to establish a simpler and more transparent grant system and a fairer distribution of resources across local governments, and also to strengthen local democracy and improve efficiency. Ever since its introduction, the block grant system has been under pressure, and earmarking has steadily increased. Also the design of earmarked grants has changed. There has been a trend towards more effective or targeted earmarking, i.e. politicians at the central level have looked for grant schemes that increase the provision of the prioritized service without creating leakages towards other services. The new schemes have

reduced the political frustration at the central level by increasing the correspondence between central intentions and local outcomes, but have led to a more complicated system that in the longer term may lead to less local innovation and initiative.

## **7B. Financing municipalities and counties in Norway - Specific grants vs. block grants<sup>73</sup> by Grete Lilleschulstad <sup>74</sup>**

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### **Introduction**

In 1986 the so-called General Purpose Grant Scheme for municipalities and counties was introduced in Norway. The new block grants replaced a financing system based on several different earmarked grants, even though a tax equalisation system already existed. In the new General Purpose Grant Scheme, both grants and tax equalisation are parts of the same system. The intention of the reform was to ensure a transparent, fair, rational and consistent distribution of income. Considerable differences existed between municipalities and between counties with respect to both level of income and level of expenditure needs. A high level of redistribution was therefore necessary, and this was achieved by the new grant scheme. The large number of earmarked grants had also been an administrative burden, both at the local and the central level.

Today the main sources of revenue for municipalities and counties are taxes, block grants, specific grants, charges and fees. Their free income consists of block grants and tax revenues. The free income is still being distributed by the General Purpose Grant Scheme. The general grants are calculated on the basis of objective criteria, and in addition the income taxes are equalized. The free income share of the total income of municipalities and counties is approximately 68 percent. Some of the responsibilities of the municipalities and counties are still being financed by earmarked grants, supplemented by financial contributions from the municipality itself and charges paid by the inhabitants. In 2009

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<sup>73</sup> This is a revised version of a paper presented at the Copenhagen Workshop on Intergovernmental Grants on 17-18 September 2009.

<sup>74</sup>The Department of Local Government, Ministry of Local Government and Regional Development

the earmarked grant share of total income was approximately 12.5 percent. Based on estimates from 2010, the level of earmarking in 2011 will be substantially reduced to the effect that the earmarked grant share of total income will be approximately 4 percent. In addition, the municipalities get revenues from interest income, stocks and property taxes.

**Table 1. Some key indicators**

Composition of revenues 2004-2010							
Year	2004	2005	2006	2007	2008	2009	2010*
Share of free income	69.3	68.3	69.1	67.5	67.0	67.6	68.0
Share of specific grants	10.0	10.5	11.4	12.4	12.9	12.5	12.9

**Table 2. \*Estimated accounting figures for 2010**

Number of earmarked grants							
	2004	2005	2006	2007	2008	2009	2010
	39	41	43	43	46	49	49

From 2004 to 2009 the share of earmarked grants has increased, mainly because of considerable growth in kindergarten grants. In 2009, earmarked grants accounted for 12.5 per cent of total income in the local government sector. In recent years the central government has implemented a reform of the kindergarten sector in order to achieve full kindergarten coverage. This commitment is financed by several earmarked grants, and in 2009, 64 per cent of the earmarked grants went to investments in and operation of kindergartens. The reform is now nearly completed, and in 2011 the kindergarten grants will be included in the general grant. The strong commitment to kindergarten coverage can explain much of the volume growth, but the number of relatively small earmarked grants has also increased over the past five years. In 2004 there were 39 different earmarked grants, in 2010 the number is 49. From 2011, when most of the kindergarten grants will have been included in the general grant, the earmarked grant share of total income will be approximately 4 per cent, and the free income share of total revenue will increase to 80 per cent (based on estimates from 2010).

## 7B.1. Guidelines and principles

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A strong public sector and a good welfare system are important and desirable goals for the Norwegian government. Local government consumption accounts for 13 per cent of GDP in continental Norway, and one in five of all employees in Norway work in the local government sector. The municipalities are the central actors in solving the large social tasks such as education, child care and healthcare. It is a national goal to offer citizens a high level of public services in all parts of the country. Therefore the central government has different goals to achieve when distributing grants:

1. Ensuring that the municipalities can afford to perform their tasks (income effect)
  2. Ensuring an equalization of expenditure costs
  3. Meeting sectoral goals; effecting the priorities of local government
- 
1. In Norway the responsibility for central welfare tasks lies with municipalities and counties. The sector has considerable tax revenues, but this does not provide sufficient resources. Therefore the central government must supplement the local sector.
  2. The distribution of responsibilities between the different levels of government in Norway is currently based on what is called the generalist local authority system. This means that all municipalities are intended to fulfil the same functions. They all have the same responsibilities regardless of size. Revenues and expenditures vary between municipalities, and it is necessary to equalize both expenditures and taxes.
  3. Grants can be a strong and efficient means to meet sectoral goals. If there is a need to raise the level of quality of a nationally high prioritised service, grants can be a tool to influence the priorities made by local government.

## **7B.2. Specific grants or block grants?**

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If the central government has delegated responsibility for a certain task to the local sector or decided to strengthen its efforts in relation to an existing task, the municipalities will get economic compensation if the expenditures increase, in order to ensure consistency between tasks and resources. The central government can then choose to increase free income through the General Purpose Grant Scheme or to establish a new specific grant. The new task can also be financed by fees. Fees and charges are mainly used to pay for water, sewage and waste disposal, but some services are also financed through a combination of grants and fees (for example kindergartens). However, the use of fees and charges is limited, because they can be regarded as extra taxes. The typical welfare services must reach everyone, independent of personal income.

The choice between general grants or earmarked grants depends on several factors, such as consideration of local democracy and local political priorities, inhabitants' needs and preferences, differences in local conditions, efficiency and also cost-efficiency, macroeconomic control, equality, quality and the desired level of activity.

An important principle in the Norwegian system is that municipalities and counties are primarily to be financed by general purpose grants. Local welfare services then become subjects of local political priorities, which make local politicians responsible for local welfare decisions; and at the same time administrative costs both at central and local level are at their lowest. Financing through general purpose grants also strengthens the opportunity to achieve macroeconomic control.

On the other hand, specific earmarked grants can be a strong and efficient means to meet a sector goal, because the supply of resources motivates for the production of a certain task. In this case the priorities are de facto decided by politicians at the national rather than the local level. Sometimes it can be a rational and reasonable decision to choose an earmarked grant. Therefore some responsibilities are financed by earmarked grants. There are

no definite or categorical rules for when to choose a specific grant, but some of the guidelines are:

- when financing goods and services with low national coverage
- when financing services only in a few districts, to reach particular groups or persons
- when financing services for a strictly limited period

### ***Low national coverage***

Earmarked grants have been used to finance services when the national coverage has been low, and in cases where it was of important political interest to achieve a higher coverage, or to raise the quality of a service. Earmarked grants have also been used to establish new welfare services. Earmarked grants can be very effective when their use is restricted to a few areas, or if the grants are given for only a restricted period. Through an earmarked grant economic incentives will be established, and a high coverage of the service can be achieved sooner than would be the case through a general grant. Studies have shown that this effect decreases when the coverage increases. In cases where the coverage was originally low, a higher level can be reached faster through a specific grant. When a certain and sufficient coverage of the service has been reached, the Norwegian policy is to include the specific grant in the general grant.

The kindergarten grant is a suitable example. The reason given for financing kindergartens through an earmarked grant (a so-called matching grant) was that the coverage had been too low, and for a long time it was a politically important goal to achieve full kindergarten coverage. Now the goal of full kindergarten coverage has been met, and in 2011 the grant will be included in the general grant. Another example is the grant to after-school activities (any program which invites schoolchildren to participate in activities after the traditional school day). When the program was new and the coverage was low, the service was financed by a specific grant. Now the municipalities have provided a satisfactory level of the service, and the grant is included in the general grant.

### ***Some particular districts or groups***

Some public services are only delivered in a few districts, to special groups of inhabitants, or the need for the service can vary

considerably among municipalities. Financing these kinds of services by a general grant is not purposeful because of the large differences in production costs. In addition, the grants may be small in terms of money. The equalization of expenditure mechanism in the general grant scheme requires a certain size of grant (or production costs) if the criteria are to be met. A too small amount of money will not change the existing criteria, and the preferred distribution between municipalities will not be achieved. At the same time, the criteria system cannot be used for services produced in only a few municipalities, because then the production costs will not differ systematically. The equalization of expenditures mechanism cannot handle these tasks; one solution is to work out special mechanisms in the General Purpose Grant Scheme. In some cases this can be done; it is possible in the scheme to distribute a specific grant for a shorter period. The grants will then be given together with the general grants, and no reporting on the use of the grants will be required. The rule in this case is that after a while the specific grant will be included in the general grant and distributed by the equalization of expenditures mechanism.

However, is it necessary to achieve an absolutely fair distribution of all services? The Norwegian municipalities have many responsibilities because they are the central element in solving large social tasks. Therefore, the sector also has large resources; the revenues of the local government sector amounts to nearly 18 per cent of GDP in continental Norway. In spite of the many small entities, the municipalities are overall robust economic units. If the financing of a specific service is included in the general grant without any changes to the existing criteria, some municipalities will gain and some will lose with respect to their expenditures. If one municipality gains in one area at one time, the next time it may lose. In the long run their income will almost be equalized. An important question is how detailed the distribution of income need to be. In some cases earmarked grants are more suitable, because it is politically important to visualize the grant. In other cases, it will not be possible to obtain an efficient allocation of resources by the general grant, because the needs are too asymmetrical and the demand for revenues too high.

An example of earmarked grants in category 2 is the grant for the housing of under-age refugees. There are too few municipalities that want to accommodate single under-age refugees. On the other hand, housing is an expensive task and not usually a task for the local authorities. The efficient solution is to pay the municipalities for the service through an earmarked grant. Another example is the grant to fishing harbours and grants for the prevention of snow slides. These grants concern only a few municipalities, but they finance important tasks that must be solved. Therefore the best solution may be to give an earmarked grant to the local authority. Without visualizing and establishing an economic incentive there is a possibility that these tasks will not be solved.

*Strictly limited period*

Also grants that are supposed to exist only for a short period of time can rationally be given as an earmarked grant. Examples are grants for science and special projects.

The Norwegian policy is to limit the use of earmarked grants. Financing the local sector by general purpose grants is an important principle for most of the political parties. Specific grants are not considered suitable as the main source of income for the municipalities. If new reforms and improvements in a sector are financed by earmarked grants, the share of income coming from general grants will be reduced. Furthermore, earmarked grants are normally given on the condition that the municipalities make their own financial contribution. This will set the free income financing under pressure, because the amount of resources spent according to local priorities will decline.

As discussed above, specific grants may in some cases be a strong and effective means to meet a sector goal. In the next chapter, different ways of designing earmarked grants will be discussed, as well as new forms of earmarked grants, namely sector plans followed by earmarked grants and compensation for rent expenditures. The first part of the chapter contains a more detailed description of different types of earmarked grants (Borge 2010).

### **7B.3. Different kinds of earmarked grants**

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We will not take into account grants that are pure refund of costs, for example in case of a service where the municipalities can forward the entire bill to the central government. In principle, earmarked grants can be designed in two different ways.

- grants given according to objective criteria (they do not influence the relative price)
- grants given according to level of activity (they influence the relative price)

Some earmarked grants are in the same way as general grants distributed according to objective criteria, for example the number of inhabitants in the municipality or other population characteristics (a categorical or «earmarked block grant»). This type of grant is mostly used to achieve a higher level of activity in a certain area, for example services to the elderly or the disabled. The municipalities must report to the central level how they spend the money, but the grant is not given on the condition of their own financial contribution.

More common are earmarked grants based on activity. For one produced unit, for example a kindergarten place, the municipality receives a grant. This type of grant normally requires a financial contribution; the municipality must pay some of the costs, but the service is then cheaper to produce (matching grants). This type of grant is supposed to cover expenditures, not investments.

There are also some related grants where the local authorities can apply to have some of their expenditures covered, or the central government covers a certain amount of the expenditures. These grants have mostly been used to support investments, not to support daily services. For example, some years ago high priority was given to construction of nursing homes, and upon application municipalities could get investment support through an earmarked grant. In recent years, the central government has also given interest support to local governments. Upon application they can get support to cover interest expenditures related to specific investments, for example to restore churches. These types of grants have also been designed as combinations of a general, earmarked

grant (given according to objective criteria) and a purely specific grant. For example, every county gets a framework investment amount, and the grant is intended to cover the interest. The total framework is distributed among the counties by objective criteria. In the next step the municipalities can apply for support until the county's framework amount is spent.

#### **7B.4. Discussion**

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Earmarked grants can be a strong means to meet a sector goal, but they have some strong disadvantages.

- high administrative costs
- unfair distribution
- weak control over the total amount of expenditures
- weak control over allocation
- efficacious?

In Norway the municipalities more or less have the same responsibilities, even if the number of inhabitants varies from 200 to 600,000. General grants take existing variations between the municipalities into consideration. The general grant is based on objective criteria and equalization of expenditures. The general grant is a stable source of income; when local decision-makers plan the budget for the following year, the level of income from the general grant is already known.

On the other hand, local authorities must normally send an application if they want an earmarked grant. The process creates administrative burdens both at the local and the central level. The local government must also know the rules for the distribution of a specific grant, as well as which grants are new, and local politicians must decide whether the municipality will apply for it or not. If a major part of their revenue comes from earmarked grants, the result can be rather chaotic. In addition, it can be difficult to know how much revenue the municipality will get for a certain task. Again, this can cause problems for the planning and carrying out of services. Earmarked grants are therefore more effective when the use is restricted to a few areas.

If a major part of the municipalities' income depends on specific grants, the allocation of services and goods may not correspond with inhabitant needs. The earmarked grant is a result of the priorities made by politicians representing the national parliament, and not at the local level. Again, the specific grants do not consider existing variations between municipalities. As a result, municipalities with a satisfying level of service quality may either lose the grant or provide an over-dimensioned service - neither is economical.

Specific grants are normally given on the condition of financial contribution from the municipalities and counties. If the grant is to function as a strong and efficient tool to carry out local priorities, this must be the underlying assumption. However, the amount of free income and the financial situation vary between the municipalities. Some of the differences are intended, for example the General Purpose Grant Scheme includes grants to remote areas, and other income sources can also cause unintended disparities. The result of earmarked grants is that the municipalities and counties that are financially strong have better opportunities to release specific grants. This may increase the differences between municipalities.

Some earmarked grants are given according to objective criteria. The goal is to strengthen a particular task or service. This type of grant is not as effective as grants that require a financial contribution, but studies have shown that they can have an effect on local priorities if they are accompanied by massive information. However, as discussed in the first part of this chapter, the local level can manipulate these grants by not using their own free income to solve the specific task. A similar problem can occur with grants which require a financial contribution. The municipality does not necessarily spend more of their free income when the central government offers a specific grant to strengthen a task. The local government can choose to spend the same amount of money as before and get more services or it can choose to reduce its normal contribution and achieve the same level of service as before. Attempts have been made to solve this leakage to other services by more reporting from the local authorities.

## 7B.5. Conclusions

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One conclusion is that earmarked grants have many weaknesses. Are they efficient tools? The answer is both yes and no. As described above, sometimes it is easier to finance a task by earmarked grants than by the general grant. If a service only targets specific areas or persons or if the coverage in a specific sector is low, earmarked grants may be efficient tools. Also, if the central government is to pay for specific services provided in the municipalities, earmarked grants can be the answer.

However, the main intention of earmarked grants is to influence local priorities. Thus, specific grants are normally given on the condition of financial contribution. The past few years we also had massive improvements for a limited period followed by earmarked grants. As described above, there are mechanisms which may neutralize the effect of earmarked grants, but the experience is that they work, especially if the coverage of the service is low. The mechanism is very simple; an earmarked grant makes it cheaper to produce a service, and the municipalities demand the grant. The problems with high administrative costs and uncertainty surrounding the budget process are on the other hand more difficult to solve. The most serious problem is perhaps that the central politicians affect the local priorities by using earmarked grants. The result can be that the local politicians are waiting for the next earmarked grant, the next «lift» instead of putting their own choices in to action. Financing municipalities and counties by general purpose grants makes the local welfare services subject to local political priorities. In general, block grants give municipalities and counties a better opportunity to adjust welfare services to local needs and demands.

Among national politicians and also among ministries, standpoints vary. The sector politicians often want to give their own responsibilities a boost and often want to use earmarked grants to fulfil a sector goal. Others are more concerned with achieving long-term efficiency and having macroeconomic control with the budgets. It is not possible to predict to what extent the local level will use an earmarked grant, and the bill can be higher than calculated in the budget. The extent to which the local sector is financed by earmarked grants is a result of the political process.

From a professional point of view, earmarked grants must be handled with care; only a smaller part of the municipalities' income should come from earmarked grants. The specific grants are effective when their use is restricted to a few areas. In Norway today there is a balance between general and earmarked grants. The past years the share of earmarked grants has increased mainly because of the strong growth in kindergartens grants. The remaining earmarked grants are rather small. From 2011 most of the revenues of the municipalities and counties will be free income (block grants and taxes). Based on estimates from 2010, only 4 percent of the total income will be earmarked grants. Still, there will be a high number of relatively small specific grants. Most of these grants finance services that will only be delivered in a few districts or to special groups of inhabitants.

One challenge is to continue the dialogue between the state and the local sector to achieve changes to the municipalities' welfare services without comprehensive use of laws and rules and earmarked grants. There is ongoing contact between the central government and The Norwegian Association of Local and Regional Authorities (KS). These consultations provide a forum for discussing the framework for distribution of revenues in relation to the tasks carried out by the local government, the financial situation of local government and efficiency means.

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# Chapter 8

## Conditional intergovernmental transfers in Italy after the constitutional reform of 2001

Giorgio Brosio and Stefano Piperno

### 8.1. Introduction

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Conditional/earmarked grants have traditionally been widely used in Italy. This is in part due to the inclination of the central government to interfere with local government priorities and behavior. The traditional importance of conditional grants also has to be explained by the piecemeal increase of subnational responsibilities during the decentralization process that have taken place in the most recent decades, particularly after the introduction of the regional governments in 1970. The most obvious and simple way to provide financing for a newly transferred competence is to allocate specific grants based on the amount previously spent by the government to which the competence was assigned. In particular, this mechanism took place at the turn of the new century after a comprehensive devolution of functions from the central government to the regional and local governments which is known as “administrative federalism”<sup>75</sup>.

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<sup>75</sup> To be more precise, in Italy the term “administrative federalism” refers to a bundle of State legislation approved at the end of the nineties (before the constitutional reform) that provided a mechanism for the devolution of administrative powers to the Regions in many fundamental areas hitherto undertaken by the State, and from the Regions to the Provinces and Municipalities. Therefore, new responsibilities (e.g.: public works, roads and regional railways, education and vocational training) were gradually transferred, in whole or in part, to Regions and local governments. Since these functions to date have been financed by a number of specific grants, this decentralization process underway in Italy can fit a conceptual definition of administrative federalism such as the one spelled out by Rattsø: “Decentralization of redistributive spending, combined with mandated and centralised financing is an administrative convenience: European fiscal federalism consequently can be

Even though these specific transfers were supposed to be transitional and to be gradually substituted by the assignment of a mix of own and shared taxes, they are still in place. The same period also saw a significant transformation of conditional grants into unconditional grants. For example, a number of conditional grants for the Regions - among which the most important was the National Health Fund - were abolished and replaced by own taxes, shared taxes and unconditional equalization grants distributed through a formula<sup>76</sup>. However, this shift was more apparent than real: the allocation of unconditional grants was subjected to continuous bargaining procedures between the State and the Regions, was dominated by the conflict over the fair assessment of health expenditure needs, and disregarded the outcome of the unconditional equalization grant formula. Moreover, the consequence is that the beneficiary governments will know the exact amount of their transfers only after the approval of their budgets, which prevents the effectiveness of the whole budget process.

Bergvall, Charbit, Kraan and Merk (2006) estimate that in the year 2002, conditional/earmarked grants in Italy represented 75 percent of total intergovernmental grants to local governments and 25 percent of total grants to regional governments. These rather large figures have oscillated widely before and after the year in question.

Possibly, the future will be different. At a first reading of the reformed constitutional text of 2001, conditional grants seem to have disappeared from the panoply of revenue sources available. The new constitution (article 119) lists five sources of financing for all levels of subnational government.

They are:

- c. own taxes and fees;
- d. shared taxes, meaning that a share of nationally collected taxes are distributed according to the place where they are generated (origin principle);

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called administrative federalism” (Rattsø, 2002, p.279).

<sup>76</sup> For a complete description of the system of intergovernmental grants in Italy, see Brosio, Piperno (2008).

- e. equalization grants;
- f. specific grants paid to individual subnational governments for economic development equalization and social cohesion purposes, for natural disasters and for funding functions delegated to them by the central government;<sup>77</sup>
- g. borrowing.

This list of financing instruments for subnational governments refers to all levels of subnational government and does not include earmarked/conditional grants, at least in the prevailing interpretation – transfers of money available in principle to all local government units on a matching or not–matching base to fund specific functions assigned to them. At the same time, the list includes two other categories of grants (items c. and d.). The obvious conclusion that may be drawn from the new constitutional text is that conditional grants are no longer included in the panoply of intergovernmental financing instruments. Otherwise, they would have been explicitly listed.

The new discipline has been the source of immediate problems, considering the large number of existing programs that were suddenly no longer constitutionally viable. For example, grants for kindergartens from Regions to Municipalities have been in danger of being discontinued and were preserved through an extensive interpretation of the new constitutional text by the Constitutional Court (see Section 4, below).

*De facto*, many conditional programs have been kept in operation, waiting for their reshaping in accordance with the new constitutional discipline. But since they are kept at a legal borderline, there is almost no information about them and they are not easily identifiable in the budgets of the paying and receiving governments.

There was also criticism of the fact that the new constitutional text

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<sup>77</sup> Article 119 states: “The State shall allocate supplementary resources and adopt special measures in favor of specific municipalities, provinces, metropolitan cities and regions to promote economic development along with social cohesion and solidarity, to reduce economic and social imbalances, to foster the exercise of the rights of the person or to achieve goals other than those pursued in the ordinary implementation of their functions”.

had gone too far ahead in recognizing the importance of subnational autonomy by excluding conditional grants. In fact, the move was somewhat unexpected, but to understand this one has to keep a few facts of the recent Italian political evolution in mind. The reform of 2001 was the work of the centre/left coalition governing at that time. Traditionally, the Italian centre/left political parties and coalitions have been sceptical towards decentralization, but they were forced to pay increasing attention to it to counteract the growing appeal on the Northern regions electorate exerted by the Northern League and its secessionist/strongly autonomist stance. The Constitution of 2001 is the political and legal response to the competition from the Northern League. As such, it had to sponsor the decentralization cause, although the sponsors were not personally fully in tune with it. The elimination of central government controls over subnational governments was a central component of the reform, which gives a constitutionally autonomous status to all subnational government units. In this framework, the elimination of conditional grants became an obvious component of the reform, also taking into account the European Charter of Local Government that recommends using them as little as possible.

However, at a more careful reading of the Constitution, an outright elimination of earmarked/conditional is doubtful. Also, the recent governmental practice of grant allocation and the recent framework law implementing the constitution (the so-called “Fiscal Federalism” law<sup>78</sup>) indicate that earmarked/conditional grants will remain a largely used instrument for financing local governments, although with somewhat different characteristics and aims.

There may be more. Conditional/earmarked grants have been abolished by the Constitution because they were seen to interfere too deeply with local autonomy. The new system of grants, however, may end up with a higher potential of interference, whether they are classified as conditional or unconditional. This is because the Constitution and the present implementing legislation intends to ensure a rather ambitious system of standards (LEP, “essential levels of service provision”) for a set of basic services for which responsibility is shared between the central and the

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<sup>78</sup> Law n.42/2009.

subnational levels. This is likely to require financing instruments that allow interference by the central government into subnational governments' choices, as it is clearly the case with conditional/earmarked grants.

This paper seeks to single out the implications of the new constitutional text and illustrates recent practice. It is divided into four sections. The first section describes very briefly the Italian system of territorial government. The second section presents the emerging system of equalization grants, part of which will consist of block grants the characteristics of which make them very similar to conditional grants. The third section is devoted to the illustration of the new practice of transfers for regional development and social cohesion purposes. The fourth section singles out the transfers from Regional to Local Governments.

## **8.2. Italian intergovernmental relations after the reform of 2001<sup>79</sup>**

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There are four main levels of territorial government in Italy, namely the Central Government, the Regions (20 units), the Provinces (109 units), and the Municipalities (8101 units). Furthermore, the Constitution introduces the possibility for large metropolitan areas to create metropolitan city governments by merging of existing municipalities.

All levels of government have the same constitutional status, which makes Italy close to a federal system of government. Equality of constitutional status increases the difficulties of managing the system because of the need to apply the same legal discipline to extremely different government units.

Regional governments have legislative powers. The assignment of responsibilities between central and regional governments is similar to the German system, where the central/federal government and the Regions/Laender have both exclusive and concurrent powers. Exclusive powers mean that Regions (and the central government, obviously) have complete autonomy to define

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<sup>79</sup> For an introduction, see Bibbee (2007), Brosio and Piperno (2008), and Giarda (2001).

their competences through legislation. Concurrent powers imply the responsibility of the central government for framework legislation, while the Regions are empowered to pass the implementing legislation. The existence of concurrent powers may have some bearing on conditional grants because they empower the central government to intervene in areas of local responsibility. Intervention may also materialize in the structuring of intergovernmental grants.

The subnational expenditure share of general government expenditure with the exclusion of pensions and social security funds has slowly increased over the years, but it still represents less than fifty percent of the total. The main item is healthcare, which is managed by the Regions.

**Table 1. Share of expenditure by different levels of government° (in percent of total general government expenditure)**

	<i>1990</i>	<i>1995</i>	<i>2006</i>
State	63	60	54
Regions	23	23	26
Provinces & Municipalities	14	17	20
Total	100	100	100

Source: Ministry of the Economy, Country General Economic Report, various years.

°Consolidated data: transfers from one level of government to the others are included in the expenditure of the recipient level. Expenditures by Social Protection Funds are not included.

**Table 2. Structure of revenue of local governments**

	Regions		Provinces		Municipalities	
	<i>1990</i>	<i>2005</i>	<i>1990</i>	<i>2005</i>	<i>1990</i>	<i>2005</i>
Revenues						
Own taxes	8.5	59.2	19.4	52.5	1.6	39.9
Fees and user charges	0.5	0.9	9.8	11.9	0.1	0.1
Grants	85.5	33.3	65.1	26.0	97.7	59.3
Non-tax revenues (*)	5.5	6.6	5.7	9.6	0.6	0.7
Total	100	100	100	100	100	100

Source: Ministry of the Economy, Country General Economic Report, various years.

(\*) Net of borrowing

On the revenue side, the expenditure increase has been paralleled

by an increase in subnational tax autonomy, particularly since the early 1990's. Local taxes played a marginal role until 1990, as reported in Table 2. They have substantially increased since then, reaching a share of about 40 percent of total revenue for the Municipalities (52 percent for the Provinces) and reaching almost 60 percent for the Regions.

Grants were dominant for all levels of subnational government until the end of the last century, but have since been on a substantial decline, particularly in the case of grants to regional governments. Recent government decisions, however, are only partly reflected in the numbers and are likely to alter the trend. More precisely, in 2008 the central government eliminated the local property tax levied on the first residence (that occupied by the owner). The government also intends to eliminate the main tax source for regional governments, namely the IRAP, which ensures a large share of health financing.

### **8.3. Block grants for the provision of essential service levels in some areas (health, education and social protection as well as others still to be defined)**

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#### **8.3.1. The new system**

The new system of block grants for basic services will emerge from two distinct constitutional provisions. The first one is the already mentioned list under article 119 and the already quoted list of financing instruments. The relevant ones are own and shared taxes and equalization grants (borrowing – which is restricted to capital expenditure – and specific grants for regional development and social cohesion are obviously excluded).

The second constitutional provision is article 117.m. which assigns to the exclusive competence of the central government the definition of “essential levels of service provision” (LEPs, *livelli essenziali delle prestazioni*) for a set of services (basic services) that are necessary to guarantee equal basic individual and social entitlements across the entire nation.<sup>80</sup> These services, which the

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<sup>80</sup> Article 117 is difficult to understand and even more difficult to translate into English. The official translation of the constitution made by the Italian Parliament reads as follows: “determination of the basic level of benefits relating

central government and the Regions and/or the Municipalities share the responsibility for providing, still have to be precisely identified, but they include health, education and social protection, plus a still undefined set of services provided by local governments (Municipalities and Provinces).

In essence, the Constitution makes a distinction between two sets of subnational policy responsibilities: those that are subject to the “essential level of service provision” constraint and those that are not, implying that the level of service provision of the latter may vary across the national territory.

As a consequence, two distinct systems of financing have to be introduced. The framework law for subnational government financing – the so-called “Fiscal Federalism” law – which was recently passed by the Italian Parliament, sets up the main characteristics of the two systems that will have to be defined through government decrees. More precisely, it introduces a dual system of equalization transfers, namely a set of block grants for essential services and a general equalization system for all remaining functions.

For the sake of simplicity, we describe only the system of block grants for the Regions, which is illustrated in *Figure 1*. In fact, the rationale of the system for other local governments envisaged by the “Fiscal Federalism” law is very similar. On the left hand side of the figure are the basic services. The equalization/block grants are determined through the following steps:

- a. Definition of the essential level of service provision (LEPs) for each service.
- b. Estimating the standard cost corresponding to the essential level for each subnational unit and for each service.
- c. Summing the costs for all the concerned services.
- d. Calculating the revenue deriving from levying, at a standardized rate, the own taxes notionally assigned to these functions, the revenue from the surcharge of the Personal

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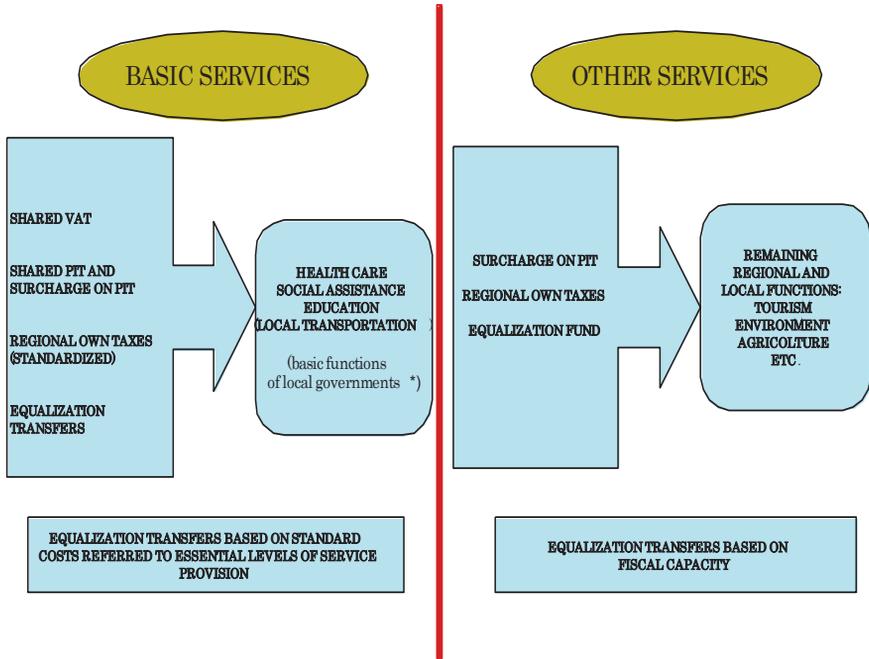
to civil and social entitlements to be guaranteed throughout the national territory”.

Income tax, and the revenue from a still to be determined share of the VAT and other shared taxes notionally pre-assigned to these services.

- e. Determining the net transfer through the difference between d. and c.

In essence, this equalization system will be based on a set of block grants. More specifically, individual gross block grants will be determined by estimating for each function a sort of standardized expenditure, determined by applying standard costs to essential levels. The net equalization total grant will be determined as the difference between the total block grants and the notionally assigned tax revenues.

**Figure 1. The new system of block grants for Regions based on the “Fiscal Federalism” Law.**



(\* ) The “basic functions” of local governments (Provinces and Communes) will be defined by the central government and financed through a mechanism very similar to the one envisioned for the Regions.

Conversely, the mechanism for the distribution of the equalization fund on the services not bound to the essential level provision is outlined to the right in figure 1. In this case the equalization scheme is based on differences in fiscal capacity.

### **8.3.2. Determining essential levels of service provision (LEPs)**

The new system is extremely complex, if not almost impossible to implement, because of the analytical, technical difficulties – and likely game-playing – in defining essential levels and the standard costs associated with them.

Determining viable and meaningful LEPs will require a very cumbersome and time-consuming procedure, which will be carried on under continuous pressure by Regions, Provinces and Municipalities. The procedure set up by the Framework Law will also allow a wide scope for lobbying and political bargaining<sup>81</sup>.

To briefly mention the substance of LEPs, a number of issues are immediately obvious. LEPs must be higher than minimum levels, otherwise the constitution would have termed them minimum service levels. Their levels of service provision also have to be sustainable and compatible with keeping financial equilibrium.<sup>82</sup>

There is little experience in Italy with these issues, although the country has had some practice with a similar concept: Essential Levels of Assistance (LEAs) for health services. LEAs are simply a list of services that any Region must supply to its citizens. LEAs do not imply either quantitative or qualitative targets (such as maximum length of queues). There is also no correspondence between LEAs and their financing. The present block grant for healthcare services is determined on a per capita basis, takes into account the age structure of the population, and makes some adjustment for interregional patient mobility.<sup>83</sup>

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<sup>81</sup> Both LEPs and standard costs will be determined by a government decree with the support of a Technical Committee (Commissione Tecnica Paritetica), which will have equal numbers of representatives from the central government and from the regional and local authorities. The decisions will then be subjected to control by a bi-cameral parliamentary committee.

<sup>82</sup> See also on these issues Buratti (2009).

<sup>83</sup> See also Brosio and Piperno (2008) on these grants.

It is easy to predict that LEPs will be set up in a very bureaucratic, input-based way, with little consideration for quality issues. This will accommodate the regional demand for funds without promoting effective convergence and homogeneity of levels of service delivery among them.

**8.3.3. Trade-off between local autonomy, efficiency and compliance**  
 The new system of block grants will also raise a trade-off problem between regional/local autonomy on the one hand, and efficiency and compliance with essential levels on the other. Assuming that the level of efficiency is the same everywhere and that each Region provides a level of service that corresponds precisely to the legally mandated essential level, then each Region would spend exactly the total amount of gross block grants it receives and there would be no problems. However, this will be a very rare occurrence. Regions are more likely to be over- and/or especially underperforming in terms of efficiency and/or compliance with essential levels of service provision, as is the case at present. For example, *Table A.1.* in Annex 1 reports data on consumer satisfaction and healthcare by Regions. It is easy to observe wide gaps in satisfaction, which are not explained by differences in per capita expenditure. Figure 2 illustrates the four possible combinations.

Case 1 presents no problems. An efficient and compliant Region could even spend less than the grant, reduce levels to the essential norm and redirect the savings to other functions. Case 2 is a problem for the concerned Region, since it has to spend more than the granted funds. Problems arise with case 4: efficient Regions provide less than essential levels and, especially, with case 3 – likely to be the most common case – Regions that are non-efficient and non-compliant with levels.

**Figure 2. Combinations of efficiency and service delivery levels**

Average efficiency ↑	4. Efficient but not compliant with levels	1. Efficient and compliant with levels
	3. Non-efficient and not compliant with levels	2. Non-efficient, but compliant with levels
Essential levels of service provision →		

The alternative options in both 3 and 4 are: a) to accept regional autonomy and to leave voters (and other political mechanisms) to solve the issue, and b) to intervene with controls and penalties. There is a propensity among scholars and central government officials in Italy to choose the second option, but its implementation will be hard, because although curtailment of grants can increase efficiency, it would make Regions even less compliant with levels. Implementation would be even harder in political economy terms, considering the large number of non-efficient and non-compliant Regions that will simply pressure for an increase in financing.

These political economy considerations receive more strength – although with differences from sector to sector - from a distinct point of view that considers the effective degree of political decentralization in Italy. Let us introduce briefly an index of decentralization that one of the authors has developed elsewhere (Brosio, 2007) and which is shown in Annex 2 below.

Essentially, this index maintains that (de)centralization of a service, or of a policy, does not refer to the institutional assignment of it to the central government, but to the probability of re-election of the central government that originates from the level of provision of this service. For example, healthcare can be constitutionally decentralized, but it will still be centralized if the probability of re-election of the central government also depends on the level of healthcare provision.

The general perception in Italy (but not only there) is that voters consider healthcare still to be largely a central government responsibility. Hence, the central government is likely to intervene massively with funds to ensure compliance with LEPs (and to a smaller extent with efficiency). Of course, to explain homogeneity of service provision it must also be assumed that equalization is a basic responsibility of the central government.

According to this index, other services for which the LEPs regime will also apply may be less centralized than health. If that is the case, the levels of central government intervention in and expenditure for those services will possibly be lower.

Finally, the choice between local autonomy and efficiency and compliance also has a bearing on the assignment of these block grants as either conditional or unconditional. According to widely shared definitions<sup>84</sup>, block grants are non-matching central government grants to local governments that give them broad flexibility as to the design and implementation of designated functions. Current definitions also imply that central government monitoring and oversight are light. To a large extent the assignment of block grants as being either conditional or unconditional depends on budgetary procedures, i.e. on the capacity of the allocating government via the budget of the recipient government to check whether the block grant has been spent on the function for which it was allocated and in the prescribed manner.

#### **8.4. Grants for regional development and social cohesion purposes**

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In Italy, huge efforts have been made since World War II to equal out regional economic disparities through a massive transfer of public resources in favour of the poorer areas. This has been carried out with the use of different policy instruments, such as increases of public sector employment in the less developed areas, transfers to local governments and a general rule mandating that at least 40 per cent of all public sector investments had to be placed in the Southern regions (which account for about 30 percent of the population).

Investments in State-owned companies and central management, and financing of public infrastructure projects were a strategic component of this policy, which was based on the assumption that filling the infrastructural gap between the rich and the poor

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<sup>84</sup> For example Finegold, Wherry and Schardin (2004) use the following one: “Block grants are fixed-sum federal government grants to state and local governments that give them broad flexibility to design and implement designated programs”. Federal oversight and requirements are light, and funds are allocated among recipient governments by formula. Most federal aid is currently distributed to state and local governments as categorical grants, which may also be allocated by formula but can only be used for rather narrowly defined purposes”.

regions would have led to convergence in their growth rates. Privatization of state companies obviously put a stop to their use as regional development instruments, and the special agency in charge of public infrastructure projects (Cassa per il Mezzogiorno) was closed down in 1992 (mostly because it had become too independent from political parties). Most of the investment effort was subsequently shifted onto the shoulders of regional and local governments, helped by centrally provided capital investment grants. This effort was supplemented by the direct financing of projects by the Ministry of the Economy. Most of the EU financing through the Regional and Social Funds was also directed towards the same goal. Not much has been achieved, however.

The 2001 Constitution retains the traditional approach to regional development based on filling gaps in the stock of infrastructure and assumes that general equalization transfers to local governments are insufficient to ensure economic convergence among Regions, even if they are meant to ensure equal provision of service delivery. Hence, the constitutional provision of special grants (literally contributions) allocated to individual subnational governments for regional development and social cohesion. The Constitution does not mandate any sectoral constraints over these grants, nor does it contain a clause implying that they have to be used only for investment purposes.

Practice shows an increasing use of this instrument. The FAS (Fund for Underutilized Areas) is the instrument used to implement article 119 of the Constitution concerning regional convergence and social cohesion. The FAS includes three types of expenditures: a) subsidies to business firms; b) grants to Regions, allocated mainly, but not exclusively, for the building of infrastructure, and c) infrastructure funding of projects selected and/or managed by the central government, including the so-called strategic ones.

Grants to Regions are presently allocated to all regions – instead of selectively as indicated in the Constitution – for political expedience. However, grants to rich Regions are concentrated on their declining industrial areas and are considerably smaller. *Table 3* reports the budgeted amount of these grants for the period 2007-2013. There are also grants to fund interregional projects. It is

important to note the large share allocated to the Southern regions that amounts to  $\frac{3}{4}$  of the total. The allocation is based on a partial/discretionary matching base, meaning that the Regions have to supplement government allocations with their own funds.

**Table 3. Allocation of grants for regional convergence and social cohesion purposes. 2007-2013. (million of Euros)**

<i>Regions</i>	<i>Total amount</i>	<i>% share of total</i>
Piemonte	889.2	3.8
Valle d'Aosta	41.6	0.2
Lombardia	846.6	3.6
Bolzano	85.9	0.4
Trento	57.7	0.2
Veneto	608.7	2.6
Friuli Venezia Giulia	190.2	0.8
Liguria	342.1	1.4
Emilia Romagna	286.1	1.2
Toscana	757.0	3.2
Umbria	253.4	1.1
Marche	240.6	1.0
Lazio	994.6	4.2
Abruzzo	854.7	3.6
Molise	476.6	2.0
Campania	4,105.5	17.3
Puglia	3,271.7	13.8
Basilicata	900.3	3.8
Calabria	1,868.5	7.9
Sicilia	4,313.5	18.2
Sardegna	2,278.6	9.6
National total	23,663	100
Total for Northern- Central Regions	5,544	23.4
Total for Southern Regions	18,069	76.6

Source: Ministero dell' Economia, Delibera Cipe 166 del 21/12/2007

There is no precise matching rate, but the matching rate proposed by the recipients is a preferred criterion for the allocation of grants among Regions. The grants are not only used for infrastructural or regional development projects, but can also be used for funding service provision in individual sectors. In 2007, part of the allocation was in fact used to finance healthcare and social service provision in the Southern Regions.

Finally, and more importantly, these transfers are used to finance

specific projects that are presented by the regional governments and which will be run by them. The share allocated to each Region derives from a basically joint central/regional decision, but the selection of individual projects is done by the central government (Ministry of Economy). These grants, which are project-specific rather than sector-specific, have a much higher level of conditionality than the usual conditional matching grants, where the selection of programs and projects to be financed is made by the recipient local government.

### 8.5. Transfers from regional to local governments

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The ban on conditional grants introduced by the 2001 Constitution seems, at a first glance, to apply to all levels of government. This was also the prevailing interpretation by all stakeholders. Obviously, the ban raised immediate and huge concerns, since it implied that all existing conditional grant programs had to be discontinued. The issue was immediately brought before the Constitutional Court with reference to the case of existing regional grants to kindergartens. The Court found<sup>85</sup> that the grant program could be continued, because while the Constitution forbids the allocation of grants for specific functions, the ban cannot be applied to Regions since that would imply restrictions in their policy-making and financial autonomy, which is also constitutionally protected. Responsibility for kindergartens is shared between Regions and local governments and the central government. However, according to the Constitutional Court ruling, the central government only has “a few discretionary powers” (our translation) in this sector.

The above Constitutional Court ruling has implications that extend beyond kindergartens, because it can be – and has been – applied to all existing similar conditional grants programs.

In practice, conditional grants from Regions have not diminished since 2001. The trend is partly observable in *Table 4*, which illustrates the share of recurrent and capital grants allocated to the Municipalities by the central and regional governments. Grants for recurrent purposes from the central government include

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<sup>85</sup> Ruling N.370 of December 17, 2003

**Table 4. Grants from the central and the regional governments to the Municipalities. Share on total revenue, selected years.**

	1996	2000	2001	2006	2007
Grants from the central government for recurrent purposes	22.7	20.2	19.1	8.9	13.2
Grants from Regions for recurrent purposes	3.4	5.7	5.9	5.4	6.0
Grants from the central government for capital purposes	1.6	2.1	1.6	1.5	2.3
Grants from Regions for capital purposes	2.3	3.0	3.5	4.9	5.0
Total revenues	100	100	100	100	100

Source: Ministero dell' Economia

equalization of non-conditional grants and show a large reduction of their relative importance. Grants for recurrent expenditure from the Regions and grants for capital purposes from both levels of government are definitely conditional and have increased their importance over the years.

## 8.6. Conclusions

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The amended constitution has eliminated earmarked/conditional grants from the panoply of instruments for financing regional and local governments. The intent behind the elimination was to pay more regard to subnational government autonomy.

At the same time, the Constitution and the legislation implementing it seek to promote equality of service provision across all areas for a set of basic services, including health, education and social protection. The Constitution also seeks to promote regional economic convergence.

This is likely to increase the need to use financial instruments that can impact negatively on the autonomy of the recipient governments, as in the case of earmarked/conditional grants.

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## ANNEX 1

**Table A1. Italy. Consumers' satisfaction and per-capita expenditure on hospital care by Region. 2000 and 2005**

Regions	Index of Satisfaction				Per-capita expenditure	
	Medical	Other	Medical	Other	Euros	Euros
	<i>2000</i>	<i>2000</i>	<i>2005</i>	<i>2005</i>	<i>2000</i>	<i>2005</i>
PIEMONTE	1.63	1.73	1.62	1.64	942	1,644
LOMBARDIA	1.75	1.73	1.71	1.80	1,012	2,073
Trentino AA	1.42	1.42	1.60	1.52	1,000	2,101
VENETO	1.76	1.76	1.67	1.59	1,000	1,637
FriuliVG	1.4	1.33	1.75	1.82	1,053	1,633
LIGURIA	1.72	1.65	1.47	1.51	1,042	1,616
EMILIA ROMAGNA	1.61	1.61	1.62	1.60	1,000	1,702
TOSCANA	1.64	1.65	1.71	1.64	994	1,667
UMBRIA	1.77	1.62	2.00	1.90	1,093	1,629
MARCHE	1.8	1.74	1.70	1.67	1,034	1,542
LARIO	1.83	1.97	1.80	1.80	929	1,099
ABRUZZO	1.96	1.9	1.84	1.89	1,032	1,451
MOLISE	1.92	2.22	2.15	2.12	865	1,247
CAMPANIA	1.86	2.03	1.88	2.16	916	1,331
PUGLIA	2.05	2.06	1.96	2.07	995	1,402
BASILICATA	1.9	1.88	1.84	1.93	1,011	1,622
CALABRIA	1.99	2.11	2.03	2.04	943	1,900
Sicilia	1.99	2.18	1.88	1.93	913	1,459
Sardegna	1.87	1.91	1.79	1.78	979	1,755

Source: Central Statistical Office.

Values of index: 1=very satisfied, 2=satisfied, 3 = dissatisfied, 4= very dissatisfied. Ordinary Regions are in capital letters.

## ANNEX 2

### **A Definition of the degree of (de)centralization based on political/electoral interrelations**

The degree of centralization/decentralization can be defined in political/electoral terms by referring to the probability of re-election of the central government.

Imagine a country with a central government,  $C$ , subdivided in two distinct regional jurisdictions,  $i$  and  $j$ . There are only two publicly provided goods, namely, defence,  $D$ , a purely national one, and healthcare,  $H$ , a mainly local and mixed one. These goods can be provided under different institutional arrangements.

The probability of reelection depends only on the level of service provision for the publicly provided goods, i.e.  $P_c(aD, \beta H)$ , where  $P_c$  is the probability of reelection of the central government and  $\alpha$  and  $\beta$  are the discount factors assigned to the arguments, with  $0 \leq \alpha, \beta \leq 1$ . This probability is related to the probability that each voter will grant his/her consent to the incumbent politician. In turn, this probability is a function of the utility of each voter. For simplicity, we assume that voters' utility function has only two arguments, namely defence and healthcare provision.

According to this approach, the degree of decentralization can be inferred from the value of  $\alpha$  and  $\beta$ . When  $\alpha = \beta$ , the system is completely centralized, since voters consider that the central government only is responsible for both goods. In fact, in a purely centralized system the two arguments are discounted equally by the central government. This is because independently from constitutional and/or other legal regulations, voters consider that the central government has the full and exclusive responsibility for their provision. When  $\alpha > \beta$ , the system is decentralized. When  $\beta$  equals zero, the system is completely decentralized and the central government bears no responsibility whatsoever for the provision of the local good. A completely decentralized system implies that the probability of re-election of each unit of government depends on the single good for which the voters hold them responsible. The probability of reelection will depend for each layer of government from the level of service provision of a single good.

An essential point has to be made. The degree of decentralization defined here does not depend on equalization (regional redistribution) issues. In other words, according to our definition the central government is evaluated by citizens in the areas assigned to the responsibility of subnational government independently of equalization issues. This means that even in those jurisdictions that do not benefit from equalization grants, voters consider the central government as having a role to play. For example, providing insurance against possible failures in the service provision by their regional government.

# Chapter 9

## Specific and general grants in Sweden - what has happened after the grant reform in the 1990's?

Andreas Hermansson

### 9.1. Introduction

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Local government in Sweden forms a significant part of the economy. By international standards, a relatively large share of the welfare services is provided by local governments. In 2009, local government expenditures accounted for 24% of GDP and 25% of employment in the economy.

To alleviate the financial burden and to compensate for differences in income and costs as well as for various development purposes, the central government allocates general and specific purpose grants to local governments.

The tax bases are defined by the central government, but local governments have the right to set their own tax rates. The aggregated average tax rate for local governments<sup>86</sup> was 31.52% in 2009 (on personal income).

Local government is divided into two levels, municipalities and county councils, with overlapping geographical jurisdictions. Municipalities are responsible for a wider set of functions<sup>87</sup>, such as running schools and social services and taking care of the elderly, whereas the county councils provide general and specialised health care and regional transport. Parliament sets goals for different

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<sup>86</sup> The highest rate for municipalities is 23.64% and the lowest 17.12%. The highest rate for county councils is 12.10% and the lowest 9.72%.

<sup>87</sup> See appendix 1 for a more detailed description.

services defined by laws under which local governments have been mandated the running of different services. Deregulation and decentralisation define the framework and the spirit of these laws. These pillars are the basis of the local government grant system that was established in the early 1990's and which marked a shift in balance from specific grants to general grants.

The foundations of the present grant system for local governments were laid down in 1993 through a reform that was intended to improve local government efficiency and in a wider sense dampen the rate of expansion of the public sector. Although some features have been modified or replaced along the way, the principles of the grant system remain basically unaltered.

The ambition of this study is to describe what has transpired since the 1993 grant reform, with emphasis on the period from 2003 to 2009. The objective is to examine whether a shift has taken place with respect to how general and specific purpose grants allocated to local governments in Sweden are spent.

The questions posed in this study are:

- Have specific purpose grants increased?
- How has the balance (policy-mix) between general and specific purpose grants evolved over time?

## 9.2. Intergovernmental grants in Sweden

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### *What is a specific purpose grant?*

Theoretically, a grant intended for a specific purpose alters the price of a particular service to the recipient local government, and depending on how the grant is designed it creates an effect on both the income and the mix of services<sup>88</sup>. In this study, a specific purpose grant is defined as a transfer from the central government to the local governments that is aimed at a specific function or activity and intended for consumption<sup>89</sup>. In this paper, the terms conditional, earmarked and specific purpose grants are used

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<sup>88</sup> Werner Z. Hirsch, Working paper no 622, University of California, p. 7, 1991

<sup>89</sup> Budget items that are classified as transfers intended for investments are excluded from the analysis.

interchangeably. Following the definitions outlined by the OECD<sup>90</sup>, earmarked grants in Sweden can be classified as discretionary, matching or non-matching grants. Though there are some exceptions to the rule, earmarked grants in Sweden are intended for consumption rather than investment. Mandatory earmarked grants were abolished following the grant reform of 1993.

In this study, the term grant refers to budget items on the central government budget bill that involve fiscal transfers to local governments. In this setting, a troubling point is that a budget item may in fact cover more than one conditional grant, meaning that the fit between budget items and specific grants is not perfect. This makes it hard to correctly assess the number of specific purpose grants at certain points in time. The Swedish Agency for Public Management (Statskontoret) has published a number of studies where the term refers to a definition structured by budget items. The same definition is applied in this paper. Unless specifically stated, grant equals budget item.

#### *What is a general grant?*

In Sweden general grants are used to close both horizontal and vertical fiscal gaps. Theoretically, a general grant increases the income of the recipient and therefore only brings about an income effect<sup>91</sup>. General grants do not fund a specific purpose or activity<sup>92</sup>. In effect, no restrictions or conditions are attached to how general grants are spent. A number of changes in the grant systems for local governments have taken place over the last 20 years. These changes have also altered the terminology used to denote general grants in Sweden. For the sake of simplicity and to make room for the big picture, the various former systems of non-conditional grants intended for local governments are denoted as general grants.

General grants meet the following two criteria:

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<sup>90</sup> Taxes and grants: on the revenue mix of sub-central governments, Blöchliger and Petzold, 2009, p. 25

<sup>91</sup> Werner Z. Hirsch, Working paper no 622, University of California, p. 7, 1991

<sup>92</sup> Statskontoret, Verksamhetsanknutna statsbidrag till kommuner och landsting, p. 20

- Grants are allocated with “no strings attached” in the sense that the funds can be spent in the manner that the local government sees fit.
- Grants are allocated within a common, non-voluntary regulatory system that is ultimately controlled by the central government.

The general grants in Sweden are non earmarked, mandatory, general purpose grants<sup>93</sup>, following the definitions applied by OECD for the purpose of classifying grants across different levels of government.

The size of the general grant to individual local government is determined by its relative position in terms of tax capacity and cost structure for mandatory functions. Equalisation of income features both a horizontal component (between local governments) as well as a vertical grant component, whereas equalisation of costs by definition is made horizontally, implying that it is financially neutral for the central government.

In the income equalisation (i.e.) system that was put in place 2005, the i.e. grant is calculated on the basis of the difference between the local authority's own taxable income and a tax equalisation base that corresponds to 115 per cent of the national average tax capacity for municipalities, and 110 per cent for county councils. Equalisation of income means that local governments with a tax capacity superseding the stipulated levels pay equalisation fees to relatively poorer local governments with the central government budget as vehicle. The difference between the average tax capacity and the individual government's actual tax capacity constitutes the “pure” central government general grant to local governments<sup>94</sup>.

The central government can decide on the size of the general grants on a yearly basis and thus exercise control over the total cost of the equalisation system<sup>95</sup>. In this sense the general grants

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<sup>93</sup> According to the schematic used by Blöchliger & Petzold, Taxes and Grants: On the Revenue Mix of Sub-central Governments, p.25.

<sup>94</sup> Local government financial equalisation, Ministry of Finance Sweden, 2008, p. 10.

<sup>95</sup> Local government financial equalisation, Ministry of Finance Sweden, 2008, p. 6.

allow scope for discretionary spending.

### *General grants in Sweden 1993-2009*

In 1993, the Swedish government introduced a new grant system for transfers to municipalities<sup>96</sup>. This system replaced the previous system where most transfers to local governments consisted of grants for specific purposes. The new municipality grant system relied on three components: equalisation of income, equalisation of costs and a supplement for municipalities with a large population decrease<sup>97</sup>. A few municipalities with a very high tax power did not receive the new grant. In the case of county councils, only small changes were made in 1993; however, a similar grant/equalisation system was imposed on local counties in 1996.

In 1996 another change was made to the general grants system. Unlike the previous system, all municipalities and county councils were now made part of the system. Equalisation was now also neutral in terms of government finances, as both income and cost equalisation were financed by local governments through a subsystem of grants and fees<sup>98</sup>. This equalisation system remained in force until 2005, when the income and cost equalisation systems were once again amended, which led to changes in the general grant system.

See appendix 2 for a more detailed description of general grants.

### **9.3. The grant reform of the 1990's**

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#### *Arguments in favour of and against conditional grants*

At the time of the reform, the central government stated that the system based on conditional grants contained a number of weaknesses that called the system into question. Conditional grants were obstacles to greater flexibility, hindered coordination at the local level, and tied up administrative resources that could be put to better use<sup>99</sup>. Also, the need for a general grant system was reinforced by the financial crisis that called for a more efficient provision of public services.

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<sup>96</sup> Proposition (Government bill)1993/94:100, Bilaga 1, s. 64

<sup>97</sup> Local government financial equalisation, Ministry of Finance Sweden, 2008, p. 31

<sup>98</sup> Local government financial equalisation, Ministry of Finance, 2008, p. 31

<sup>99</sup> Prop. 1991/92:150, del 2, s. 44

Specific grants had been invented for a number of purposes, namely to provide financial support, to equalise differences in taxing capacity and costs, and to stimulate the expansion and provision of certain public services<sup>100</sup>. The system relied on the assumption that conditional grants could contribute towards equalising service levels and secure an element of basic security and fairness to citizens, irrespective of where they lived. These features played an important part in expanding the scope and size of the public sector.

The grant reform hinged on the concept that grants given to local governments towards activities for which they were responsible should be dismantled and instead included in a coordinated general grant system. The size of a grant to a specific municipality was made independent of the actual activities undertaken by that municipality, and the grant was instead calculated as a function of the perceived structural needs of the municipality (both in terms of income and costs). In order to finance the new general grant for municipalities, 18 specific purpose grants were abolished in 1993. Financially, these funds represented the major part of the conditional grants.

Another pillar of the grant reform was achieving a more transparent division of responsibilities between the central government and local governments. According to the proposal put forward by the central government, the state should take responsibility for public services at large and the economy as well as for securing that citizens' needs are ultimately catered to. For these reasons, the central government should have the tools needed to outline the economic scope of local governments.

The motives behind the grant system reform were to equalise financial conditions for local governments, to enhance local flexibility, to transfer power for shaping services according to local needs and to promote economic efficiency. The central government should limit its role and generally refrain from regulating details and instead focus on control and supervision through nationally established objectives and goals. By mandating to local governments a higher degree of freedom with respect to

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<sup>100</sup> Prop. 1991/92:150, del 2, s. 43

organisation and capabilities<sup>101</sup>, the new Local Government Act that was adopted in 1992 was a further step in that direction.

*Criteria for specific grants that should remain*

46 grants with a specific purpose were not abolished in connection with the 1993 reform, as exceptions were made for grants that were allocated to local governments according to the following criteria:

- if they were payments for services undertaken on behalf of the state,
- if they were intended for investment and development,
- if they existed due to labour market considerations,
- for public housing,
- if they were paid on equal terms to local governments and other organisations and
- if they were intended for renewal and development projects.

#### **9.4. The impact of the grant reform in the 1990's**

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Between 1990 and 1992, the sum of transfers to local governments increased by 16 billion SEK (+21 %), mainly due to an increase in specific purpose grants. Diagram 1 illustrates the impact of the restructured grant system. In 1990, the payments from specific purpose grants were roughly six times higher than were those from the equalisation grant<sup>102</sup> (classified as a general grant).

Transfers from the specific purpose grants increased up until 1992 and then dropped dramatically in 1993 when the new general grant system was introduced and the general grant overtook specific purpose grants in size. The central government budget was running yearly deficits, and the ratio of public debts to GDP was increasing by the year. As a preventive measure, the government proposed a cutback on the new general grant to local governments. Following the government's announced structural programme<sup>103</sup>,

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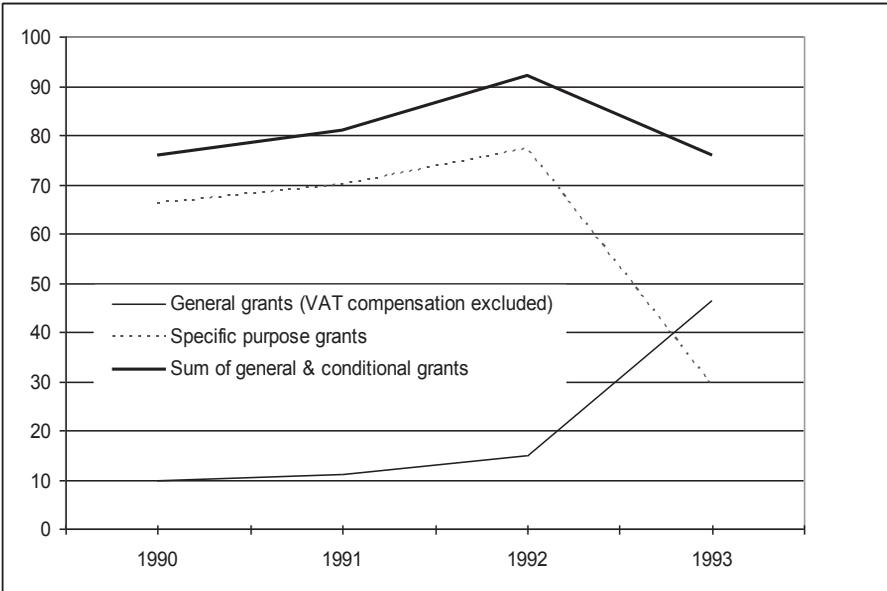
<sup>101</sup> Prop. 1993/94:100, Bilag a1, s. 66

<sup>102</sup> Here, the term general grant refers to the grant that was distributed for redistributing income to local governments with high tax rates and low tax power.

<sup>103</sup> This term was not specifically used in the relevant government bill, but in reality it was of equal significance. Prop. 1991/1992:150, Del 2, p. 57

the sum of transfers to local governments decreased by roughly 7.5 billion SEK between 1992 and 1993. Also, as part of the 1993 grant reform, various fees paid by local governments to the central government were abolished. To offset the financial impact of this, the general grant was reduced by an equal amount. In 1993, the general grants amounted to 39.6 billion SEK for municipalities and 7.9 billion SEK for county councils.

**Diagram 1. General and specific purpose grants in the early 1990's - Current prices, billion SEK**



Sources: Ds 1994:61 & Regeringens skrivelse 1994/95:220.

The 1990's recession in Sweden lasted for three years: 1991-1993, when the GDP decreased by 4 percent. Local government consumption continued to increase by 2 per cent in 1993, but fell by 3 per cent during 1992-1994. The decrease in central government grants contributed to this trend, but it is mainly attributed to a fall in tax revenue, which accounted for 66 per cent of local government income in 1994<sup>104</sup>.

<sup>104</sup> Regeringens skrivelse 1994/95:194, pp. 14-15

*Specific grants as a source of income in the 1990's*

Another way of studying the impact of the grant reform is to relate transfers from specific purpose grants to local government income. In 1990, transfers from specific purpose grants<sup>105</sup> represented 18% of local government income. By 1992 this ratio had increased to 19%, and in 1993 it had fallen back to 7%. The grant reform implied that local governments had to operate in an altogether new fiscal situation.

*The majority of the amount of specific grants went to municipalities*

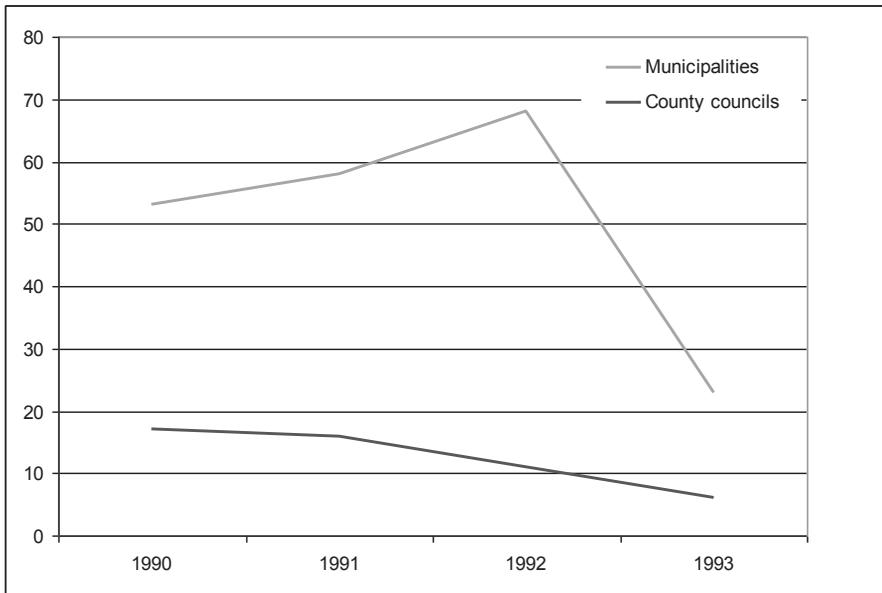
As illustrated by diagram 2, in the early 1990's, the majority of the specific grants were allocated to municipalities. While the specific grants allocated to the municipalities went up between 1990-1992, the amount allocated to the county councils declined. Specific purpose grants amounted to approximately 22% of the municipalities' income in the period 1990-1992. With respect to county councils, income from specific purpose grants amounted to approximately 10-13% of their total income. Taxes were the prime source of income, amounting to 70% of county council income, whereas the municipalities relied on taxes providing around 50% of their income in the early 1990's. The central government imposed a moratorium (or freeze) on the local government tax rates that were in place during the same period, which meant that local governments were basically limited to applying their 1990 tax rates on the year 1993<sup>106</sup>. After the moratorium was lifted, the average local tax rate has risen from 29.9 in 1993 to 31.56 in 2010.

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<sup>105</sup> This sum includes transfers from the social security system for the county councils

<sup>106</sup> Ds 1994:61, p. 39

**Diagram 2. Specific purpose grants for municipalities and county councils 1990-1993 - Current prices, billion SEK**



Sources: Ds 1994:61 & Regeringens skrivelse 1994/95:220.

### *Less specific purpose grants?*

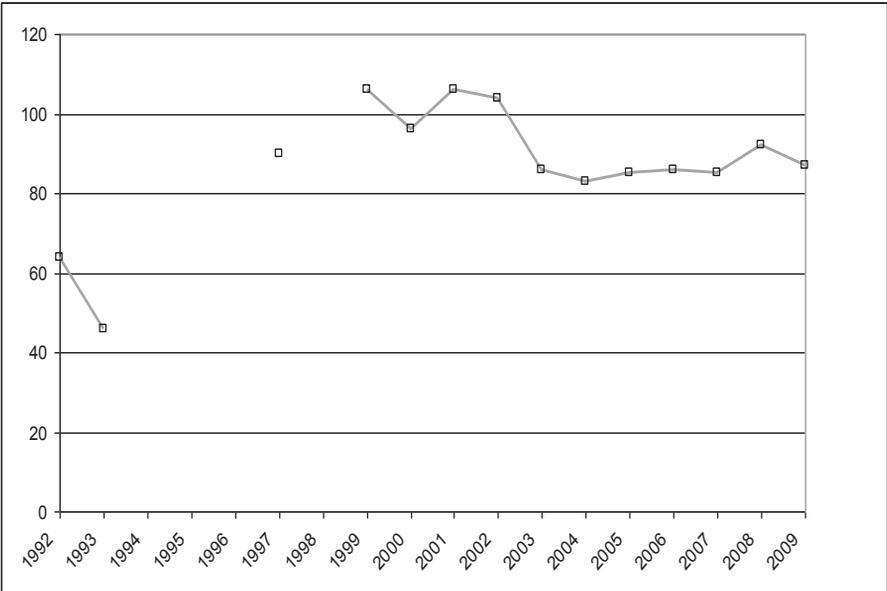
Diagram 3 illustrates the number of specific grants between 1992 and 2008. Since data for some years in the mid-90's have been hard to come by, this time series is unfortunately not complete. However, it does provide an overview of the extent to which specific purpose grants have been used.

In the 1990's, extensive changes were made to the systems of central government grants to municipalities. The number of specific grants for local governments fell from 64 in 1992 to 46 in 1993, when the grant reform came into force<sup>107</sup>. Resources from the dismantled specific grants were used to finance the new (general) equalisation grant. Following the reduction in the number of conditional grants in 1993, the number specific grants had gone up to 90 by 1997. In 1999 and 2001 the number of specific grants peaked at 106.

<sup>107</sup> Proposition (Government bill) 1991/92:150, del 2, p. 57

Between 2002 and 2003, the number of specific grants fell fairly drastically, and since then the number has maintained a steady level at around 90. The drop between 2002 and 2003 does not reflect a policy change towards local governments. Instead methodological changes took place in the collection and registration of data. Also, a conscious effort was made to restructure smaller grants into larger bundles, which affected the number of budget items with transfers to local governments.

**Diagram 3. Number of specific grants**



Sources: Incomplete time series. Proposition (Government bill) 1991/92, del 2. Statskontoret, rapport 2003:5. Ekonomistyrningsverket, Statsbudgetens realekonomiska fördelning. Ministry of Finance

### 9.5. The last decade

#### *Specific and general grants 2003-2009*

Diagram 4 shows the distribution of specific purpose grants and general grants for local governments in monetary terms from 2003 through 2009. Between 2003 and 2009 the sum of grants has increased by 38 billion SEK (+43%), partly due to an increase in the general grants following the new local government equalisation system that was established in 2005 (see appendix 2), and partly as a result of a temporary increase of 14 billion SEK of the general

grants made to counter the impact of the financial crisis in 2009. In monetary terms, 75% of the specific grants were allocated in the areas of education, social services and healthcare (in 2006)<sup>108</sup>. These areas form the nucleus of local governments<sup>109</sup>.

Transfers from specific grants were larger than from general grants in 2003 and 2004, but in 2005 the ratio shifted<sup>110</sup>, because some specific grants were abolished and used instead to finance the new (general) equalisation grant. The sum of transfers from specific purpose grants increased from 46 billion SEK in 2003 to 56 billion SEK in 2006, but has since declined to 48 billion SEK in 2009.

A comparison of diagrams 3 and 4 shows that transfer sizes do not seem to correlate with the number of specific grants, as the number has been more or less constant during the period under review. Both policy changes and technical changes have an impact on the size of transfers from general and specific grants, but they are only marginally reflected in the variation of the number of specific grants.

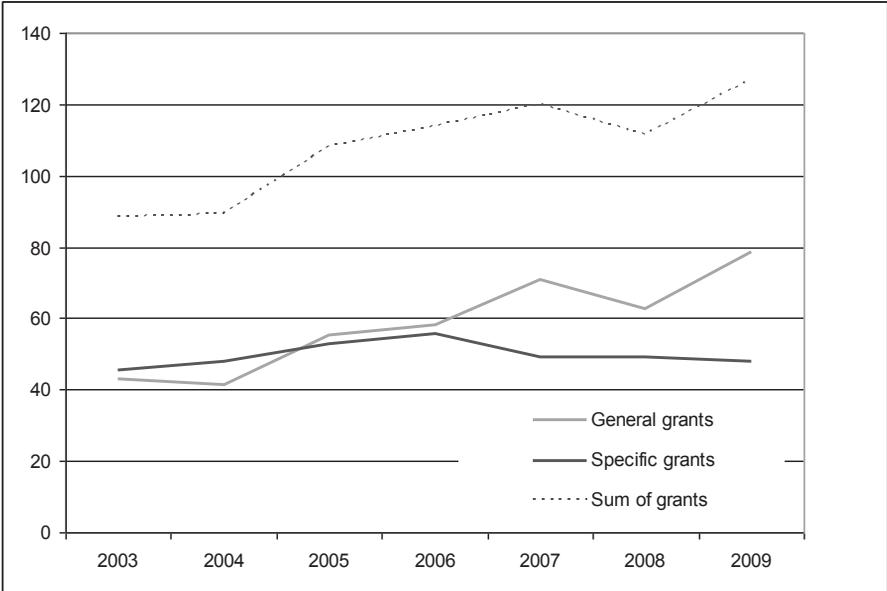
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<sup>108</sup> Own calculation based on data from Ekonomistyrningsverket.

<sup>109</sup> See appendix 1 for a description of the responsibilities of municipalities and county councils.

<sup>110</sup> In addition, local governments have benefited from tax deductions. These deductions are not classified as expenditure in the government budget bill, nor in the national accounts. In 2002 the tax deductions amounted to 5 billion SEK. The peak came in 2005 when they amounted to 13 billion SEK. Since then they have diminished in relevance, partly because a large part of these deductions were incorporated into the general grant in 2007.

**Diagram 4. Specific purpose grants and general grants**  
**- Current prices, billion SEK**



Source: Ministry of Finance.

A number of technical changes having an impact on the perceived policy mix between specific purpose grants and general grants were introduced in 2007. Some tax deductions on local governments' payload were transferred from the income side to the expenditure side of the central government budget, which increased the general grant by approximately 7 billion SEK. In addition, some specific purpose grants were terminated and 4 billion SEK transferred to general grants.

The definition of general grants implies that the central government does not exercise any discretion in the allocation of the grant or determining how it is spent. But general grants also serve as a vehicle for neutralising the impact of central government policies with fiscal implications for local governments as a group. Changes in economic policy and legislation having such an impact can occur in a range of fields, such as tax base size, pension rights or delegation of functions to local governments.

If the central government delegates functions to local government,

it is by principle obliged to offset the imposed financial burden by increasing the size of general grants. Widening the basis of raising taxes or user fees may be offset by withdrawing funds from general grants. Compensation or withdrawal of grants is made on a per capita basis.

One illustration of this mechanism at work is that in 2008, the general grant intended for municipalities was reduced by 12 billion SEK in order to neutralise the financial impact of a real estate tax reform<sup>111</sup>. The central government handed over the revenue of the real estate tax to the municipalities. This increased the revenue of the municipalities, which in turn set off the decrease in the general grant. This explains why general grants decreased between 2007 and 2008, as illustrated by the time series in diagram 4.

*The majority of the amount of specific grants is allocated to county councils*

Diagram 5 illustrates the portion of specific grants that were distributed to municipalities and county councils between 2003 and 2009. The major part of the amount of specific grants was allocated to county councils, although it should be noted that one single specific grant accounted for nearly 30% of the specific grant transfers to local governments. Since 1998 the county councils have had formal responsibility for paying pharmaceutical benefits. The central government finances the bulk of these costs by means of a specific grant that in 2009 amounted to 22 billion SEK<sup>112</sup>.

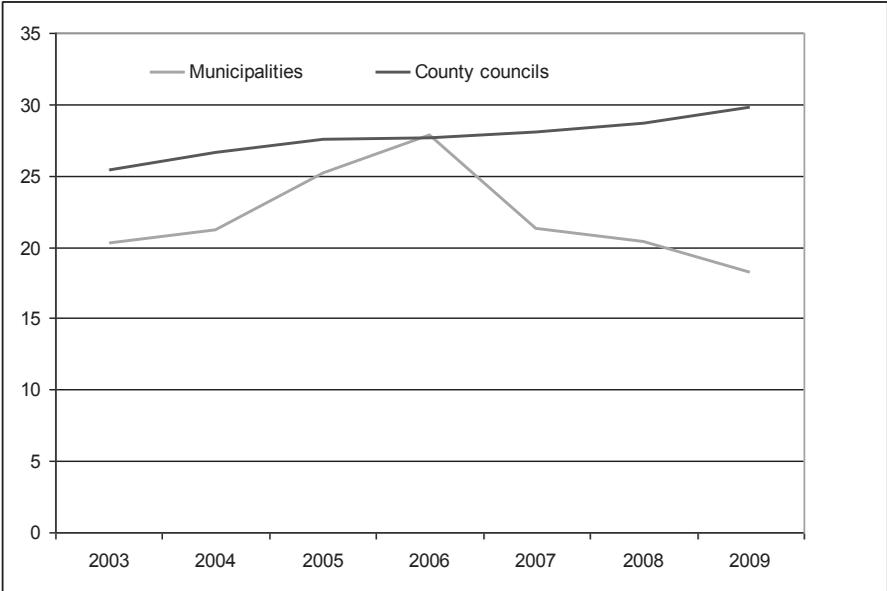
The specific grants intended for county councils show an increasing trend over time, whereas the trend for municipalities seems to be the reverse. Specific grants for municipalities increased by 7 billion SEK between 2003 and 2006 and then fell back by slightly more in the years 2007 to 2009. The abovementioned pharmaceuticals grant accounts for nearly 75% of the conditional grants for county councils. Costs of pharmaceuticals have increased during the period and by the same token, the grant has been increased to compensate for that.

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<sup>111</sup> Which allowed the municipalities to raise fees on real estate that corresponds to the previous state tax.

<sup>112</sup> Ekonomistyrningsverket, preliminary calculations, SBR 2009

**Diagram 5. Specific purpose grants for municipalities and county councils - Current prices, billion SEK**



Source: Ministry of Finance

Note: Figures do not include tax deductions.

*Specific and general grants as a source of income*

Data stated above indicated that the proportion of local government income provided by specific grants went down from 17% in 1992 to 7% in 1993. Diagram 7 illustrates central government grants as a proportion of local government income between 2003 and 2008.

Between 2003 and 2006, specific grants accounted for roughly 8% of local government. This proportion had dropped to 6% in 2009. Meanwhile, general grants for the sector grew in importance. In 2003, general grants accounted for 7% of local government income. By 2007, this proportion had grown to 10%, and as a result of the temporary addition in 2009<sup>113</sup> for offsetting the impact of the financial crisis, general grants accounted for 11% of total income. The curve representing the sum of all grants as a share of local

<sup>113</sup> The temporary addition in general grants was paid out in December 2009, but is intended for use in 2010. Since it impacts on the central government's budget balance for 2009, I have chosen to include it for 2009. But from a local government viewpoint, the funds should be accounted for in 2010.

government income moves upwards in 2005 (diagram 6), but then declines over the subsequent three years, even though the grants grew in monetary terms during the same period. This relative decline in significance is due to the fact that tax revenue has grown at a faster rate than central government grants. In 2005, the sum of general grants, conditional grants and tax deductions accounted for 19% of local government income whereas in 2008 they represented 15%.

The grant share of income in 2009 is 17%, which is due to an increase in general grants. However, this increase has been stated as a temporary measure, and we should therefore be careful not to interpret it as a permanent or structural shift in the politics of grants to local governments.

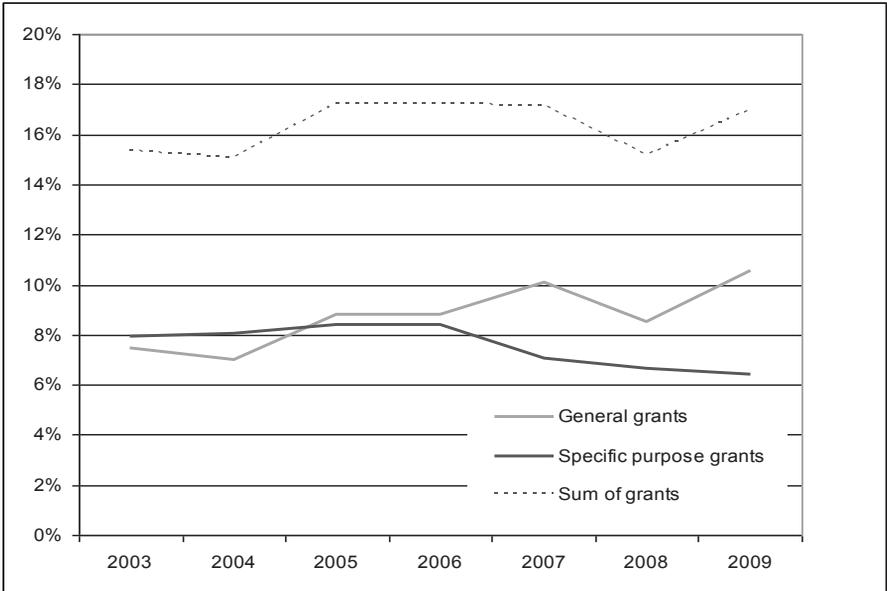
As suggested by diagram 5, the majority of the specific purpose grants are allocated to county councils. By breaking down the data it appears that between 2003 and 2009 transfers from specific purpose grants have remained relatively steady as a share of county council income (12-13%), whereas their significance as a source of income for municipalities has declined since 2006. In 2006 specific grants accounted for 6 % of municipality income. In 2009 this proportion had fallen to 4%.

Between 2006 and 2007, transfers from specific grants declined while those from general grants grew. This is because some specific grants were terminated and used instead in the framework of general grants. As a result, the gap widens between the general grant curve and the specific purpose grant curve (diagram 6). In 2008 the sum of all grants declines. The reason for this is described in the following section (*Economic policy has an impact*).

**In conclusion**, general and specific purpose grants were equally important sources of income for local governments between 2003 and 2006. From 2007 and onwards, general grants have become more significant at the expense of specific purpose grants, which suggests that a change in the policy mix has occurred that, if the trends of the last years are extrapolated, may become structural and lasting. Guided by the history outlined here, apart from 2009, the equilibrium level of all central government transfers to local governments seemingly corresponds to 15 % of local government

income.

**Diagram 6. Grants as proportion of local government income\***



Source: Ministry of Finance

\* Income according to the definition of the national accounts.

Note: Preliminary calculations for 2008 and 2009.

*Economic policy has an impact on the grants*

By checking for changes in general grants originating in new government policies and legislation that have financial implications for local governments, we can produce a slightly different picture of the financial significance of grants to local governments. For the sake of comparison with the points made in the above discussion, the curves are calculated relative to local government income. Diagram 7 shows a curve that illustrates the actual transfers from general grants and another curve showing the size of transfers in a hypothetical state. Let us call this the hypothetical general grant curve.

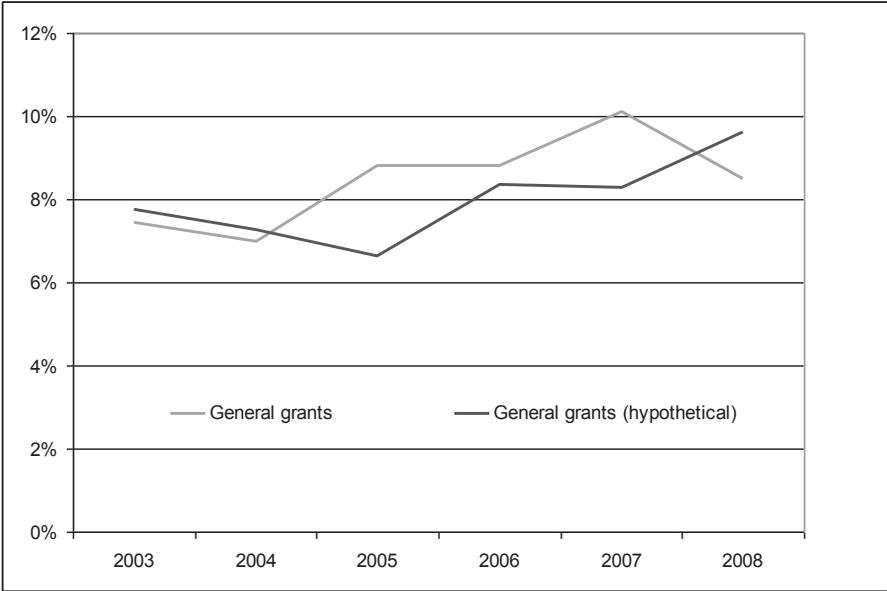
*What do we mean by a hypothetical general grant curve?*

Let us present an example. In 2003 the size of the general grant was reduced by 31 billion SEK, nearly halving the available funds. This cutback was due to a change in the methodology for

reimbursing local governments for the value added tax that they had paid on the purchase of services and goods. In 2003 and 2004 the hypothetical general curve lies above the actual grants curve (diagram 7) due to a pension reform of approximately 10 billion SEK that increased the size of the tax base.

In 2005, 2006 and 2007, actual general grants exceeded the hypothetical general grant, meaning that the local governments received compensation from the central government for neutralising the fiscal impact of changes in policy and legislation that made it more expensive to undertake activities and functions.

**Diagram 7. Actual and hypothetical general grants as a proportion of income**



Source: Ministry of Finance

Hypothetically speaking, had the central government e.g. not implemented the real estate reform of 2008, transfers from general grants would have accounted for 9.6% of the income, and income from all grants 17% instead of the actual 15%.

## 9.6. Conclusions and discussion

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Following the reform of the intergovernmental grant system in the early 1990's, conditional grants declined in financial significance. Instead, greater emphasis was put on the use of non-conditional, general grants.

In accordance with the stated intentions, the grant reform of the 1990's had an impact on the policy mix between conditional and general grants. As a result, funds from conditional grants fell from representing 17% of local government income in 1992 to 7% in 1993. However, in spite of the intentions of the grant reform, the number of conditional grants grew significantly between 1993 and 2001, partly in response to policies adopted with the ambition of influencing the priorities of local governments. Specific grants were instrumental in achieving that. From 1997 and onwards, both specific purpose grants and general grants have increased in size. During the last seven years, the sum of grants from central government has corresponded to a steady 15% to 17 % of local government income.

Evaluating the past seven years, transfers from specific grants increased between 2003 and 2006, but have since then fallen back. Between 2003 and 2006, conditional grants accounted for 8% of local government income, but the proportion has been reduced to 6% since then. Along with the decline of specific grants, general grants have increased in size and significance as a source of income.

But what may appear as a coherent policy for central government grants depends to a large extent on changes motivated by a technical rather than a political rationale. Specific purpose grants and tax deductions have been discontinued and used instead in the framework of general grants. Changes in pension rights and tax policy also play into the perceived mix between general and specific purpose grants.

The point to be made here is that the perceived size of the grants is deeply dependent on the function allocated to the grant systems and what kind of transactions that take place there. Had we looked at a time series starting in the mid 1990's, VAT compensation from

the central government to local governments would have inflated the general grants, making them appear a much more significant source of income. Several such structural changes have taken place over time, which necessitates a certain pre-understanding of which story the data truthfully can account for. There is also a dynamic and interaction between conditional grants and general grants. Specific purpose grants are introduced to support the central government agenda, and then perhaps discontinued after a few years. At various occasions, the funds have then been reallocated to the general grant system.

So the reality in terms of the policy mix between specific and general grants may be less impressive than it appears at first. There is reason to question whether the intentions of the grant reform of the 1990's have truly been fulfilled. The criteria for which specific purpose grants should remain have had limited guidance for policy makers, and the appetite for influencing local government priorities by means of financial incentives has grown.

But referring to events in 2006 and onwards, transfers from specific grants have taken a downturn, and it could be argued that the specific purpose grants that have been abolished and included in the general grant system have resulted in a greater freedom of operation for local governments.

Even though specific purpose grants have declined in financial importance, there has been a shift that requires further comment. In the early 1990's, municipalities relied to a larger extent than county councils on income from specific purpose grants. With the introduction of the pharmaceutical grant in 1998, this situation has now been reversed. Specific purpose grants have become more important to county councils, whereas specific purpose grants have declined in significance for municipalities compared to the early 1990's.

Relating to the topic of grant design, a relevant question is how the central government can add resources to the local government sector without interfering with the presumed equilibrium created by the equalisation systems?

In Sweden, specific grants have different purposes, rules and

target groups. Some grants are intended for all local governments. Other grants are partly intended for all local governments. A third category consists of grants where the funds are not explicitly destined for local governments, but where transfers to local governments take place.

Specific purpose grants intended for a *particular* group of municipalities and county councils are the kind of grant that has increased by the highest rate between 1993 and 2001<sup>114</sup>. Some grants of this particular kind are used to compensate individual local governments for activities that they undertake on behalf of the central government. In these instances, conditional grants are perhaps best viewed as payments for a service, which does not have implications for the equalisation system. They serve rather as a complementary system.

However, according to the Swedish Agency for Public Management there is a rather large group of grants intended for particular local governments which may give rise to conflicts and distortions, especially when conditional grants target local government functions and activities that indeed are covered by the cost equalisation system. This distortion poses a challenge to the equity component<sup>115</sup> of the cost equalisation system, mainly because specific grants that are allocated to particular local governments finance activities that the non-receivers either cannot undertake or have to pay for out of their own funds<sup>116</sup>.

According to the same agency, however, it can be argued that if local governments have equal access to conditional grants, and the conditional grants are indeed used to expand activities beyond the cost/ambition level assumed in the equalisation, then conditional grants do in fact not pose such a threat to equalisation<sup>117</sup>.

Whether a conditional grant interferes with the equalisation systems or not, can be determined by using the following criteria,

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<sup>114</sup> The Swedish Agency for Public Management (Statskontoret), rapport 2003:5, p. 78

<sup>115</sup> Intergovernmental fiscal transfers, Boadway & Shah, The World Bank, p. 15, 2007

<sup>116</sup> The Swedish Agency for Public Management, 2003:5, p. 9

<sup>117</sup> The Swedish Agency for Public Management, 2003:5, p 87

according to the Swedish Agency for Public Management.

Firstly, there should be no overspill from the specific grant to other expenditure/functional areas. To safeguard against this, the central government may have to invent control systems and to properly ensure that the conditional grants are used in the right manner and within the proper field of activities. This will lead to bureaucracy.

Secondly, the conditional grant in question should be allocated in a manner that corresponds to the expected costs that individual local governments may have of the additional activities financed by the grant. The Swedish Agency for Public Management has suggested that optimally, the grants should be allocated on the same grounds as the corresponding statistical model used in the cost equalisation system.

So far the discussion has been limited to the technical arguments about the design and allocation of grants. But dwelling on the pros and cons, politicians have incentives to consider how grants play into the strong tradition of local government self-rule. To a large extent, this is a defining parameter in the relation between the central and local governments. Specific purpose grants allegedly influence the priorities made by local governments. The conditionality of specific grants represents a transfer of power from local governments to the central government; creating conditions for “back-door centralism” according to some observers<sup>118</sup>. This presents a democratic dilemma.

Another dimension of the political economy of grants is the “iron triangles” that surface when special interest groups are activated in defence of specific purpose grants. The director overseeing the whole range of economic relations of a local government typically holds a preference for general grants, whereas the director in charge of e.g. schools typically favours conditional grants within his area, since the revenue cannot be taken over by other functional areas of the local government<sup>119</sup>.

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<sup>118</sup> Skolans kontrollregim, Inger Andersson et. al., 2006

<sup>119</sup> According to a survey by Riksdagens Revisorer, Statens styrning av skolan – från målstyrning till uppsökande bidragsförmedling, rapport 2001/02:13, p. 36

## Appendix 1

### **The functions of local governments in Sweden**

Local government in Sweden is divided into two levels that consist of 290 municipalities and 20 county councils. The division is due to geographical and scale considerations, and there is no hierarchy between them. Local governments have the right to levy taxes on individuals' personal income<sup>120</sup> and to some extent raise user fees to finance the provision of services. The average tax rate was 31.44% in 2008, of which 2/3 represent taxes levied by the municipalities.

The municipalities are responsible for public services in a number of areas such as basic and secondary education, kindergartens, elderly care, social services, communications, environmental protection, fire department, public libraries, water and sewage, waste management, civilian defence, public housing and physical infrastructure. On a voluntary basis, municipalities may also provide or subsidise leisure activities, sports and culture, technical assistance and energy supply, as well as promote tourism. To a certain extent they may promote and subsidise business development.

County councils are responsible for providing primary and specialised health care and dental care. They may also engage in promoting culture, education and tourism.

Regional and local public transport is a common responsibility for municipalities and county councils.

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<sup>120</sup> Profits on capital, interest rates and windfall gains (e.g. housing) are taxed by the state.

## Appendix 2: General grants in Sweden

**Table 1. General grants in Sweden**

Period	Name	Components
(-1992)	Tax equalisation grant for municipalities.	Consisted of a general and an additional tax equalisation component. Subsystem of fees and grants. Equalisation of structural costs, mainly demographic and social factors. Supplement for population decreases.
(-1995)	Tax equalisation grant for county councils.	Consisted of a general and an additional tax equalisation component. Subsystem of fees and grants. Equalisation of structural costs, primarily demographic factors.
1993-1995	Equalisation grant for municipalities	Consisted of income and cost equalisation and a special supplement for municipalities with a large population decrease. A few municipalities with tax capacity above the guaranteed level fell outside the grant system. This system did not consist of any grants or fees.
1996-2004	General grant for municipalities and county councils	Consisted of income and cost equalisation, transitional regulations and a general government grant paid on a per capita basis. Equalisation of income and costs were financially neutral for the central government, since charges and grants were financed by the local governments. The system included all municipalities and county councils.
2005-	Local government equalisation grant for municipalities and county councils	Consists of income and cost equalisation, a structural grant, a transitional grant and an adjustment grant/charge. Income equalisation is financed primarily by the central government and to a lesser extent by the local governments. Equalisation of costs is financially neutral for the central government since charges and grants are financed by the local governments.

# Chapter 10

## Contemporary needs regarding general and earmarked grants in Korea: An assessment

Hyun-A Kim

### 10.1. Introduction

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In South Korea, decentralization was resumed in 1995, the year when local elections were held after more than 30 years of centralization. By instituting local elections, local governments can now take their own development initiatives, as elected local officials need to be sensitive to the needs of their constituents. Hypothetically, during the electoral process, people articulate their demands through their voting preference, and to maintain their roles, local representatives must defer to voters' preferences. This change, as brought about by the electoral process, has had profound effects in Korea with regard to the process of political decision-making and public administration agendas, as witnessed by the significant relationship between re-election results and the intergovernmental grants (Kim 2005). There is an incentive for local officials to use money from the central government, rather than to resort to increasing the local tax rate. Given the ongoing political, global and fiscal trends in Korea, the local government's role has expanded in tandem with increases in its fiscal size. However, the fiscal power of Korean local governments has not increased proportionately. In reality, the total amount of local expenditures financed by intergovernmental transfers has grown steadily over the last 10 years. As a result, the restructuring of intergovernmental fiscal relations has become a very important issue in Korea.

This chapter reviews the structure of intergovernmental fiscal transfers in Korea and seeks to reflect on recent changes to the

Korean intergovernmental fiscal system from a political economy perspective. The chapter then suggests, as a policy recommendation, that the contemporary needs of social expenditures should be considered first. It is also argued that the recent changes in the intergovernmental fiscal relations in Korea support the use of earmarked grants. In particular, for the sound management of local public finance, a strong linkage between marginal increases in local revenue and increases in local expenditure is recommended. This will ease transfer burdens and ultimately make local governments fiscally more responsible.

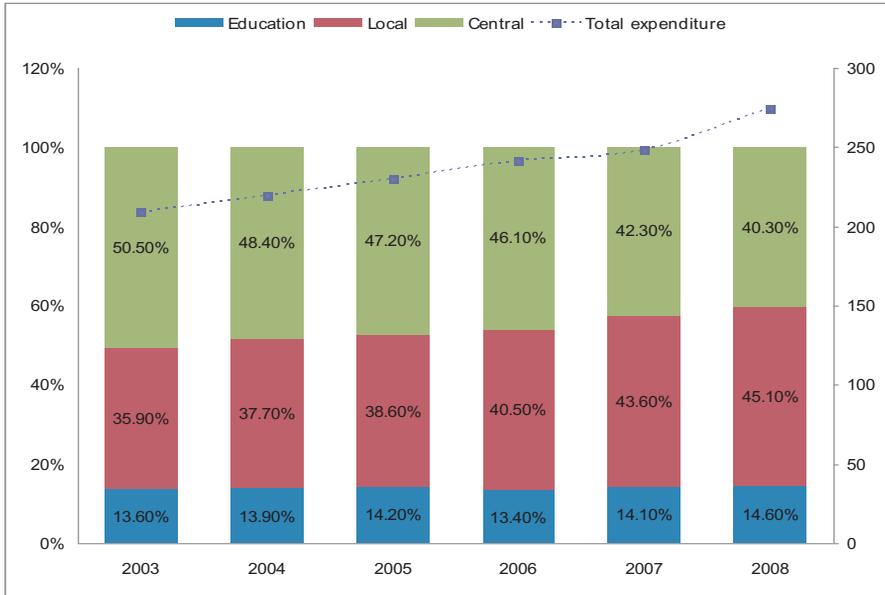
## **10.2. Intergovernmental fiscal transfer system**

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In Korea, the local share of total government expenditures has been rising steadily over the last decade. In 2008, the ratio of sub-national government expenditures, including local education, to all expenditures was around 60 per cent (Figure 1). The average trend in other countries shows that the ratio of sub-national government to total expenditure increased from less than 31 per cent to more than 33 per cent, in a statistically significant way (Blöchliger and Vammalle, this volume). As Figure 2 shows, Korea ranks high among the OECD countries in terms of local expenditure share. The reliance of local governments on grants has increased in Korea due to the insufficiency of local tax base and the central government's preference for disbursing intergovernmental grants to expanding the local tax base. Consequently, Korea's share of sub-central transfers to total government expenditure ranked the highest at around 26 per cent as shown in Figure 2.

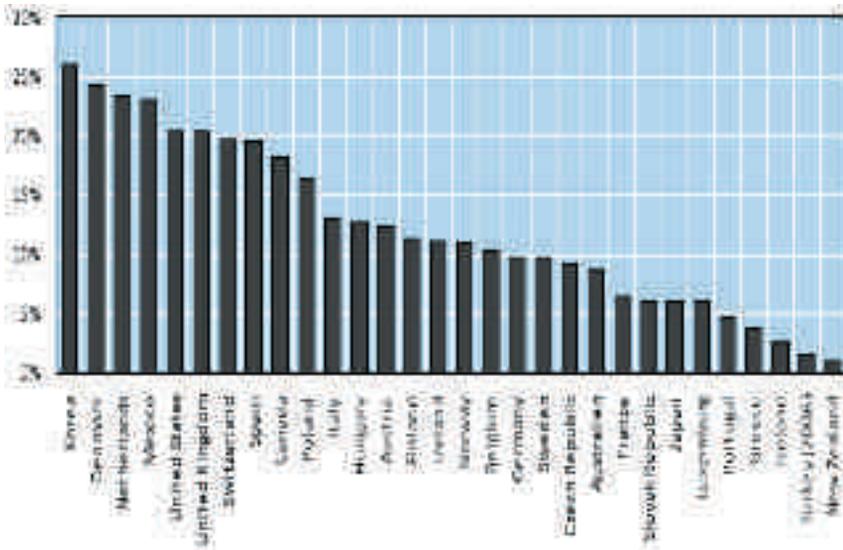
Figure 1 shows that between 2003 and 2008, the ratio of central government expenditures to total expenditures in Korea decreased by around 10 per cent. With the trend of rapidly increasing welfare programs, the share of local expenditures is expected to rise in the future. During the last administration (2003 through 2007), social welfare expenditures increased significantly, and local governments relied on fiscal transfers, such as general and specific grants. In this same period, the amount of fiscal grants from the central government increased by 12.1 per cent, compared to an 8.7 per cent increase in local tax revenue.

**Figure 1. Expenditure size and share (trillion Won)**



Source: Summary of local budget for fiscal year 2008, MOPAS.

**Figure 2. Share of grants in total government expenditure (2005)**

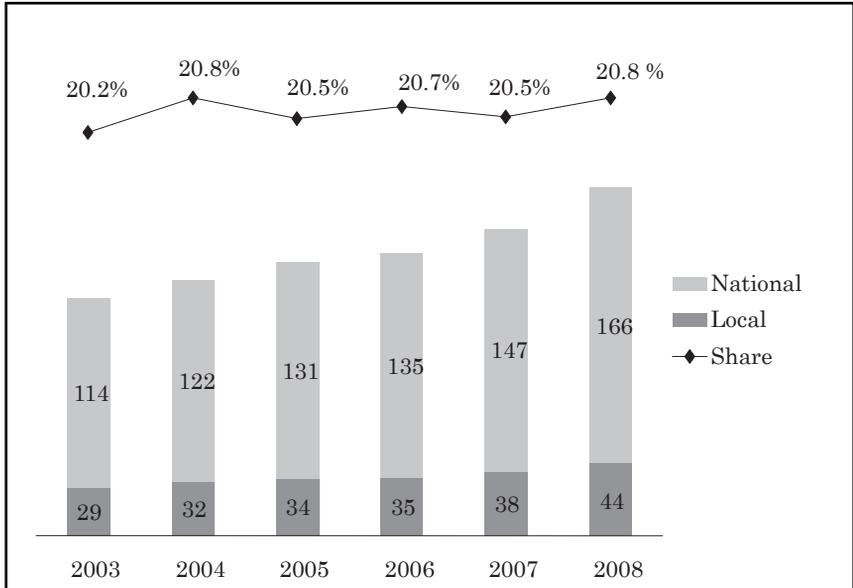


Source: OECD (2009).

### 10.3. Limited local taxation power

While the size of local expenditure is large, very limited autonomy is available to local governments in terms of their spending decisions. The ratio of local tax revenue to total tax revenue has been kept at about 20 per cent over the last two decades, and local tax rates and the tax base are determined by the central government. The Local Tax Act allows local governments and councils to adjust local tax rates by as much as 50 per cent above or below the standard rate. Thus, on the face of it, taxing power is in the hands of local authorities. Nonetheless, local tax rates in Korea remain almost the same, because local governments fear that a relatively high tax rate may adversely affect residents' location decisions, prompting an outflow of local tax revenue. There were some cases where local governments did change the local tax rates, but it was restricted to several local governments (10 of 250 lower level local governments) which lowered the property tax rate following the introduction of the property tax reform in 2005. However, this was quickly followed by the central government's intervention to remove the 'flexible tax rate' system of property tax.

**Figure 3. Share of local tax revenue to total tax revenue (₩trillion)**



Source: Summary of local budget for fiscal year 2008, MOPAS.

As a result, inter-jurisdiction tax competition rarely occurs in Korea. There are several reasons for the absence of power to adjust taxation. First, fiscal responsibility rests with the central government, rather than with local governments. The Korean government does not allow bankruptcies of local governments, and the current budget system allows the central government to play an ultimate role over and above any local government. Second, an increase in the total amount of intergovernmental fiscal transfers results in a greater demand for more grants from the central government in preference to an increase in the local taxation rates. The limit of the local government's taxing power is also seen from the trend of the share of local tax revenue in total revenue. In 1990, the share of local tax revenue was about 57.3 per cent and has been reduced steadily since then, and in 2007, the share of local tax revenue was 50.9 per cent while that of general and earmarked funds was 29.5 per cent and 19.6 per cent, respectively.

**Table 1. Ratio of tax and grants to total local revenue**

Year	Ratio to local revenue (%)		
	Taxation	General	Earmarked
1990	57.3	24.9	17.9
1991	58.1	25.0	17.0
1992	59.2	24.6	16.2
1993	59.3	23.7	17.0
1994	59.8	22.0	18.3
1995	58.7	21.7	19.5
1996	57.6	21.1	21.3
1997	56.8	20.9	22.3
1998	51.6	21.2	27.2
1999	51.7	18.2	30.1
2000	51.2	20.5	28.3
2001	51.1	23.4	25.5
2002	51.4	19.7	28.9
2003	53.0	21.4	25.6
2004	54.3	22.6	23.1
2005	51.5	28.7	19.8
2006	51.6	27.1	21.3
2007	50.9	29.5	19.6

#### 10.4. An overview of intergovernmental grants

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There are four types of intergovernmental grants in Korea. The Local Shared Tax (LST) is a general purpose grant which is distributed mostly based on the formula. The National Treasury Subsidy (NTS) is an earmarked matching grant which consists of discretionary capital grants and reimbursements, mostly for local welfare expenditures. The third is the Special Account for Balanced National Development (SABND), which was introduced in 2005 by selecting appropriate groups of earmarked capital grants among the NTS for consolidation purpose. The fourth one is the Decentralization Revenue Sharing (DRS), whose purpose is to decentralize some of the welfare public services supported by the NTS system and compensate local governments with general grants.

##### *Local Shared Tax*

The LST is divided into ordinary LST and special LST. Notably, the reliance of local governments on LST as a source of local revenue has increased from 15.0 per cent of total revenue in 2002 to 20.9 per cent in 2007. In contrast, reliance on earmarked grants has declined from 22 per cent to 13.8 per cent of total revenue in the same period. In comparison to other OECD countries, the 2.5 per cent share of LST as a percentage of GDP in Korea seems to be quite high. The ratio of LST to National Domestic Tax has gone up from 13.27 per cent in 2000 to 19.24 per cent since 2006.<sup>121</sup> Among unitary countries, Japan scores the highest, with a 4 per cent share of general grants; the northern European countries such as Finland, Sweden, and Denmark have somewhat lower shares, 3.8 per cent, 2.6 per cent, and 2.8 per cent respectively (OECD, 2009).

The objective of ordinary LST is to equalize the fiscal capacities of local jurisdictions as well as to fill the vertical fiscal gap. The equalization formula used to distribute LST makes calculations for each local government, taking into account its standardized fiscal needs, its revenues, and the difference between them. Calculations of standardized figures and adjustments for special local circumstances are made, based on a pre-determined formula that

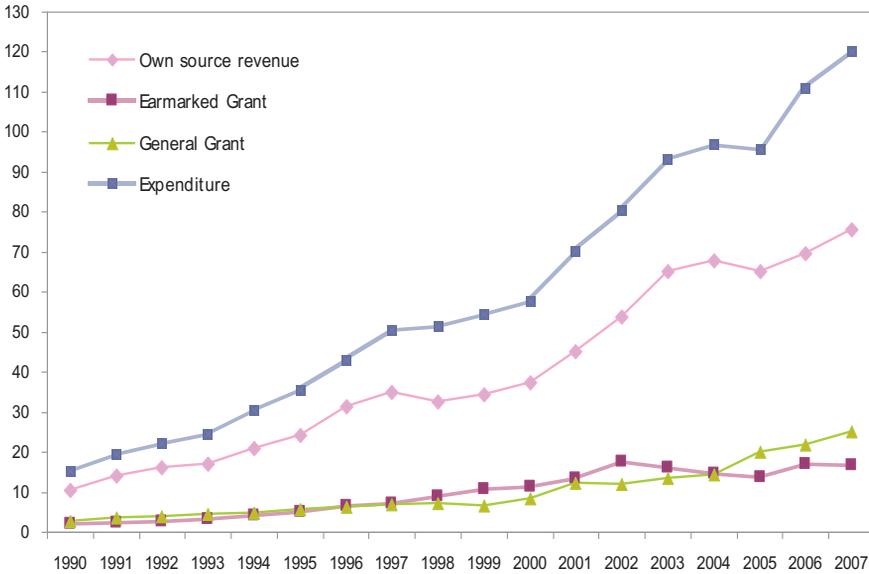
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<sup>121</sup> National Domestic Tax is national taxes excluding earmarked taxes such as Education Tax and Special Tax for Rural Development.

ensures objectivity and transparency. The Ministry of Public Administration and Safety (MOPAS) controls the formula and then determines the distribution of equalization grants among jurisdictions.

The ratio of intergovernmental fiscal transfers to local revenue has been stable over the last five years. LST is a major fiscal equalization system. An intergovernmental transfer system can be decentralized in a way that minimizes central control. Since 1982, the amount of LST has been determined as a fixed percentage (13.27%) of the Domestic National Tax: before that time, the amount was determined on an ad-hoc basis. Also, the distribution method of the LST fund was determined by using a formula based on a budget deficit concept – namely, the difference between basic financial demand (standardized fiscal needs) and basic financial revenue (standardized fiscal revenue). This reform makes it possible for local governments to make a reliable forecast of intergovernmental revenue.

**Figure 4. Fiscal trends in local governments (₩trillion)**



***Decentralization Revenue Sharing***

When the NTS reform took place in 2005, Decentralization

Revenue Sharing (DRS) was established as a type of general grant. The name "revenue sharing" was given as the funding source derives from 0.94 per cent of National Domestic Tax as is the case of LST. The DRS provides financial resources for around 150 programs. Originally, the funding source came from specific grants (NTS). The DRS system apparently focuses on providing transfers that help ensure that local governments have a relatively high degree of fiscal autonomy in providing local public services. However, DRS has been subject to much controversy regarding the nature of its function to support local welfare programs. As a result, there have been continuous arguments for system change.

The rationale behind the introduction of DRS was to devolve welfare provision to local governments. While NTS projects are controlled by line ministries in central government, the responsibility of DRS spending lies with local governments. From the perspective of designing a grants system, however, it was not hard to expect that a change from earmarked to general grants in support of social welfare programs would result in under-provision of welfare programs. There are at least three reasons for this. First of all, fungibility makes the connection between DRS and local spending on welfare programs not very tight. Secondly, local representatives have no incentive to invest money in welfare beneficiaries who have weak voting power. Thirdly, empirical studies support the assertion that, in the case of Korea, strong links between social service expenditures and earmarked grants exist at the regional level.

### ***National Treasury Subsidies and the Special Account for Balanced National Development***

National Treasury Subsidies are conditional grants for specific projects and reimbursements for mostly welfare programs. The main function of NTS is to address politically sensitive expenditures like social welfare and attend to local governments' increased fiscal needs. For example, healthcare and subsidies for low-income households are national programs, but they are provided by local governments and funded by NTS. The fiscal responsibility of NTS lies with both line ministries and the Ministry of Strategy and Finance. In consultation with ministries, the ultimate size and number of projects to be funded by NTS are determined by the national assembly. The share of NTS as a

proportion of total revenue of local governments has been rising rapidly since 1995, and, in 1999, it became larger than that of the LST.

In 2005, NTS was reformed with the introduction of a block grant called the Special Account for Balanced National Development (SABND). The purpose of introducing SABND was for (i) the cooperative co-development of metropolitan and rural areas; (ii) the correction of imbalance among regions and independent localization through innovation and individual characteristic-based development; and (iii) the creation of a balanced and individual society, in which all citizens enjoy a high quality of life. The reason behind the reform was to enhance transparency and simplicity with regard to both distribution and fiscal autonomy in local spending. The Presidential Committee on Government Innovation & Decentralization and the Ministry of Strategy and Finance initiated the overhauling of NTS. As a result of the reform, more than 100 specific grants were consolidated into a block grant.

The distribution of SABND is based on a formula, through which local governments can expect stable transfer amounts, whereas the amount of NTS is discretionary. In determining the distribution of SABND that covers 87 projects and eight ministries, a regression model is used that has five explanatory variables: population, land area, the proportion of elderly people, fiscal capacity, and local income tax (Inhabitant Tax). As a result, the discretionary power of line ministries in allocating funds through NTS has been partially reduced.

To allow local governments to spend these funds in line with their specific priorities, flexibility was given to shift the funds to a variety of purposes. At the province level, fiscal flexibility with respect to the SABND is achieved by devolving local planning powers and allowing the province to carry over grants, up to 20% of the total budget, during a specific period.

When the SABND was initiated in 2005, it was expected that devolution of national projects to local governments would force local public officials to plan and prioritize their own projects. However, the three-year implementation evaluation did not lead to strong local efforts to promote a high quality of public-service

delivery. In 2008, it was found that SABND needed to be improved, among other reasons due to changes in the number of financed projects and enlargement of the size of grants. In summary, SABND needs to be modified further to become a block grant in its real sense.

### **10.5. Assessment of general and earmarked grants in Korea**

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In theory, matching grants stimulate, with both income effect and substitution effect, local spending more than do general grants, which have only an income effect. In other words, pure specific matching grants are price subsidies that will lower the price of the grant-eligible commodity and alter the price relations of locally-produced commodities. General grants do not change price relativities, which means they only have an income effect: this means in turn that local government spending on different services should reflect each service's income elasticity of demand (Gruber 2005, Oulasvirta 1997).

To understand the related theory as it applies to policy matters, the rationale of fiscal transfer in the economics literature can relate to the spillover to other jurisdictions that have different rates for public goods. The best way to deal with this problem is to use some form of matching grant. As a rule, in the circumstances seen in most developing countries, some conditionality is therefore highly desirable, particularly in cases where important national services such as education and health are provided by local governments (Bird and Fiszbein 1998).

#### ***Securing fiscal control by using earmarked grants***

Does this theory well explain intergovernmental grants in Korea? To answer this question, let us examine the case of the Local Transfer Fund (LTF), which existed between 1991 and 2004 as a categorical matching grant for local roads and environmental facilities. At an economic development stage, capital investment projects such as roads and SOC infrastructure are crucial to economic growth. In this sense, the LTF played an important role in building local infrastructure. In particular, though the main feature of the LTF, like other national subsidies, had changed, road construction played an important role in "filling quantity gaps" with regards to SOC across local authorities. As Lotz (2009)

mentions, directing funds to where costs arise through the use of matching grants is a sound policy for investment projects. Relatively few empirical studies have been made on the effect of matching grants on local expenditures. Nonetheless, it appears that local governments may be more responsive to grants for capital projects such as roads than to grants for social services such as education and welfare (Slack, 1980).

Another rationale for matching grants may be the equalization of differences in need or in preference for spending, where such differences cannot be observed by the central government (Bird and Smart, this volume). The case of the NTS in Korea may serve as an example: NTS are earmarked and mainly consist of matching grants. It is true that earmarked grants serve as an instrument of central control in Korea. But, if the central government wants to stimulate local governments to deliver new public services, matching earmarked grants may be effective and are used in many countries, as is reported by Jorgen (2009). Given that the share of social expenditure has been rising dramatically in Korea, the role of earmarked matching grants is important for cost sharing between the central and local governments.

### ***Vertical and horizontal fiscal imbalance***

In most countries, a large mismatch in revenues and expenditures across different levels of government calls for a "balancing act" that is fulfilled in part by intergovernmental fiscal transfers (Bird and Smart 2001, Boadway and Hobson, 1993). To match revenues with expenditures, LST, a general grant, is mainly used in Korea. Fiscal decentralization was the main policy agenda of previous administration (from 2003 to 2007), and many changes were made to local public finance and local tax systems. Those changes were brought about to address the severe problem of vertical fiscal imbalance between central and local governments. Weak local tax base and fiscal imbalance among jurisdictions caused the central government to make a systematic fiscal intervention. In fact, local governments became highly dependent on national grants to finance their infrastructure, and revenue capacities were unevenly distributed, despite national laws that required local governments to provide public services in accordance with uniform standards. Nowadays, the majority of public services have some connection with financial redistribution schemes. As the concept relates to

public services, this trend of redistribution exacerbates the fiscal gap between central and local governments.

In addition to the vertical imbalance, a horizontal imbalance has also been a major issue in intergovernmental fiscal relations in Korea. A sizeable share of grants results from the central government's desire to lessen disparities in the tax base or financial needs among local governments. For example, the Seoul metropolitan city has a solid financial status due to a rich tax base. Most counties in rural areas have the share of own-source revenue at about 17.2 per cent, whereas one ward in Seoul has a Fiscal Independence Index (FII) of 86%.<sup>122</sup> Put more precisely, the LST has contributed to a reduction in horizontal fiscal disparities. Many empirical studies support the successful performance of the LST in equalizing fiscal capacities across local authorities in Korea.

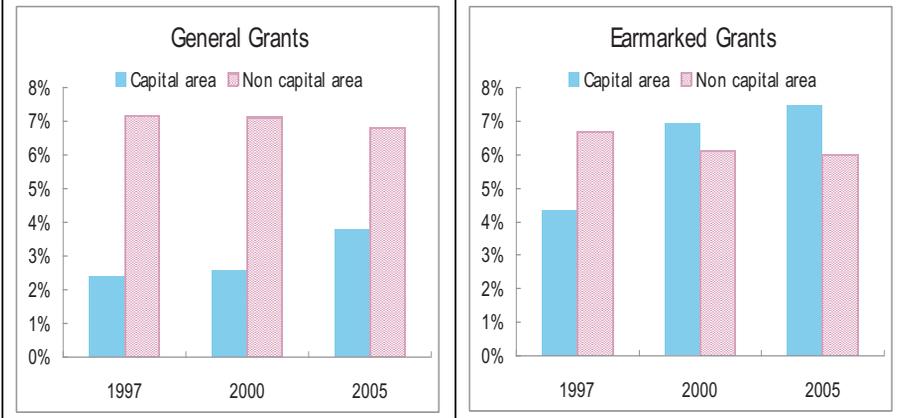
Figure 5 shows differences in the distribution of grants between urban and rural areas. The grey bar "Capital area" represents the average aggregate values of grants to Seoul, Kyoung-gi, and Incheon (three upper-level local governments in the capital area). The other, patterned bar "Noncapital area" represents the average values for the remaining areas in Korea (i.e. 13 regions). This figure indicates that a major percentage of general grants has been consistently distributed to rural areas. Empirical studies of other countries have not always shown such results. Slack (1980), for example, citing the case of Ontario, Canada, shows that an increase in population is generally accompanied by an increase in unconditional grants

<sup>122</sup> The FII is the ratio of own-sourced revenue versus total revenue. The higher an FII value, the higher the jurisdiction's self-financing capacity.

	Seoul	Metropolitan cities	Provinces	Cities (>50,000)	Counties	Wards
Average	85.7	60.5	35.4	40.7	17.2	37.1
Highest		71.2 (Incheon)	66.1 (Kyonggi)	74.0	56.9	86.0
Lowest		47.8 (Gwangju)	11.0 (Jeonnam)	10.8	6.4	13.0

Source: Summary of local budget for fiscal year 2006, MOPAS

**Figure 5. Grant distributions between urban and rural areas**



From a "federalist" viewpoint, simple lump-sum transfers with no conditions attached are considered desirable in maintaining adequate resources for providing services at an acceptable, minimum standard. This implies that it is neither necessary nor desirable for the central government to attempt to interfere with local expenditure choices. From this perspective, Korea can be regarded as pursuing this federalist idea, or the idea of fiscal federalism (Oates, 1972). For local governments in Korea, a sizeable share of revenue comprises equalization grants, as mentioned above. Recent changes from specific to general grants such as DRS, SABND and the merging of the LTF with the LST bring about emphasis on fiscal flexibility as seen in the case of general grants.

However, in order to ensure fiscal accountability at both the central and local government levels, the management of general grants should be carefully investigated. Because of the revenue-sharing method in the LST, issues of accountability and fiscal responsibility often arise. To receive more grants, local governments have an intrinsic incentive to enlarge local needs while reducing local capacity; however, a large amount of equalization grants given to correct fiscal disparities tends to make poor local authorities depend more on the central government and therefore weakens local autonomy. In addition, the complicated formula used to calculate LST makes many local officials believe that the amount of LST will be reduced if they raise local tax rates. In other words, the ambiguity in the calculation of the LST makes

many local governments believe that efforts to boost their tax revenues will reduce the amount of the LST money they will receive. This in turn weakens the ability of local governments to independently make their own long-term planning decisions.

### ***Identification of roles of intergovernmental grants***

Theory suggests that matching grants favour local governments with sufficient financial resources such as large cities and metropolitan governments. In contrast, equalization grants favour poorer and smaller areas with low fiscal capacities. However, the bar graphs in figure 5 show that, prior to year 2000, both general grants and earmarked grants were larger in rural areas than in the Seoul metropolitan area. Only after 2000, more earmarked grants have been distributed to urban areas than to rural areas.

In other words, until 2000 both general and earmarked grants had similar objectives, and both grants were concentrated to the local governments outside the capital area. With the increase of the transfers after 2000, however, this pattern has changed. With an increase in welfare expenditures, intergovernmental grants, either general grants or earmarked grants, have adopted the tendency to be tied to specific projects or budgetary line items. Also, in recent years, a greater share of earmarked grants has been allocated to populous capital areas. In a sense, this trend has made the role of intergovernmental grants more visible.

### ***Setting correct prices in the public sector***

Transfers should not be designed to discourage municipalities from charging appropriate prices for services (Slack, 2007). As Bird and Smart (2001) point out, the basic task in transfer design is to "get the prices right" in the public sector, in the sense of holding local governments accountable to both local residents and higher levels of government.

With soft budget constraint and under strong central-government control, local authorities tend not to exhibit responsible behaviour in allocating resources. After all, there is no incentive to be efficient when someone else's money is being spent. Considering these points, local governments in Korea have exhibited some of the least responsible and accountable behaviour patterns among the OECD countries, in terms of discrepancies between local

revenue share (around 20 per cent) and expenditure share (45.1%; education districts 14.6 per cent).

The Presidential Council on National Competitiveness (PCNC) has declared that regulatory reform and public sector innovations that focus on efficiency should be given more priority. To encourage greater efficiency, the idea has been brought forward to merge jurisdictions in order to reduce sharing costs; in fact, the current administration is considering the redrawing of districts. Such a restructuring of regionally-based areas will differentiate the fiscal structure of the central and local governments. First and foremost, the funding structure for fiscal transfers needs to be considered.

*Political needs: Tax sharing or general grants?*

In 2009, a long debate took place, dealing with a new means of "tax-sharing" to increase revenues among local authorities; this means was discussed within the context of the then new Local Consumption Tax (LCT) and Local Income Tax (LIT). Since 2005, the MOPAS has sought to introduce LCT and LIT. For LCT, 5 per cent of total value-added tax (VAT) revenue goes to local authorities. In terms of administration costs, the introduction of LIT might be somewhat easier since the Inhabitant Tax, a local tax, is a surcharge on income tax. This means that a simple increase of the surcharge rate of Inhabitant Tax can strengthen the role of local income tax.

With regard to the LCT and LIT, there were two main impediments to negotiation among the central ministries and local governments. The first was the manner in which the taxes were differentiated from the current revenue sharing schemes (i.e. Local Shared Tax). The other issue was the effect on fiscal disparities. In particular, the tax bases of LCT and LIT are concentrated in the capital area. Therefore, across Korea, the fiscal gap between rich and poor areas would become wider after the introduction of LCT and LIT. As a result, LCT and LIT in Korea are designed and regarded not as pure local taxes but as tax-sharing mechanisms. In other words, the political consensus regarding fiscal transfers in Korea is that tax-sharing increases local revenue that is preferable to general grants.

It is interesting that, nominally, LCT and LIT are considered "local taxes", true definitions aside. Even if local authorities do recognize

the true nature of these taxes, they prefer a symbolic name like "Local Consumption Tax" or "Local Income Tax" to "general grants". The underlying reason is a political motivation. Through the efforts of congress members and local representatives, these tax-sharing mechanisms have been evaluated as being sound in developing local autonomy.

### **10.6. Factors to be considered in reforming the Korean grants system**

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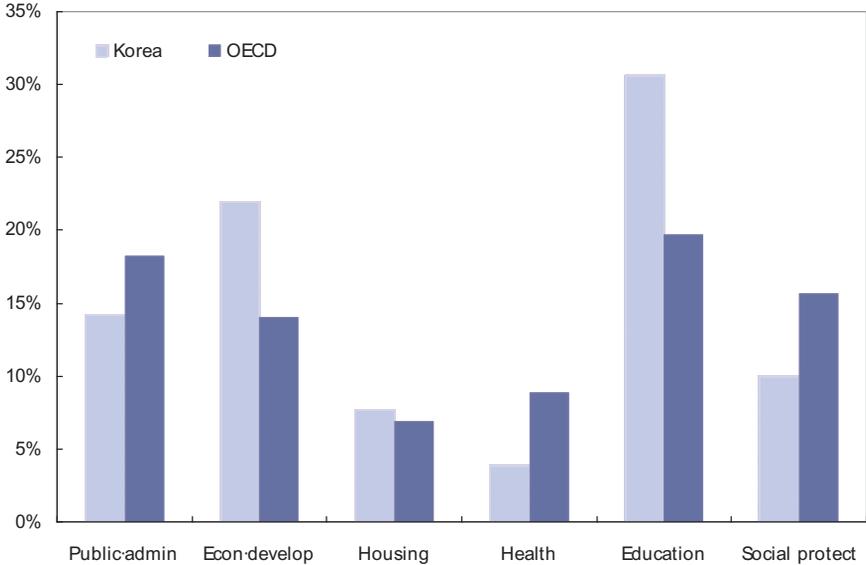
#### ***Increase in local government revenues through "tax-sharing"***

The implementation of LCT and LIT reduces the revenue base of general grants, i.e. LST, because LST is a share of the central government's tax revenue. From the perspective of the central government, therefore, a reduction in general grants is a natural step. However, from the recipients' perspective, it will seem that more funds are flowing to richer areas, exacerbating an already wide fiscal gap between urban and rural areas. Eventually, the demand for general grants for poor areas may be stronger compared to those for other areas; even so, a countervailing effect on the size of general grants does exist. For this reason, policy-making suggestions for the determination of general grants (i.e. size and redistribution schemes) may be debated in the near term.

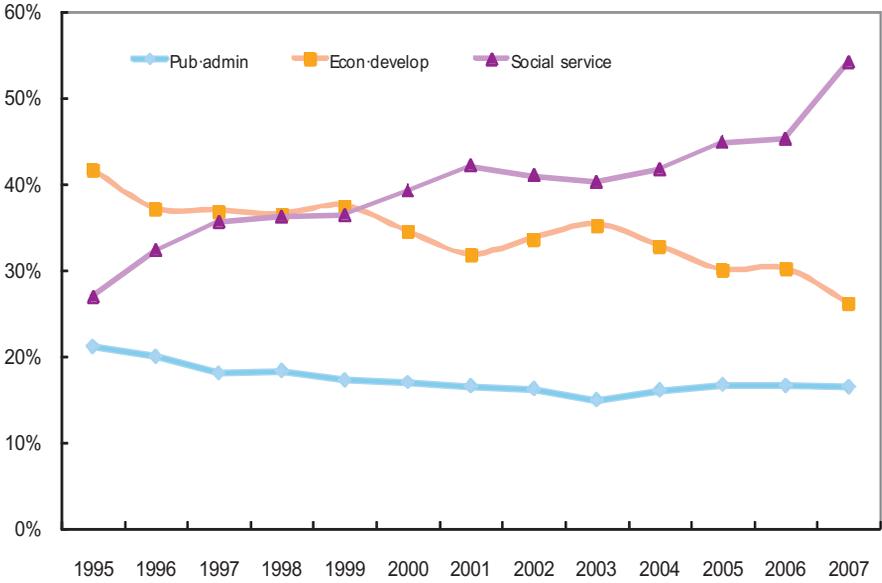
#### ***Expenditure needs: Enlargement of social services in terms of local expenditures***

Until 2000, economic development and education had been the major expenditure areas of local governments. Currently, however, about 60 per cent of all national subsidies go to the Ministry of Health, Welfare, and Family Affairs. Also social services represent the largest share, about 50 per cent, of local expenditures. Due to a low birth rate and an aging population, the central government's fiscal role is increasing at a pace with an increased demand for a transfer of roles and responsibilities to local governments.

**Figure 9. Composition of local expenditures (2005)**



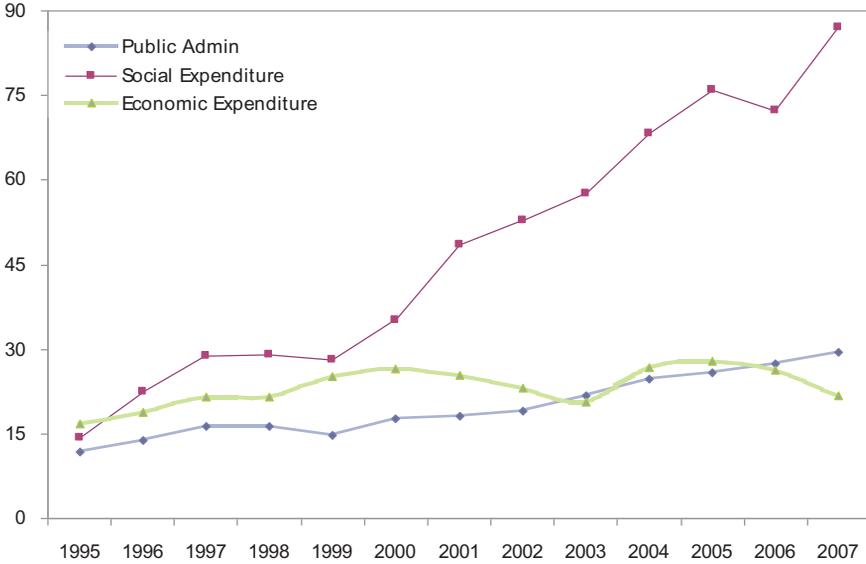
**Figure 10. Share of local expenditures by function**



Although social service expenditures have increased steadily since 2000, the expenditure share of social services such as health and social protection is still smaller than in other developed countries. In fact, Korea's ratio of social-service expenditures to GDP is the lowest among the OECD countries as of 2005. Local municipal representatives have now more incentives to increase public-service related expenditures, e.g. welfare, health, and sanitation, in order to get reelected; to win votes, they may expand local welfare projects and lobby for ever larger matching grants that are earmarked specifically for these areas (Kim 2005).

According to theory, advocates of general grants assume that budget flexibility among local authorities is essential to increasing efficiency. Further, with respect to efficiency vis-à-vis resource allocation, general grants might be useful in circumstances where there is information asymmetry regarding local needs; however, international experiences have not always supported this assertion. Most new services in Sweden, for example, are initially provided through the use of earmarked grants, but those earmarked grants tend to become general grants after a couple of years (Lotz 2009). On this topic, the issue of local autonomy is inevitably raised. It is possible for a local government to have a certain level of fiscal autonomy similar to that seen in developed countries. In any case, the systematic change from earmarked to general grants may have some negative effect on local authorities' provision of public services. The switch to block grants from matching grants, in line with the 1996 U.S. welfare reforms, raised many of the same questions. Brueckner (2000) shows that downward pressure on welfare spending comes from the adoption of block grants; in addition, the 1993 Finnish grant reforms serve as a case in which a change to general grants without government supervision might have bestowed more power upon central management in the local government and reduced the power previously enjoyed by sector officers and services (Oulasvirta, 1997). Empirical studies support the assertion that earmarked grants have played an important role in expanding Korea's welfare spending and other social expenditures. An increase in social expenditure is not accompanied by general grants (i.e. LST) but rather by subsidies from the central government (i.e. NTS).

**Figure 11. Per capita social expenditures in Seoul (₩10,000)**



***What conclusions can be drawn from Korea's intergovernmental fiscal transfer system?***

Answering this question requires mentioning the prerequisites of the current fiscal-relations paradigm. Any analysis of grant effects is linked to the distribution of power between central and local governments. An underlying assumption of strategic behaviour in local governments is inherent in the so-called "soft budget problem". In Korea, the fiscal power structure is asymmetrically divided between central and local governments; in other words, fiscal power is skewed in favour of the central government. Since ultimate fiscal responsibility and accountability belong to Korea's central government, local governments have been unwilling to raise local taxes to fund the increase in expenditures. In terms of fiscal control, the concentration of central-government power has a positive side. However, excessive central government authority damages fiscal sovereignty and thus exacerbates the soft budget problem. Fundamentally, soft budget relations between donors and recipients may exacerbate the effectiveness of any grant system, regardless of the type of grant involved.

To alleviate the soft budget problem, a stronger connection between

a marginal increase in local revenue and local expenditures is required. One of the greatest deficiencies of the current system in Korea is that cost-signalling related to changes in local expenditure is not apparent to local taxpayers. The Tiebout model is based on the assumption that spending with strong tax-benefit linkages should occur at the local level (such as public safety), while spending with weaker tax-benefit linkages (such as redistributive services) should occur at higher levels of government. To strengthen the link between local tax rates and the provision of public services in Korea, in-depth spending reforms must be undertaken. In the course of developing such reforms, policy-makers should determine what and how much fiscal power should be handed over to local governments.

## 10.7. Conclusion

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Even though sceptics of decentralization point to the negative relationship between grants and fiscal performance, as seen in various countries worldwide (Rodden, 2002), fiscal decentralization may be an inevitable choice for many countries. Although local governments in Korea have limited discretion with respect to their revenue sources, empirical studies indicate that fiscal decentralization can be a very effective means of self-government, because it makes more fiscal resources become available to local governments. As is the case in other countries, transfers have been used as a main tool to increase local-level revenues in Korea. This chapter cannot make a definitive conclusion regarding choices between general and earmarked grants in Korea. Moreover, recent changes such as tax-sharing (stemming from political needs) and earmarked grants (stemming from expenditure needs) tend to cloud the judgment regarding which of the two kinds of grants would be superior in the case of Korea. This chapter has therefore mainly focused on the effectiveness of earmarked grants in Korea as a developing economy.

The NTS reform of 2005 underscored whether or not a change from earmarked to general grants would be desirable. There are several notions by which the relative advantages of general grants, i.e. LST, and earmarked grants, i.e. NTS, can be compared. First, until 2000 there was not a discernible difference in the respective roles of general and earmarked grants under tight central government

controls. With the increase in the size of grants, especially those related to welfare spending, earmarked grants now have more distinctive characteristics. Second, with the increased role of tax-sharing, the number and size of general grants (LST) are expected to be reduced. Finally, the soft budget constraint and the disincentives to self-financing seem to impede justification for increasing general grants. In summary, an evaluation of the functions of earmarked grants and general grants in Korea need to be made based on these recent changes in the system of intergovernmental grants.

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# Chapter 11

## Grant design in Denmark and factors behind the use of grant earmarking

Niels Jørgen Mau

### 11.1. Introduction

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The question of how to shape grant systems is a classic, fiscal federalism subject. On the one hand, different levels of government have degrees of own autonomy, but on the other, the functions of local governments often include aspects of national as well as of local public goods, which means that the levels must somehow be linked. The system of economic transfers from the Central Government to local governments is an important instrument for creating such a link.

The economic transfers are established on the background of the division of responsibilities between the levels, the character of those responsibilities and the characteristics of the specific expenditure areas. Moreover the development in techniques of data collection and information storage has profound effects on grant design. Those circumstances are changing over time, and the question of what is the 'best' grant system is more or less permanently on the agenda of public economic policy. Finally, both economic and ideological aspects are in play when "decentralisation versus centralisation" is discussed, and this also influences the choice of grant system.

This is also the case in Denmark, which has experienced a whole series of grant system reforms since the first comprehensive local government reform in 1970. Sometimes changing the grant system has been the main focus of reforms, while at other times it has been a consequence of change of responsibilities or other factors.

Section 2 of this article gives a short description of the public sector at different levels in Denmark. Section 3 seeks to identify some trends for grants financing of regions and municipalities. In section 4 the overall motives for the Central Government in designing the grant systems are described, and in section 5 these motives are compared to the conditions and preferences of local governments in the use of different kind of grants. In section 6 the variables from the earlier sections will be summarized in one single composite measure or index, and the definition of this measurement made dependent on two different scenarios. Either where the Central Government is to make a decision about financing (possibly new) services supplied by local governments, or where the aim of the CG is that local government policies should conform better to national priorities, which makes it necessary to encourage local government activities in existing areas. Section 7 seeks to illustrate the possible use of the above index on a few selected Danish cases and to evaluate the character and targets of those initiatives. Finally some conclusions will be made in section 8.

The classification of grants to be used in this paper is partly based on the standard OECD classification, but adds a number of new dimensions:<sup>123</sup>

- a.** general grants (or in OECD terms non-earmarked grants): grants transferred to local governments according to a formula based on objective criteria
  - a.1.** general grants, i.e. distributed without conditions of any kind;
  - a.2.** conditional block grants, i.e. general grants distributed with conditions about local activity;
  
- b.** earmarked grants: grants transferred to local governments according to activity:
  - b.1.** mandatory reimbursement grants<sup>124</sup>: a certain percentage of local government expenditures is reimbursed (this could also be

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<sup>123</sup> OECD, see Blöchliger & Vammalle (2009). The OECD also has categories for “discretionary non-earmarked grants” and “non-matching mandatory earmarked grants”. However, those categories are of statistically less importance.

<sup>124</sup> My categories b.1 and b.2 together are referred to as “mandatory matching grants” in OECD terms.

termed traditional matching grants, open-ended earmarked grants or simply co-financing schemes);

**b.2. mandatory activity linked grants**

**b.2.1.** stepwise grants for income transfers, i.e. the grant (e.g. a reimbursement grant) depends on certain local activities in such a way that the size of the grant is reduced gradually if central directions are not followed (e.g. if the length of the period of transfers to an individual exceeds central guidelines);

**b.2.2.** meter grants, i.e. grants linked to a single – simple – measure of production (e.g. reimbursements with a maximum limit for amount per recipient);

**b.2.3.** production-linked grants, i.e. grants linked to a composite measure of production or output<sup>125</sup>;

**b.3.** discretionary grants or application grants, i.e. grants depending on prior approval (matching and non-matching).<sup>126</sup>

## **11.2. The organisation of the Danish public sector and fiscal federalism**

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An evaluation of the public sector financial system must take into account factors such as the size of the sector, the tasks, and how the sector is organised. Denmark has one of the largest public sectors in the world – in relative terms. There are three tiers (and social security funds of minor importance): the Central Government, the regions and the municipalities; the latter two constitute the local governments. *Table 1* illustrates the division of tasks (using definitions from the official national accounts). It is obvious that the decentralised sectors are very important. For social protection and health functions, around 90% or more of the expenditures are regional/municipal, but also in the case of education a significant share of the expenditures is municipal. In broad terms it could be said that ‘allocation’ is a predominantly local government responsibility, while ‘fiscal policy’ and ‘redistribution’ are mainly taken care of by the Central Government<sup>127</sup>.

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<sup>125</sup> This category of grants are similar to Shah’s “result-based grants”, see Shah (this volume).

<sup>126</sup> I thank Jørgen Lotz for very helpful comments and suggestions.

<sup>127</sup> Redistribution is here defined as transfers between the rich and the poor. Local governments perform another type of redistribution in favour of families with

**Table 1. Public expenditures of government classified by functions, 2007**

		Central government	Municipalities	Regions	Social sec. funds	Total public expenditures
		----- Bn. DKK -----				
1.	General public services	86.6	20.7	0.6	-	107.9
2.	Defence	26.3	0.2	-	-	26.6
3.	Public order and safety	15.5	1.5	-	-	17.1
4.	Economic affairs	33.7	21.6	1.5	-	56.7
5.	Environmental protection	4.9	4.7	0.4	-	10.0
6.	Housing and community Amenities	6.1	4.0	0.0	-	10.1
7.	Health	0.8	28.3	94.0	-	123.1
8.	Recreation, culture and religion	11.8	14.4	0.0	-	26.2
9.	Education	68.7	55.9	0.0	-	124.6
10.	Social protection	36.8	279.6	6.8	37.2	360.4
	Total	291.2	430.9	103.4	37.2	862.7

Source: Data provided by Statistics Denmark (*Danmarks Statistik*) (2009).

The local government share of the public sector is very high in Denmark, see *table 2*.<sup>128</sup> Particularly expenditures are decentralised more than in most other countries. The data are from 1998/1999, but decentralisation of expenditures has presumably become even more common since then – 2007 data for 2007 for Denmark are shown in brackets. However, when it comes to local taxes, decentralisation in Denmark was reduced in 2007 as a consequence of the 2007 public-sector structural reform, in which the former tax-financed counties were turned into grant-financed regions, see below.

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children and of elderly in need of care.

<sup>128</sup> See also UNPAN (2004) for an international comparison.

**Table 2. Municipal expenditures and taxes in selected countries, 1998/1999 (Denmark also 2007)**

	Municipal <sup>1</sup> expenditures % of GDP	Municipal <sup>1</sup> expenditures % of total public expenditures	Municipal <sup>1</sup> taxes % of total tax revenue
	----- per cent -----		
Denmark (2007 in brackets)	31(32)	55(62)	32(24)
Sweden	26	43	31
Finland	20	37	22
Germany	8	18	8
Austria	9	18	10
UK	11	27	4
Netherlands	18	42	6
Belgium	7	15	5
Italy	12	25	12
Spain	6	16	17

<sup>1</sup> »Local governments«, i.e. municipalities and counties /regions. Source: OECD. *National Accounts 1988-1999, vol.2 (2001), Revenue Statistics 1965-1999 (2000)* and Danmarks Statistik. *Statistiske Efterretninger, Offentlige finanser, 2008:25.*

The discrepancy between the share of expenditures and taxes is financed by transfers from Central Government to the other sectors, see *table 3*.

**Table 3. Financing tasks of public subsectors, 2007**

	Central government	Municipalities	Regions	Social Security funds	Total public Expenditures
	----- Bn DKK -----				
A. Tasks to be financed	291.2	430.9	103.4	37.2	862.7
B. Financed by other subsectors	-301.1	183.0	97.8	20.3	
- from Central Government	.	204.0	76.8	20.3	301.1
- from municipalities	-204.0		21.0	-	-183.0
- from regions	-76.8	-21.0	-	-	-97.8
- from soc. security funds	-20.3	-	-	.	-20.3
C. Financed by private sectors	592.3	247.9	5.6	16.9	862.7
- from deficit	-78.5	3.3	0.2	-0.0	-75.1
- from sale of goods and services	19.8	24.1	4.7	0.0	48.6
- from interest and transfers	47.6	20.7	0.7	0.3	69.3
- from taxes	603.4	199.9	-	16.6	819.9
* on production and import	281.2	19.2	-	-	300.4
* on incomes and property	318.2	180.7	-	-	498.8
* social sec. contributions etc.	4.1	0.0		16.6	20.7

Source: Danmarks Statistik: *Statistiske Efterretninger., Offentlige finanser, 2008:25.*

Section “A” shows the distribution of tasks, whereas section “C” describes how the financial burdens are distributed. In other words, since those distributions differ we get internal financial transfers appearing in section “B”. The coloured figures, especially those marked in red indicate the important factors described in this paper.

### 11.3. Trends and development of transfers to local governments

#### 11.3.1. Financing regions

As already indicated, the regional level is mainly financed by grants. The predecessors of the regions – the counties – had tax financing as their primary revenue source<sup>129</sup>.

<sup>129</sup> In the early 1990'es it was even considered, although most enthusiastically by the counties, to generally abolish block grants and rely only on own taxes. Taxes were apparently seen as “closer to the citizens”. In the end, however, the Central

The regional grants are mostly general grants (type a.1 - around 75%), mainly from Central Government, but from 2007 a small part of the general grants has come from the municipalities.

The remaining grants (around 25%) consist of activity-related type grants:

- from 2002, a Central Government financed grant dependent on the regional increase in hospital production (a production-linked grant, i.e. type b.2.3).
- from 2007, a municipality-financed grant related to a range of hospitalisation and healthcare services to the population of the municipality (a meter grant, i.e. type b.2.2).

So the importance of grant financing has increased dramatically compared to the situation before 2007. Note that this was garnered with central political declarations to create (more) equal access to health services for the population irrespective of geographical location.<sup>130</sup> The attempts to create new regional earmarked grant schemes which are linked to activity are also noteworthy.

### **11.3.2. Financing municipalities**

For municipalities, general grants (a.1) and traditional mandatory reimbursement grants (b.1) have been the classic way of transferring funds from Central Government. Activity-related schemes, especially application grants (b.2.4), have existed but on a smaller scale.<sup>131</sup>

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Government was not willing to give up the block grants and thus, it was found, lose an instrument of financial regulation.

<sup>130</sup> Indenrigsministeriet, 2005

<sup>131</sup> Indenrigs- og Socialministeriet, 2009b.

**Table 4. Central Government transfers to municipalities<sup>1</sup>**

Transfers:	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Share (%): Mandatory reimbursement grants	55.2	59.8	56.7	51.7	53.8	55.1	49.4	50.5	46.9	45.9	43.0	45.7	44.9	41.0
General grants	44.8	40.2	43.3	48.3	46.2	44.9	50.6	49.5	53.1	54.1	57.0	54.3	55.1	59.0
<i>Total</i>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Total in bn DKK</i>	<i>34.2</i>	<i>35.5</i>	<i>39.7</i>	<i>43.8</i>	<i>43.6</i>	<i>47.3</i>	<i>56.6</i>	<i>58.3</i>	<i>66.3</i>	<i>68.8</i>	<i>75.4</i>	<i>89.6</i>	<i>94.4</i>	<i>108.0</i>
% of expenditures <sup>2</sup>	<i>19.9</i>	<i>19.6</i>	<i>20.9</i>	<i>21.9</i>	<i>20.7</i>	<i>20.8</i>	<i>23.6</i>	<i>23.2</i>	<i>25.2</i>	<i>25.1</i>	<i>26.5</i>	<i>24.7</i>	<i>26.9</i>	<i>27.7</i>

<sup>1</sup>1996-2006 Municipalities excl. Copenhagen and Frederiksberg. <sup>2</sup>Gross expenditures excluding VAT

Note: Mandatory reimbursement grants and expenditures exclude certain schemes with 100% reimbursement from Central Government, i.e. social age-related pensions and child benefits. 2008 and 2009 figures are budgeted.

Source: Indenrigs- og Sundhedsministeriet, Velfærdsministeriet: *Det kommunale budget*.

*Table 4* shows that until around 2004, mandatory reimbursement grants (b.1) lost ground, which lead to a rise in the share for general grants, and during the entire period it appears that transfers have become more important in municipality financing. The development – i.e. most often reduction – of reimbursement rates for specific programmes appears in *table 5*. Note that the reimbursement schemes are open-ended and thus may have substitution or “price effects” – even though eligibility are tightly regulated by Central Government (except for the last three items).

**Table 5. Central Government mandatory reimbursement grants for municipal expenditures, 1985-2010**

Municipal expenditure category	Reimbursement rates 1985	Reimbursement rates 1995	Reimbursement rates 2000	Reimbursement rates 2010	Public consumption	Income transfer
Old age pension (excl. Personal suppl.).....	100	100	100	100		+
Early retirement pension (new allotment)	100	50	35	35		+
Child benefits	100	100	100	100		+
Sickness benefits	75	100/50 <sup>1</sup>	100/50/0 <sup>1</sup>	100/65/50/35/0		+
Housing benefits, elderly persons	75	75	75	75		+
Specialised social expenditures	50 <sup>2</sup>	50 <sup>2</sup>	50 <sup>2</sup>	50/25 <sup>3</sup>	+	
Unemployment insurance benefits	.	.	.	100/75/50 <sup>4</sup>		+
Cash benefits, rehabilitation benefits	50	50	50	65/35 <sup>5</sup>		+
Welfare benefits for refugees	.	.	100	75		+
Housing benefits for households	40	40	50	50		+
Care for elderly people	50	0	0	0	+	
Kindergartens	50	0	0	0	+	
Home care, nursing care	50	0	0	0	+	

<sup>1</sup>Reimbursement rates are lowered in relation to the length of the period an individual can receive sickness benefits.

<sup>2</sup> Mutual reimbursement schemes between counties and municipalities (e.g. counties cover 50% of municipal expenditures).

<sup>3</sup> Reimbursement only for expenditures exceeding DKK 1,630,000 DKK (50%) and DKK 870,000 DKK (25%).

<sup>4</sup> Reimbursement rates are lowered in relation to the length of the period an individual can receive unemployment benefits.

<sup>5</sup> Reimbursement rate 65% for 'active' rehabilitation efforts and 35% for 'passive' transfers to unemployed individuals.

#### 11.4. Types of grants and Central Government preferences

In a unitary country like Denmark, the Central Government and Parliament have overall responsibility for designing grant schemes. It is therefore natural to take the Central Government's position as the starting point when discussing how to organise

grants<sup>132</sup>

There are two motives on the C.G. agenda: supporting local-level accountability and maintaining influence on the part of the central level. Sadly, however, those motives often compete when it comes to grant design.

#### 11.4.1. Accountability at the local level

One view is that the Central Government is responsible for ensuring economic conditions that in turn ensure that the public sector works efficiently with respect to allocation as well as costs. The C.G. must support local governments in their efforts to efficiently weight citizens' preferences against costs, comparing possible production of services according to correct relative prices and using the technically most efficient way of production. With this in mind, nothing should normally be hidden to local governments when they consider the costs of an activity, the economic consequences of fulfilling the citizens' demands and the economic impact of different methods of production. Then general grants will be the natural choice in the event economic transfers to local governments have to be made.

For these purposes the Central Government might even consider introducing special subsidies for the most efficient local governments in order to encourage accountability. This is a complicated policy to implement for three reasons:

- *Firstly*, it is difficult to establish a reliable measure of efficiency using parametric or non-parametric techniques. At least in a Danish setting this has not yet been possible. The mere fact that the various measurement techniques produce very different results poses a problem to reliability, see Finansieringsudvalget (2004, ch. 20);
- *Secondly*, it is difficult to distinguish between factors which the local government is responsible for and factors which have to do with external conditions;
- *Thirdly*, the use of grants in support of the 'successful' (i.e. efficient by the applied measure) local governments' economy may be criticised as a punishment against the

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<sup>132</sup> About transfers serving many purposes, see also OECD Network (2006).

authorities with economic problems that are not inefficient but rather deprived for other reasons.

A conclusion based on the above considerations suggests that general grants should be the first choice.

#### **11.4.2. Influence by the central level – local or central priorities**

Another view is, however, that most of the decentralised welfare services tend to have the nature of national rather than local public goods, and the benefits of decentralisation are seen to lie more in the field of administrative efficiency than in the allocation of resources. This view would require the grant design to support the Central Government preferences for allocation.

In this view, the Central Government/Parliament has a need to influence decisions made on the local level. The Central Government has a wide range of instruments at hand for this purpose, i.e. legislation, recommendations, agreements – and economic transfers. In the latter case, earmarked grants linked to the activity will be relevant.

For local governments providing services and taxing the overall population, it may seem reasonable to concentrate its efforts around the interests of some sort of “median citizen” (median voter). This can actually be seen as an advantage to local government decision-making compared to decisions made by the national Parliament.<sup>133</sup> At the same time, the nation expects the local governments – and also the median voter - to take into account that needs differ across the population and no citizen should be left behind. And it cannot be ruled out that local governments, when listening to the local electorate, in some situations act contrary to “minorities”. The use of waiting lists for managing budgets is an archetypical example. But the centre does not necessarily accept the local use of waiting lists (for health treatment, kindergartens, nursing homes etc.) as a rationing device. Earmarked grants can then be one instrument of

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<sup>133</sup> With fulfilment of the assumption about monotony of preferences on expenditures and taxes it is easier to avoid ‘failures’ in decision-making at the local level that offers more homogeneous services to the citizens than the Central Government, e.g. Arrow’s voting paradox (Arrow, 1963).

motivating local governments to take into account the national priorities (regulation, of course, is another frequently used instrument).<sup>134</sup>

In Denmark many schemes of earmarked grants can be understood in that context. For kindergartens and care for senior citizens a mandatory reimbursement grants scheme was established in 1994 offering 30-50% extra reimbursement for municipalities that increased expenditures - especially if their level of expenditures was initially low.<sup>135</sup> Later, in the case of kindergartens, the municipalities with no waiting lists were given the possibility to increase parents' payments (very much like an earmarked grant). Such measures have been successful in the sense that it has been possible later to implement a *legal* regulation to the effect that municipalities are not allowed now to use waiting lists as a rationing device for children over the age of 6 months waiting for kindergarten.<sup>136</sup> Separate schemes for nursing homes (residential homes) and health services at hospitals have also been implemented, see section 7 below.

Other examples are found in cases where the central concern for preservation of certain places of national value, e.g. cultural and historical sites, or the national interest in giving the population living on islands good living conditions, e.g. by providing ferry routes, have motivated earmarked grant schemes. Also treatment of certain vulnerable population groups such as refugees and disabled persons has given rise to earmarked schemes in Denmark (see the reimbursement grant scheme for refugee expenditures mentioned in *table 5* above).

All this may result from the fact that the Central Government/Parliament simply holds a different view than that of the average local government about what are the most important areas to be given priority. To avoid the risk of appearing too patronising towards local governments, the instruments have in some of these cases consisted of different designs of conditional block grants (a.2)

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<sup>134</sup> Related to this problem is the use of earmarked grants to correct for spillovers between local authorities - see Bird & Smart (2010).

<sup>135</sup> Finansieringsudvalget (1998, ch. 6), Mau Pedersen (1995, ch. V).

<sup>136</sup> Larsen et al (2009).

rather than earmarked grants (perhaps because earmarked grants were seen as a kind of threat to the local governments if they failed to respond to central level wishes). Examples of such a solution include various schemes for financing extra efforts towards the elderly referred to in section 11.7.

### **11.4.3. Other Central Government motives**

In addition to ensuring accountability and obtaining influence, the Central Government can have a number of other motives<sup>137</sup>.

#### **11.4.3.1. Macroeconomic regulation of local government finances – countercyclical grants**

It can be argued that a local government's responsibility for being a stable provider of local public goods to the population requires stable finances. The Central Government is expected to protect local governments from the economic consequences of cyclical fluctuations in revenues and expenditures. In Denmark, this policy has resulted in countercyclical regulations of general grants, and local finances have become part of the automatic stabilisers of the fiscal policy. A share of the general grants in Denmark (the so-called 'balance grants') is by legislation set aside for this purpose, so this has become a regulated fiscal rule in the Danish budget policy (other OECD countries seem more often to use discretionary grants, see OECD (2010)).

Since the purpose is to counteract the influence of the business cycle and nothing else, it seems obvious to use general grants instead of earmarked grants.<sup>138</sup> Regulating general grants may also be an instrument for intentional, macroeconomic policy or control, i.e. to make a fiscal stimulus for local government activity, or to ensure that local governments live up to their agreements with the Central Government.<sup>139</sup>

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<sup>137</sup> The next three sections does not contain an exhaustive list. Also transfer of tax revenues from the central to the local level as well of grants for equalisation could be mentioned, cf. Mau Pedersen (2007).

<sup>138</sup> The consequence of such a policy, *ceteris paribus*, is of course aggravated fluctuations in the Central Government budget balance, e.g. in Denmark 2008-2010 a deterioration of more than 7% of GDP (Finansministeriet (2009), Larsen et al (2009)).

<sup>139</sup> From 2009 a law has been passed in Denmark providing that DKK 1 bn of block grants can be withheld if local governments do not meet their overall

#### **11.4.3.2. Compensating for change in responsibilities between levels with general grants**

Finally, another role played by general grants can be to serve as a compensating mechanism when mandates and responsibilities are changed between levels - or more generally when the Central Government makes regulations that result in an increase or a reduction of local government costs. This kind of compensation is being offered by nearly all European governments (see Lotz (2008b)) and has a long tradition in Denmark as an integrated part of the negotiation system.<sup>140</sup>

Since the Danish Central Government usually takes a lot of initiatives and makes many decisions that have an impact on local governments' expenditures, it has been seen as the most practical and least distorting solution to compensate via the general grants, i.e. without interfering with expenditures in certain areas. This policy is seen as effective, but is rarely found in other countries, and in nearly all other European countries compensation is made through earmarked grants (Lotz (2008b)). And also in Denmark this policy may be challenged from time to time for more far-reaching changes, and earmarked grants and/or corrections of the equalisation system may gain more appeal.

#### **11.4.3.3. Motivating local governments to change production methods – block grants**

Finally, the Central Government may find that certain ways of production should be given more or less weight in local governments. Areas such as the use of IT, contracting out, changing the composition of current versus capital production factors may be on the agenda - or simply finding more effective production methods.

Targeted earmarked grants may appear to be the ideal instrument for this purpose, but to avoid accusations of patronising the Central Government may abstain from using earmarked grants proper and prefer to use less forceful instruments instead, such as negotiated agreements, recommendations etc. Most recently a kind of conditional block grant schemes has been introduced in

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budgets in accordance with particularly agreed expenditure limits.

<sup>140</sup> In Danish the principle from 1984 has been named "DUT" (Det Udvidede Totalbalanceprincip, i.e. translated 'the extended principle of total balancing').

Denmark to encourage investments in certain areas ‘close to the citizens’.<sup>141</sup>

## 11.5. Grants in relation to local government conditions

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The possible outcomes of the choice of grant design based on the Central Government’s preferences discussed in section 11.4 may in many ways need qualifications to take into account the working conditions and preferences at local government level.

### 11.5.1. Variation and identification of expenditure needs

Traditional equalisation of expenditure needs variation applies objective factors that are supposed to mirror the expenditure needs<sup>142</sup>. However, identifying such needs is not an easy task, and there may be distortion costs related to the application of certain objective expenditure needs factors, especially if those factors have to bear the burden of a high level of variance in needs. In such cases, activity-related grants in the form of earmarked grants (typically reimbursement schemes) might be considered. This is particularly tempting *if* the variation in expenditure needs is exceptionally high, *if* it is difficult to find well-functioning expenditure-needs factors (often correlated to the first problem), and *if* neutrality towards decision-making is not seriously undermined by reimbursements.

For income transfers to households, where the measuring out of payments is prescribed in detail by law, this last condition might be met – or at least met to some degree. From the last two columns of table 5 it actually seems to be the case that the remaining reimbursement schemes in the Danish public sector are set up mostly for income transfers.

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<sup>141</sup> As part of the government’s “Quality reform”, a fund of DKK 50 bn. has been established to be used primarily to support investments in hospitals, schools etc. during the period 2009-2018. With respect to municipalities, allocations from the fund are distributed in accordance with number of municipal inhabitants, i.e. as the general grants. However, municipalities are told to use own funding of minimum the same amount as the grant allocations. See Indenrigs- og Socialministeriet (2009a).

<sup>142</sup> On methods, see OECD (2006) and Kim et al (2008).

### **11.5.2. Discretionary local government power**

Local governments may or may not have discretionary power over their use of inputs, application of production methods, and over the choice and level of services they want to produce. Depending on this discretionary power the response – or elasticity – of earmarked grants versus general grants differs from one situation to the next.

If the Central Government wants to influence local government behaviour, see section 11.4.2 above, then a strong price elasticity, i.e. sensibility of activity or behaviour to changes in grants, will be seen as an advantage.

On the other hand, the Central Government might not want to interfere with local government decisions, see section 11.4.1, but may rather have other motives for distributing earmarked grants, e.g. accurately compensating needs. In such a situation, a strong elasticity of earmarked grants – indicating a wide room for manoeuvre of the local governments – must be considered a disadvantage.

The room for manoeuvre of local governments of course varies between sectors and kinds of services. Often the local authorities will report that their degrees of freedom are constrained. For example, the municipalities have to live up to certain legal standards of primary schools, production of healthcare is regulated in many respects, and as regards social transfers, see above, the ‘product’ may be regulated in detail. However, local governments - in Denmark and presumably in many other countries - nevertheless still have important degrees of freedom with respect to service levels and standards and how they organise production. Even in the case of social transfers, municipalities will have a number of options when choosing between types of income transfer or rehabilitations activities (see section 11.7 below).

### **11.5.3. Measurability**

When the Central Government wants to influence local government decisions, the optimal target should be the local government’s performance or the effect of its activities. The next best solution is a measure of the character and volume of production. Often, however - at least in a Danish context, a well-defined quantitative measure of production does not exist at the

central level of government. Instead we may only have a measurement of input, i.e. in practice a calculation of the costs of production. In other cases we have some *indications* of production or performance, although not quite precise measures.

Taking into account that we want to hit the target as accurately as possible, the quality of the measures – the “measurability” – of e.g. production or performance becomes a parameter that must be taken into account when considering using earmarked grants to influence local priorities.

## 11.6. A composite index as a guide to the choice of grant design

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### 11.6.1. Constructing a composite index

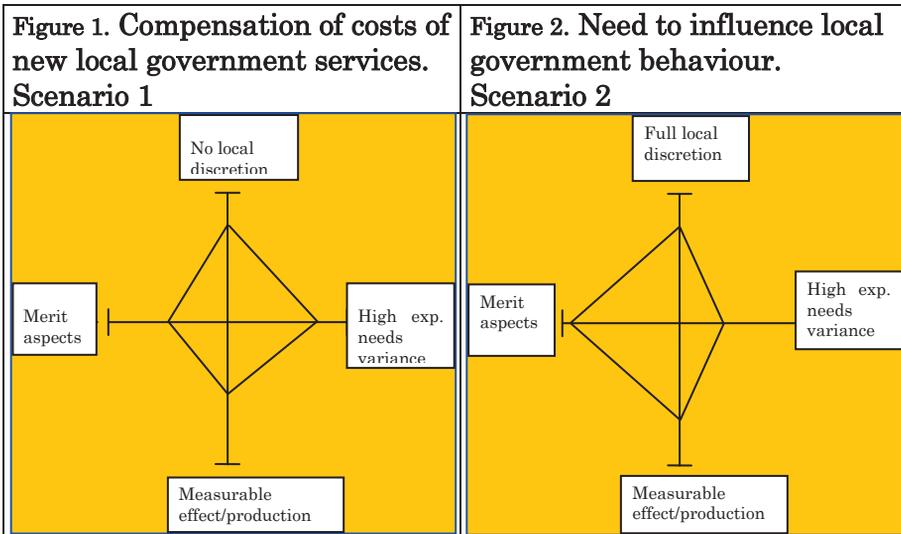
When the Central Government considers establishing a new grant scheme it has to determine whether it should be an earmarked grant or a general grant. In this section, a composite index is proposed to summarise the strengths or weaknesses of factors that pull in the direction of earmarked grants rather than general grants. The preceding sections define the decisive – and to some extent interrelated - factors as the following four:

- *local discretion* or discretionary power of local governments. We need to distinguish between two situations. In scenario 1, the Central Government wants to engage via a grant scheme in the financing of e.g. new local services but has no intention of seeking to influence local government behaviour. As explained above, local discretion here works against the use of earmarked grants. But if interfering in local government behaviour is the very motivation of the Central Government to distribute grants (scenario 2), then of course earmarked grants become most attractive if local responsiveness - discretionary power - is high.
- *expenditure needs variation*. As previously described, a high level of variation and/or difficulties in identifying relevant objective expenditure needs measures may implicate the use of earmarked grants (reimbursements), because general grants may not adequately distribute compensation to the local authorities that need compensation.
- *measurability*. If a certain behaviour is the aim (as in scenario 2), this behaviour should be measurable in order

for earmarked grants to appear relevant. And vice versa, poor or lacking measurement methods should lead to the use of general grants.

- merit aspects.* The existence and intensity of national merit aspects of a decentralised function work in favour of earmarked grants – to internalise externalities. Merit aspects may or may not be among the reasons the Central Government has to engage in local financing. In the first case a high intensity of merit aspects is of course correlated with having a scenario 1 situation.

So all in all we get two indexes – illustrated by *figure 1* and *figure 2*. The area inside the rectangle illustrates the value of the index, i.e. the potential for earmarked grants vs. general grants: A low area and a low value of the index point towards using general grants, a large area and high index value point towards the use of earmarked grants.



The purpose of such an index is only to *indicate* the potential of a certain grant scheme against a given target in one measure – taking into account that several factors must usually be weighed against each other before the Central Government can make a decision. The weakness is obviously the estimations of the factor value and scale of measurement. Is it possible in a strict sense to add e.g. measurability and merit aspects? Besides, some of the

factors might be interrelated.

## 11.7. Relevant Danish cases<sup>143</sup>

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### 11.7.1. Grants to support care for the elderly<sup>144</sup>

Elderly care has for many years been a subject of special attention by the Danish Parliament. Since such services are the responsibility of municipalities and are controlled by comparatively few legal regulations, i.e. municipalities have a high level of discretion, it may have seemed obvious for the central level to use grants schemes in an attempt to upgrade these activities. In the period 1998-2010, four such attempts have been made. First, in 1998, a grants scheme was approved towards initiatives to improve care for the elderly. The grant required prior application, i.e. it was a b.3 type of grant, and was only given for one year. Later, more permanent grant increases were implemented in three steps: grant 'a', 'b' and 'c':

#### a. Description

***Grant a: General grants for elderly care combined with a collective agreement with the municipal associations – and later general grant***

In 2001, Parliament decided to increase the general grant by DKK 0.5 bn. in 2002 and subsequent years in order to increase spending on elderly care. The instrument of control – for the first year – was an agreement with the local government association that they would insure that its members would spend the increased grants as intended. The grant was distributed according to the number of elderly people living within the municipal borders, i.e. a

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<sup>143</sup> Other relevant examples could be mentioned. For example a recent change in responsibilities illustrates that the idea of general grants has its limitations for other reasons than lack of measurement: The transfer of responsibility for employment services and benefits to insured unemployed individuals from Central Government agencies to local governments with full effect from 2010. The financing of these new tasks by local governments breaks the tradition of using mainly general grants for new local competencies. Instead, a combination of mainly mandatory reimbursement grants and to some small extent conditional general grants had to be used. The reason for this was that expenditures are unevenly distributed between local governments by the financial system. See Danish act on unified system of employment, June 12, 2009.

<sup>144</sup> This section 7.1 and 7.2 below are partly based on a paper by Jørgen Lotz (2008a).

conditional block grant type a.2.

***Grant b: Earmarked grants – and later general grant***

In 2005, Parliament decided again to improve care for the elderly. A sum of another DKK 0.5 bn. was allocated in the 2006 finance bill towards this purpose. The grant scheme was prolonged for the subsequent years.

For the year 2006, municipalities were asked to apply for the funds from the Ministry of Social Affairs describing the projects they wanted to have financed, i.e. a type b.3 grant. It was a condition that the results and effect could be documented, and applications were carefully validated at the time.

For the year 2007, control of the activity in municipalities were loosened, and authorities only had to confirm that it would spend at least its share of the general grant increase on elderly care, i.e. a type a.2 grant. The grant was distributed according to the number of elderly. From 2008 and onwards the grant scheme was changed into an ordinary general grant, i.e. return to type a.1 grant.

***Grant c: General grants***

In 2009, after local budgets for 2010 had been determined, the Central Government and its coalition partner decided to increase general grants by DKK 0.3 bn. towards improving elderly care. No conditions were made for local governments, i.e. an ordinary type a.1 general grant.

**b. Evaluation – composite index for earmarked grants**

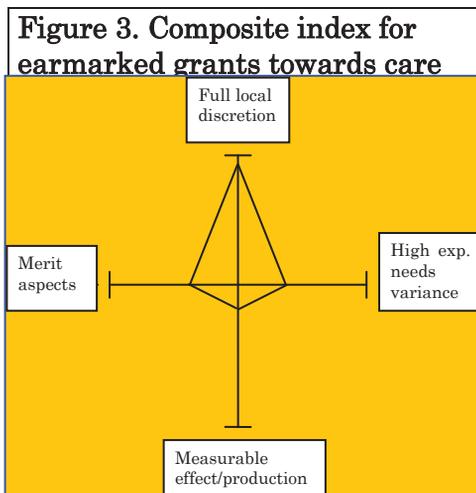
The four dimensions can be characterised:

- *local discretion.* This is a scenario 2 situation, since the central level wants to influence municipal spending on elderly care. With respect to elderly care, municipalities have a wide degree of freedom, e.g. to choose between different ways of organising services for the elderly, and they have – within budgetary limits – possibilities of increasing the service level.
- *expenditure needs variation.* Even though the share of elderly members of the population differs between municipalities, the variation is rather modest.
- *measurability.* In Denmark, a wide range of key factors

have been developed to measure certain aspects of the quality of elderly care, including satisfaction surveys among the elderly. But no single measure of production other than total costs exists.

- *merit aspects*. It seems difficult to argue about intense merit aspects in elderly care. However, elderly care is increasingly becoming a national concern, and TV spots on shortcomings in the service provision to the elderly in 'remote' regions cause problems for the government. Also, waiting lists for residential homes are criticised – although they are dealt with in a separate scheme.

As a result, the composite index may look like this, i.e. a low potential for this type of earmarked grants (b.1), see figure 3. However, if merit aspects are to an increasing extent brought onto the national agenda, this may change.



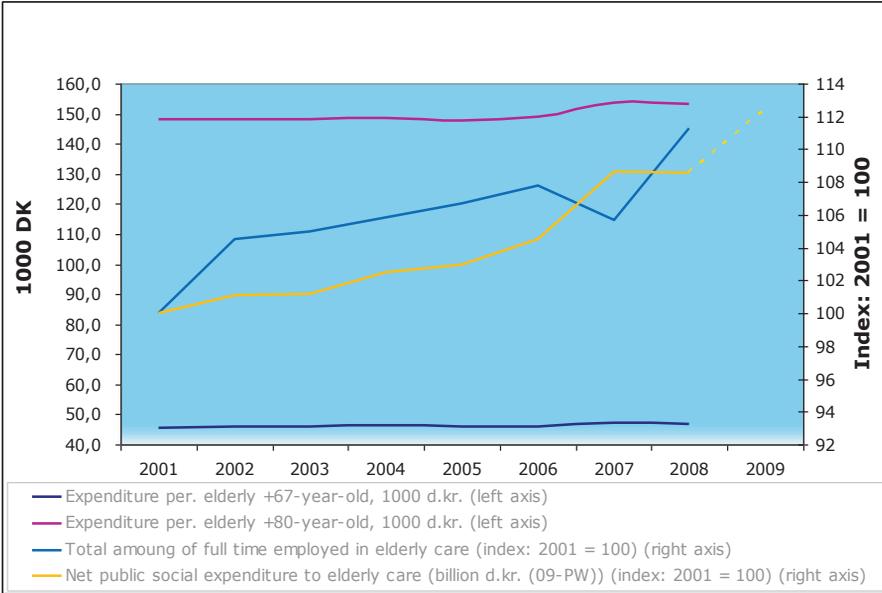
### c. Evaluation – fulfilment of targets?

With respect to the grant a-scheme, the extra grant was the subject of public debate in 2004 - had it resulted in a corresponding increase in spending on elderly care or has the money been swallowed up by more administration? The government initiated quite complicated analyses, including a new, detailed questionnaire to all municipalities on their spending. The investigation into this question verified that only  $\frac{1}{4}$  of the grant was spent on administration. The government managed to convince Parliament

that the money was spent as intended, and only then did the political debate come to an end.

No comprehensive quantitative evaluation of effect has been implemented for either the grant a- or the grant b-scheme. *Figure 4* shows the development in expenditures and in one of the input values – labour. It seems obvious that real expenditures as well as number of employees have been increasing over the years – by 1.5-2% per year – which are relatively high growth rates compared to the real growth in overall municipal expenditures. So in that respect the target has been met. However, when it comes to expenditure per senior citizen, the level is almost unchanged. Whether that would have been different without the extra conditional block/general grants is hard to say. The Central Government has refrained from using earmarked grants and most recently, in 2010, only used ordinary general grants, which may also indicate a positive assessment by decision-makers of the effect.

**Figure 4. Indicators of development – elderly care**



Source: Ministry of the Interior and Social Affairs, 2009.

**11.7.2. Grants to support growth in hospital output**

a. Description

In 2002, a new grant was introduced to encourage increased activity in the hospital sector. Counties (now regions) are responsible for running public hospitals, see above. Hospital production is measured by DRG (Diagnosis Related Groupings) values for the different hospital treatments, adding up to total costs for all treatments performed in a year. With the DRG measure this grant is a type b.2.3 grant – a production-linked grant.

The counties were assumed to increase their production by 1.5% (later 2%) in productivity gain, but when this was exceeded they earned a share of the grant. In this sense the grant was marginal, and deadweight losses were avoided.

Proportional shares of the grant were distributed on account to each county at the beginning of the year in order to ensure sufficient liquidity to finance an increased production. The grant

was closed-ended; no county could earn more than the initial share. Three counties (out of 13 units) failed to earn their full share. They lost half of the difference but were allowed to transfer the remaining half for use the following year.

b. Evaluation – composite index for earmarked grants

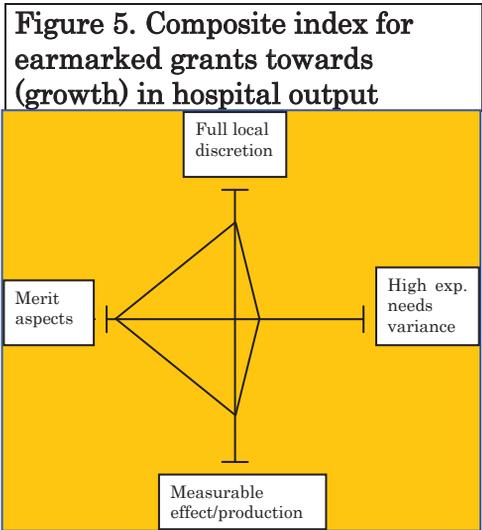
The following four dimensions can be characterised:

- *local discretion.* This is also a scenario 2-situation, since the central level wants to increase the activity level of counties/regions as regards hospital output. The local authorities have discretion about the level of hospital output or production measured in DRG.
- *expenditure needs variation.* There is only modest variation between counties/regions.<sup>145</sup>
- *measurability.* Since the introduction of DRG measures in the Danish hospital sector it has been possible to record a measure of production.
- *merit aspects.* In recent years, the total level of health care services has been a high priority of the Central Government, which seems to indicate national merit aspects. Like in the case of elderly care, waiting lists are also handled in a separate scheme ('behandlingsgaranti'), but lowering waiting lists are nevertheless a very important side-effect of boosting production.

The composite index indicates a rather high potential for this type of earmarked grants (b.2.3):

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<sup>145</sup> A complicated discussion is in progress on the distribution of marginal expenditures compared to the share of block grants.



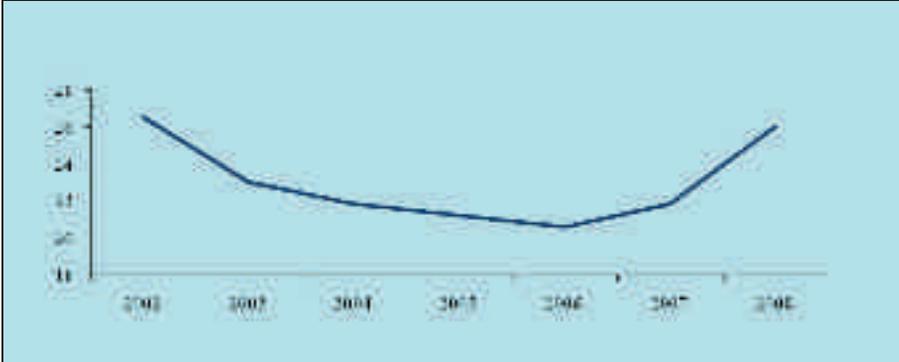
c. Evaluation – fulfilment of targets

The scheme was criticised because of considerable initial administrative problems and delays before the Ministry could announce the annual baselines. It also had to be taken into account that there is some sort of systematic imbalance in measurement since the registration of ‘expensive’ DRG diagnoses seems to be increasing from one year to the next – this is called the “DRG creep”.

However, the conclusion is that the results of this new grant were visible and generally recognised. The number of treatments increased e.g. in 2002 by 11% and by 2.5% in 2003, and waiting times for treatment began to decrease, which thus fulfilled the main objective of the grant. It has been discussed what the more permanent effect of the scheme could be – if it would only be possible to increase the growth rate in the beginning and then end up by only maintaining production at the now higher level (as expressed by the then Minister of Health: “to accelerate the car and then keep the speed”).

*Figure 6* shows the waiting-list figures. The reduction from 2002 to 2006 is significant, and there are some technical explanations for the increase in 2007. The marked increase in number of waiting weeks in 2008 is due to a major hospital strike that included nurses and other groups of health workers.

**Figure 6. Waiting lists for public hospital, 2002-2008, no. of weeks**



Source: Sundhedsstyrelsens venteinfo.dk.

Note: Expected length of waiting periods, i.e. the maximum waiting period for 'the next patient with no special complications' reported by public hospitals. Average of 18 different diagnoses.

### **11.7.3. Reduced reimbursement rates for long periods of sickness benefits**

#### a. Description

In Denmark, employees on sick leave receive either normal wages or sickness benefits. The first three weeks of absence are financed by the employer, but after three weeks sickness benefits take over. Sickness benefits are covered by municipalities, but their expenditures are (more or less) reimbursed by the Central Government.

In the 1980's, most reimbursement rates for municipal expenditures towards income transfers were harmonised at 50%. However, over the past 10-15 years some reimbursement rates have been reduced to encourage municipal preventive efforts such as activation programmes, job training activities, fast rehabilitation etc. It is becoming a type b.2.1 transfer, where the *design* of the earmarked grant is the instrument. Reimbursement of sickness benefits is an illustration of this. The reimbursement rate for such municipal expenditures was initially 100% (in the 1980's – see *table 5*). Since then the reimbursement rate has been differentiated depending on the length of the sickness benefit period so that the rate is reduced to zero when the sickness period has extended for more than one year. The philosophy could be that

when the period of sickness absence is that long, it becomes a social problem in itself – not ‘only’ a health problem – and the municipal authority must very seriously consider other initiatives, such as activation schemes, cash benefits or even early retirement – or of course intensify their efforts to get the individual back into a job. Over the most recent years, the system has been refined to include gradual reduction of reimbursement rates with length of sickness period and higher reimbursement rates when the municipality seeks to activate the individual receiving sickness benefits. However, it should be stressed that the situation is also regulated by law, which means that e.g. a sickness benefit period cannot, other than in certain exceptional circumstances, be extended to last longer than 52 weeks. So two sets of ‘regulations’ are in force: legal and economic.

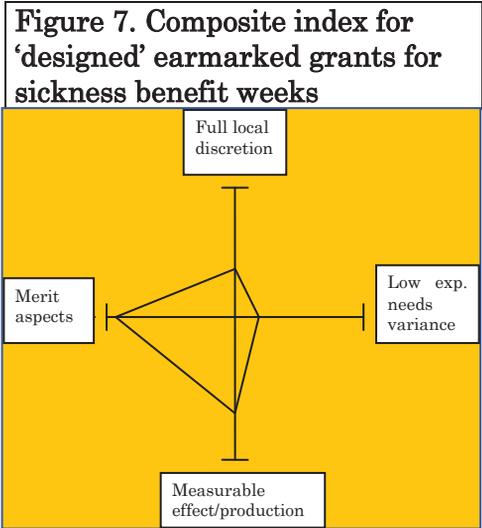
#### b. Evaluation – composite index of earmarked grants

The following four dimensions can be characterised:

- *local discretion.* This is also a type of scenario 2-situation. The central level apparently wants to stress municipality decision-making. It should be noted that the discretionary power of the local authority is limited, as the level and conditions of paying sickness benefits to individuals are regulated in detail by law. But still the role of the municipal authority has been underlined, e.g. the use of frequent interviews/meetings with the individual receiving sickness benefits and the offer of different alternative activities.
- *expenditure needs variation.* Variation in expenditure needs between municipalities is quite important since some areas have a significantly higher level of sickness absence than others.
- *measurability.* The number of sickness benefit weeks is a very relevant measure of ‘production’, since lowering this is the obvious target.
- *merit aspects.* The level of sickness is very important to the society as such, not only because of the costs, but also because the loss of working hours due to sickness reduce production. The case for decentralising has to compete with national interests.

The composite index may then look like this, i.e. a middle potential

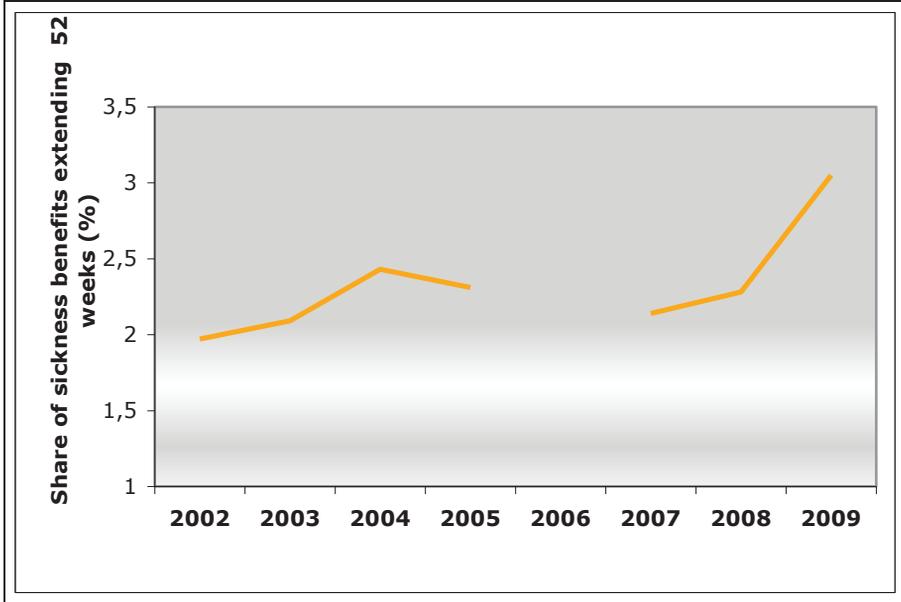
for this type of earmarked grants (b.2.1), see *figure 7*. Note that we have to change the scale of the need variance dimension, since introducing stepwise grants in practice here means *lowering* grants/reimbursements, i.e. high expenditure needs variation works against this type of earmarked grants.



c. Evaluation – fulfilment of targets

Have sickness periods – especially long periods of sickness – been reduced? The most recent figures do not confirm this, see *figure 8*. However, based on such few figures it is of course not possible to make any definite statements about this.

**Figure 8. Sickness benefit weeks related to sickness periods of more than one year**



Source: Danmarks Statistik, DST, September 2009. No data for 2006 (before the structural reform).

The situation is actually quite complex, as indicated in *table 6*. This table shows the causes of prolongation of sickness periods to more than 1 year. It is evident that some of the explanations for prolonged sickness benefit periods are to some degree “in the hands” of the local authority while others are not. If nothing else, this stresses the complexity of designing earmarked grants.

**Table 6. Prolonged sickness benefit schemes for individuals, June 2004-June 2008, per cent**

Causes:	04/05	05/06	06/07	07/08
Prolonged due to rehabilitation	31,9	28,1	25,2	26,7
Registered working accident	2,3	3,1	3,3	3,6
Early retirement application being considered	16,5	16,0	14,2	13,4
Receiving treatment/waiting	12,1	12,2	13,0	13,2
Waiting for treatment at public hospital	0,4	0,4	0,3	0,6
Health recovery not possible	1,8	1,8	2,0	1,9
New period of sickness	0,6	0,6	0,6	0,7
Clarification/further examinations	34,3	37,8	41,3	39,9
Total	100,0	100,0	100,0	100,0
Number of prolonged individual cases	19.000	18.300	17.600	23.500

Source: KMDs sygedagpengeregister.

### 11.8. Concluding remarks

Many aspects have to be taken into account when designing grant schemes. Often decisions about mandates, grants and equalisation have to be made simultaneously.

Such are the conditions of public decision-making, but it is useful to systematically consider which factors are in play. Four such factors have been identified as local government discretion, needs variation, measurability of production and national merit aspects. To ensure that none of those aspects are forgotten, they may experimentally be summarised in a kind of composite index.

As is always the case in social sciences, it is difficult to estimate the effect of financial systems, e.g. earmarked grants. If the effect is doubtful, the administrative and distorting costs should be weighed out against the advantages of general grants, making real costs more visible to the local authorities.

Recently a new generation of grant schemes has been developed, focusing on the production and effects of the programmes instead of costs, i.e. result-based grants. For such 'intelligent grant systems', it is a very decisive fact if production – or even better the effects or results - can be measured. So measurability may become

the key to future development of such schemes. New methods of measurement will make certain kinds of earmarked grants more attractive.

In Denmark the measurement of health service production has made great progress in the last 10 years, and earmarked grants for stimulating growth in desired production make use of the very progress in this area. Still, it is only a measure of production, and more production definitely does not always mean better health.

Production and quality measures are also in focus in other areas of the Danish landscape of local government output, for example in education, kindergartens and elderly care. It is obvious, however, that the production of elderly care is difficult to quantify, and the results of better education can only be measured after a number of years. Alternatively, other measures have been discussed, e.g. certification of institutions, accreditation, new accounting methods etc.<sup>146</sup> But we still need to be convincing enough to overcome the reluctance of local government organisations to embrace such new methods. Introducing measures of “results” also depends on some consensus about the purpose of the activity – what should really be the “results”? This is perhaps easier to agree upon when it comes to health services and primary schools than in the case of for example kindergartens, elderly care or social assistance. Nevertheless, in a Danish context it seems that focus is shifting from the process of production, e.g. “learning”, “care for the elderly”, “looking after children” to the effects such as “knowledge”, “social qualifications”, “quality of life” etc.

However, we still lack reliable, national-scale measures of effects, and it is possible that such measures are most easily discussed and used at the local level, as it is closer to the institutions.

Moreover, even if and when we get reliable measures of effects for several areas of public welfare it is still not obvious that result-based grants are to be recommended. This seems to be the case even though such grants, as argued in Shah (this volume), should be more effective in respect to results since they focus on output

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<sup>146</sup> The Danish ‘Kvalitetsreform’ (Quality reform) also includes initiatives to improve measurement, see Regeringen (2007).

instead of input – like traditional earmarked grants or reimbursements schemes do. However, it should be taken into account that earmarked grants, whether being input- or output based, by their very nature are sector-oriented rather than unity-oriented. Therefore, coordination and general economic considerations might be weakened or more difficult to carry out if e.g. general grants are replaced by result-based grants (or any other kind of earmarked grants for that sake). This will possibly be the experience both on the central and the local level of government.

So, for the time being the bottom line is that general grants still seem to be preferable in most cases. They support allocations across the various expenditure mandates, allocations that the local governments have both the possibility to carry out and an own interest in.

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# Chapter 12

## Provincial-local fiscal transfers in Canada: Provincial control trumps local accountability

Enid Slack

### 12.1. Introduction

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In the 1970s, Canadian municipalities were characterized as “puppets on a shoestring” (Canadian Federation of Mayors and Municipalities, 1976), and the provincial role with respect to cities was described as one in which “father knows best” (O’Brien, 1975). Not much has changed in 35 years. Unlike the relationship between the federal and provincial governments, local governments in Canada are highly controlled and tightly constrained by provincial governments (Bird & Tassonyi, 2003). Indeed, local governments are often referred to as “creatures of the provinces” because they have no original powers in the Constitution and enjoy only those powers that are delegated to them by the provinces.

In reality, the province establishes local governments and their geographic boundaries, mandates their expenditure responsibilities, sets standards for local service provision even for services that are not mandated, limits their own-source revenues largely to property taxes and user fees, sets the rules around levying the property tax, requires that municipalities not incur a deficit in their operating budget, and determines the extent to which municipalities can borrow to meet capital requirements. At the same time, the province influences municipal expenditures through its grant programs.

The good news is that the high degree of provincial control over local governments in Canada means that there cannot be any visible fiscal crisis at the local level: municipal governments are

strictly held to balanced budgets for operating purposes, and their borrowing for capital expenditures is constrained by provincial legislation and regulations. The bad news, however, is that municipal governments in Canada have only very limited fiscal autonomy and are constrained from solving any fiscal problems they may have.

This paper provides a case study of provincial-local transfers in Canada and evaluates the extent to which they are designed for local accountability or provincial control. The evaluation is based, in part, on a review of trends in provincial transfers to municipalities and school boards over the last 20 years, and, in part, on an assessment of the extent to which grants are designed to satisfy the rationales for intergovernmental transfers found in the traditional fiscal federalism literature (vertical fiscal imbalance, horizontal fiscal imbalance, and externalities), or the political rationales set out in the “second generation theory of fiscal federalism” (Oates, 2005) .

The second section presents trends in municipal expenditures and revenues in Canada over the last two decades. The third section reviews the special case of education funding. The fourth section focuses on trends in provincial-municipal transfers and looks at whether earmarking has increased over the last two decades. The fifth section sets out the standard rationales for transfers and evaluates the extent to which provincial-local transfers in Canada are designed to meet those objectives or more political objectives. The sixth section describes some of the problems with transfers in general and with transfers in Canada specifically. The seventh section provides concluding comments on provincial-local transfers in Canada in the context of the overall provincial-municipal fiscal system.

In this paper, the term “specific-purpose” grant is used interchangeably with the term “earmarked” grant. These grants are conditional on being spent on specific functions by the recipient government. Earmarked grants may be matching (the recipient has to match donor funding) or non-matching (lump sum) grants. “General-purpose” grants are the same as “non-earmarked” grants and include general-purpose grants as well as grants given for specific purposes but not earmarked for that purpose (Bergvall,

Charbit, Kraan, & Merk, 2006) and (Blochliker & Petzold, 2009).

## 12.2. Trends in municipal finance in Canada

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Canada is a federation with three levels of government: the federal government, ten provincial and three territorial governments, and about 4,000 local governments. Canada's *Constitution Act, 1982*, lists the jurisdictions over which federal and provincial governments have lawmaking authority. Local governments are only mentioned in the Constitution as one of the responsibilities of provincial governments.

Provincial legislation sets out the powers of municipal governments. A few cities (for example, Toronto, Vancouver, Winnipeg, Montreal, and Saint John) are governed by separate Charters or other special legislation that confer powers and duties (but few, if any, extra revenue tools) additional to those of other municipal governments. For example, the City of Toronto Act gives Toronto greater authority and autonomy than other municipalities in the province. In terms of taxes other than the property tax, however, it is restricted to selective taxes on vehicle registrations, alcohol, entertainment, and tobacco, as well as a land transfer tax.

Municipal governments in Canada deliver a wide range of services as can be seen in Table 1. Municipal expenditures per capita, on average across the country, were approximately \$2,000 in 2007. Municipal services extend from those that have private good characteristics (for example, water, sewers, solid waste, and transit) to those that have public goods characteristics (for example, police and fire protection, local roads, streets, and street lighting). In some provinces, municipal governments also provide services that are redistributive in nature (such as welfare assistance, health, and social housing). More than half of all municipal expenditures today are for transportation (roads, streets, snow removal, public transit), protection (police and fire), and environment (water, sewage, solid waste collection and disposal). Expenditures on environmental services have increased in relative importance over this period, reflecting the growing importance that municipalities place on clean water and environmental issues as well as higher provincial standards.

Social service expenditures include social assistance and services such as homeless shelters, women's shelters, immigration settlement, food banks, etc. Social assistance is a provincial financial responsibility in every province except Ontario, where costs are shared between the provincial and municipal governments.<sup>147</sup> For the country as a whole, social services accounted for almost 9 percent of total municipal spending in 2007; when Ontario is excluded, social services only accounted for less than 1 percent.

Health expenditures are the responsibility of provincial governments, except for land ambulance in Ontario (and in parts of the province of Alberta and in the City of Winnipeg). Relatively limited municipal expenditures are also made on public health (e.g. anti-smoking campaigns, restaurant inspections, etc.) in some provinces. Expenditures on recreation and culture have accounted for 12 to 13 percent of municipal expenditures throughout the 20-year period. Debt charges for capital projects have dropped dramatically over the last two decades, reflecting a drop in interest rates and a reduction in municipal borrowing.

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<sup>147</sup> The uploading of social service costs to the province is slated to begin in 2010 and be completed by 2018.

**Table 1. Municipal expenditures by function, Canada, 1988 and 2007**

Province	1988 \$millions CAD	1988 %	2007 \$millions CAD	2007 %
General government services	2,749	9.9	6,887	10.1
Protection	4,122	14.8	10,960	16.1
Transportation	6,197	22.3	13,822	20.3
Health	560	2.0	1,676	2.5
Social services	2,053	7.4	6,095	8.9
Resource conservation/ind'l development	585	2.1	1,464	2.1
Environment	4,064	14.6	12,461	18.3
Housing	3,241	11.6	8,564	12.6
Recreation and culture	489	1.8	2,348	3.4
Regional planning	572	2.1	1,370	2.0
Debt charges	2,657	9.5	2,249	3.3
Other	560	2.1	303	0.4
Total expenditures	27,849	100.0	68,199	100.0
<ul style="list-style-type: none"> <li>■ Protection: courts of law, correction and rehabilitation, police, firefighting, and regulatory measures.</li> <li>■ Transportation and communications: roads and streets, snow and ice removal, parking, and public transit.</li> <li>■ Health: hospitals and preventive care.</li> <li>■ Resource conservation and industrial development: agriculture, tourism, trade and industrial development.</li> <li>■ Environment: water, sewer, solid waste collection and disposal, and recycling.</li> <li>■ Debt charges: interest payments.</li> <li>■ Other expenditures: miscellaneous expenditures and <i>municipal</i> expenditures on education.</li> </ul>				

Source: Source: Statistics Canada, CANSIM Table 385-0024 - Local general government revenue and expenditures, current and capital accounts, year ending December 31.

Turning to municipal revenues, Table 2 and Figure 1 show that own-source revenues (mainly property taxes and user fees) are the largest municipal revenues. Intergovernmental transfers account for less than 20 percent of municipal revenues, and these are largely from provincial governments. Over the last 20 years, the

relative importance of own-source revenues has grown, in large part because the dependence on transfers has fallen. The annual average growth in property taxes per capita in constant dollars over the period was 1.2 percent; transfers fell by 0.1 percent over the same period. This decline represents a decline in general purpose (non-earmarked) transfers of 2.7 percent per year and an increase in specific purpose (earmarked) transfers of 0.6 percent per year (in constant dollars per capita). Federal transfers to municipalities have historically been fairly small, and all federal grants are earmarked for specific purposes. Figure 1 shows that specific purpose grants have fluctuated more than general purpose grants and more than property taxes over the last 20 years.

Since municipalities are not permitted to budget for operating deficits, the annual budget must include sufficient revenues to cover all operating expenditures. If expenditures exceed revenues in a particular year, the resulting deficit must be covered in the following year's budget.<sup>148</sup> Borrowing is permitted, however, for capital expenditures.

Although it may appear from the trends in municipal expenditures and revenues that there has been an increase in local autonomy over the last 20 years, appearances can be deceiving. Even though municipalities have been relying increasingly on own-source revenues, the rules and regulations set out by the province both on the standards for services and the collection of taxes and user fees suggest that provincial control has not declined. The following section on education funding illustrates, even more strongly, the increase in provincial control over the last two decades.

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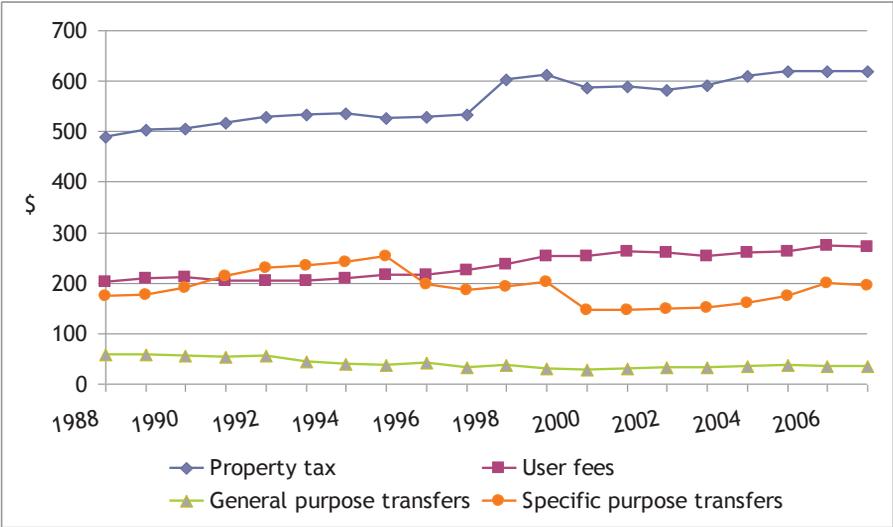
<sup>148</sup> The Province of Ontario has become more flexible in recent years, permitting municipalities to balance their budgets over a two to five-year period.

**Table 2. Municipal revenues by source, 1988 and 2007**

	1988 \$millions CAD	1988 %	2007 \$millions CAD	2007 %
Own source revenues:				
Property and related taxes	13,112	48.4	33,450	50.7
Other taxes	384	1.4	901	1.4
User fees	5,426	20.0	14,658	22.2
Investment income	1,628	6.0	3,504	5.3
Other	292	1.1	999	1.5
Total own-source revenues	20,843	77.0	53,512	81.2
Transfers:				
General purpose transfers (non-earmarked)	1,579	5.8	1,880	2.9
Specific purpose transfers (earmarked)	4,649	17.2	10,534	16.0
- Federal	194	0.7	1,067	1.6
- Provincial	4,455	16.5	9,467	14.4
Total transfers	6,228	23.0	12,413	18.8
Total revenue	27,071	100.0	65,925	100.0

Source: See Table 1.

**Figure 1. Major municipal government revenues by source, constant dollars per capita, 1988-2007**



Source: See Table 1.

**12.3. The special case of education**

In most provinces, elementary and secondary education is delivered by local school boards that are funded wholly, or in part, by the provincial government. Provincial governments levy property taxes in eight provinces (the exceptions are Quebec and Saskatchewan), but provincial property taxes are only dedicated to education in five provinces (British Columbia, Alberta, Manitoba, Ontario, and Nova Scotia).<sup>149</sup> In Ontario and Nova Scotia, for example, the education property tax rate is set by the province, collected by municipalities, and remitted to school boards. School boards have not had taxing powers in Ontario since the provincial takeover of education funding in 1998.

Figure 2 shows that school board expenditures declined through much of the 90s and beyond with an increase in 2004. Over the same period, provincial transfers for education have generally

<sup>149</sup> Provincial property taxes are not specifically earmarked for education in New Brunswick, Prince Edward Island, and Newfoundland and Labrador.

increased, and property taxes have fallen. The big drop in 1998 reflects a major reform in Ontario whereby the province took over the funding of education, created a new funding formula, and took over the property tax for education. As part of this reform, the province lowered its newly acquired education property tax, leaving room for municipalities to raise theirs.

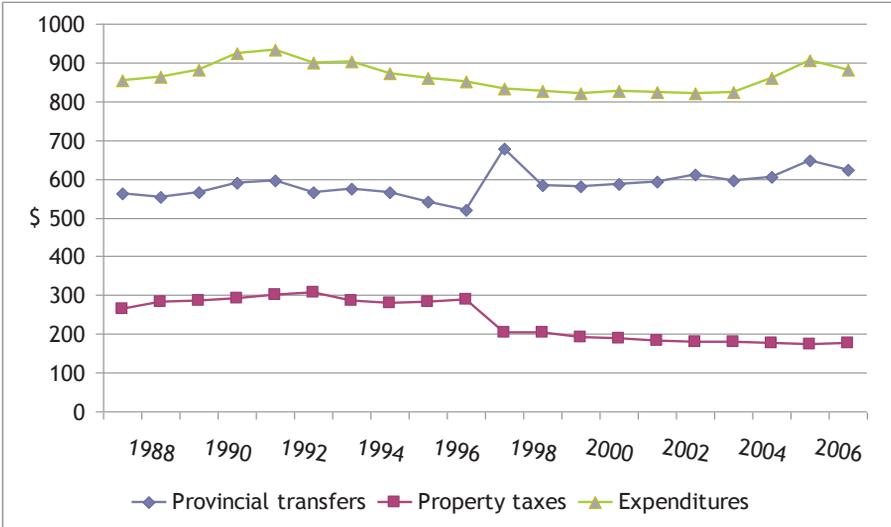
On average across Ontario, the reduction in education property taxes was compensated for by an increase in provincial grants. For some of the larger, richer school boards where transfers were less significant, however, there has been a decline in overall revenues.<sup>150</sup> Moreover, the takeover of education funding by the province meant that locally elected school boards no longer have taxing authority. Certainly in the case of education in Ontario, provincial control has been paramount and overrides local accountability.

Of course, the interesting question is what happened to student outcomes as a result of the provincial takeover of education funding in Ontario. This study has not been done, but standardized testing in reading, writing, and mathematics in Ontario does permit an analysis of the impact of funding changes on student performance. A recent study, for example, found that equal per-student funding of public and Catholic schools has resulted in competition for students, and this competition has modestly improved student performance on provincial tests (Card, Dooley, & Payne, 2008).

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<sup>150</sup> Prior to the local services realignment, two school boards in Ontario (Toronto and Ottawa) were in a negative grant position with respect to the major equalization transfer for education. They were not required to submit funds to the province, however. These boards were able to raise additional property taxes to meet local needs but were no longer permitted to do so after the provincial takeover of education funding.

**Figure 2. School board expenditures and major revenues, constant dollars per capita, Canada, 1988-2007**



Source: Statistics Canada, CANSIM Table 385-0009 - School board revenue and expenditures, year ending December 31.

### 12.4. Trends in provincial-municipal transfers in Canada

This section shows the trends in provincial-municipal transfers in Canada over the last two decades and attempts to answer some of the questions that were posed for this conference.

*Are provincial-local transfers in Canada largely specific-purpose (earmarked) or general-purpose (non-earmarked)?*

In contrast to federal-provincial transfers in Canada, provincial-municipal transfers are largely specific-purpose. Table 3, which shows the ratio of grants for municipal services only and for municipal services and education combined, however, highlights some of the differences across provinces. In all provinces, specific-purpose grants as a proportion of total grants are higher when education is included because all grants for education are conditional. Overall, the ratio of specific-purpose grants to total grants is 85 percent for municipalities and 95 percent for municipalities and school boards combined. In three of the smaller

provinces (New Brunswick, Manitoba, and Saskatchewan),<sup>151</sup> however, the ratio of specific purpose to total transfers is significantly less than the national average.

**Table 3. Specific-purpose (earmarked) transfers as a proportion of total transfers, by province in Canada, 2007**

Province	Municipal only	Municipal and education
British Columbia	65.1%	97.6%
Alberta	96.9%	99.3%
Saskatchewan	56.2%	90.2%
Manitoba	47.4%	84.1%
Ontario	88.2%	94.4%
Quebec	83.7%	97.1%
New Brunswick	44.4%	46.9%
Nova Scotia	66.6%	93.7%
Prince Edward Island	77.2%	95.6%
Newfoundland and Labrador	84.3%	97.3%
Canada (incl. northern territories)	85.2%	95.4%

Note: School boards in New Brunswick are administered by the provincial government.

Source: See Figure 2.

*Have specific-purpose (earmarked) transfers been increasing?*

Figure 1 showed the breakdown of provincial-municipal transfers by specific and general purpose from 1988 to 2007. It shows the swings in specific-purpose transfers over the period, with a major decline in the mid to late 1990s and a rebound starting in 2000. General-purpose transfers as a proportion of municipal revenues have remained both low and constant over the last 20 years and, indeed, over the entire post-war period (Bird & Chen, 2001). In short, provincial money has come with restrictions and controls designed to “meet provincial wishes at the local level” (Bird & Tassonyi, 2003).

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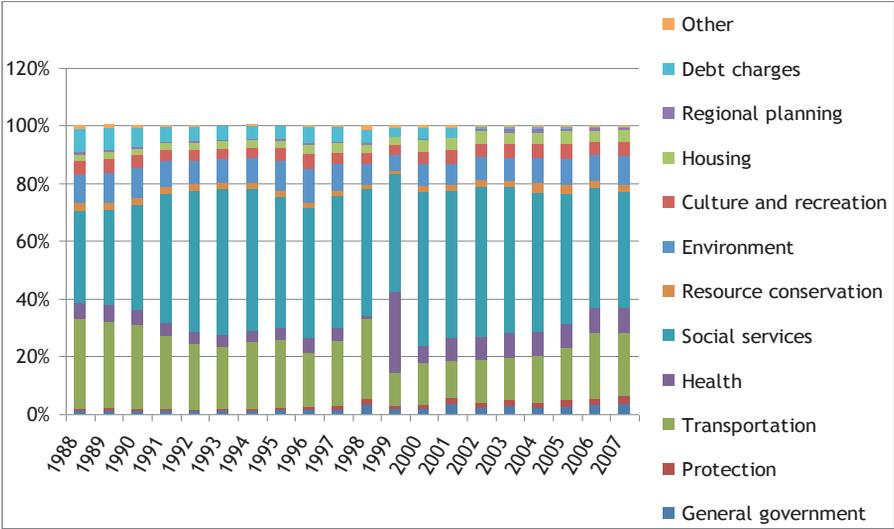
<sup>151</sup> The high proportion of general-purpose (non-earmarked) transfers in New Brunswick reflects the implementation of the "Equal Opportunity" program in 1967 whereby the province took over responsibility for health, education, social services, and the administration of justice and has, since that time, shared the property tax field with municipalities. Saskatchewan also has undertaken a realignment of services. Manitoba has a revenue-sharing program with municipalities that accounts for the largest portion of its transfers (see below).

*What is the composition of specific-purpose transfers?*

Figure 3 shows the composition of provincial specific-purpose transfers from 1988 to 2007. Because social services are jointly funded by the province and municipalities in Ontario, Figure 3 shows significant transfers for social services. When Ontario is taken out of the chart, the largest transfers are earmarked for transportation (roads and transit) and the environment (water, sewers, solid waste). Moreover, transfers for these two functions have been increasing over the last two decades.

It has been argued that one of the reasons for earmarking is to assist municipalities with large expenditures on infrastructure. Most public infrastructure in Canada is the responsibility of municipal governments. The local government capital stock represented 48 percent of the total capital stock of all three levels of government in 2002 compared to 34 percent for the provincial government and 18 percent for the federal government (Harchaoui, Tarkhani, & Warren, 2004). Local public infrastructure largely comprises roads and highways (45 percent of total local public infrastructure in 2000), followed by sanitary sewers (at 17.3 percent) and sewage treatment (at 12.2 percent).

**Figure 3. Composition of provincial specific-purpose transfers, Canada, 1988-2007**

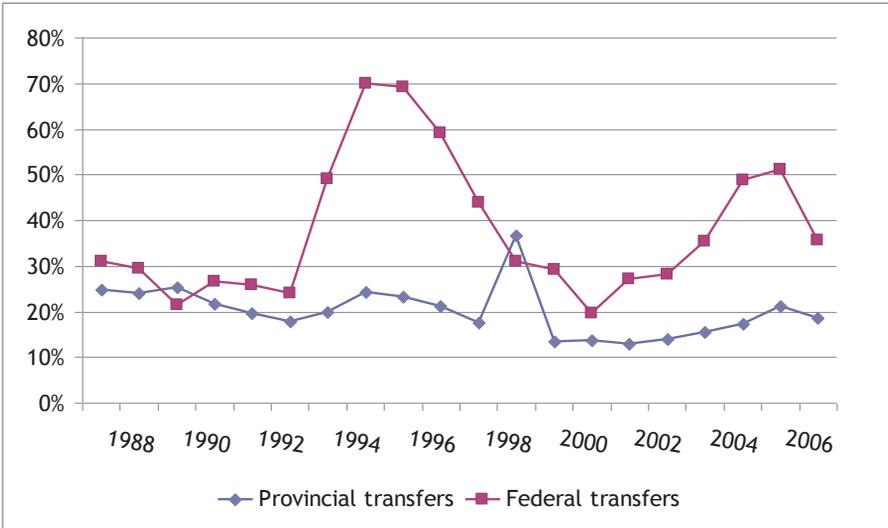


Note: The transfer for health increased in 1999 because the provincial government of British Columbia made a \$1.9 billion capital transfer for debt forgiveness for municipal hospitals.

Source: See Table 1.

Figure 4 compares capital transfers as a percentage of total transfers for the federal and provincial governments from 1988 to 2007. Although federal transfers to municipalities are fairly small, they tend to be earmarked for capital purposes to a much greater extent than are provincial transfers. Figure 4 also shows considerable variability in the percentage of transfers that are earmarked for capital purposes over the 20-year period. The decline in the proportion of federal capital transfers after 2006 will likely be reversed starting in 2009 because of the current federal stimulus package which includes funding for infrastructure investment.

**Figure 4. Capital transfers as percent of total transfers, 1988-2007**



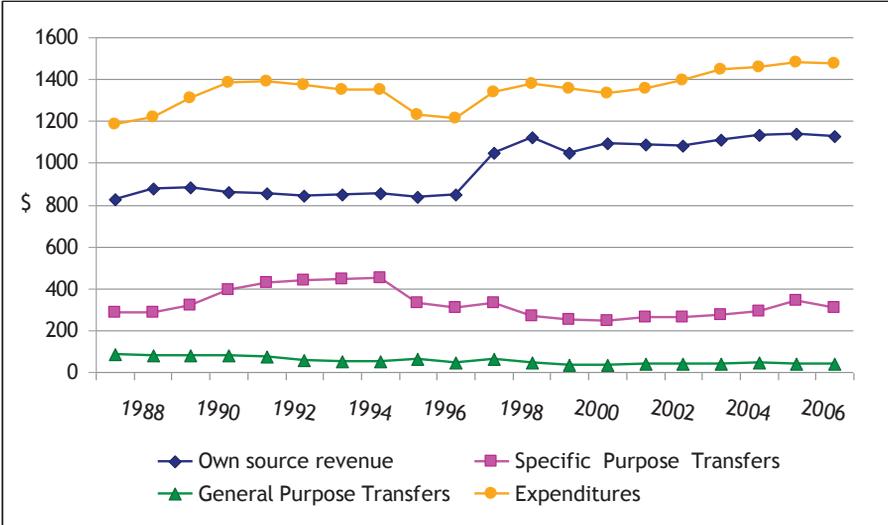
Source: See Table 1.

*Is there a relationship between earmarking and decentralization?*  
It is difficult to answer this question for the entire country since every province is different. An interesting case study is Ontario, however, where a major realignment of provincial and local services took place in 1998. Figure 5 shows the trends in municipal

expenditures and revenues in Ontario from 1988 to 2007. In 1998, municipal expenditures per capita in constant dollars increased to reflect the additional responsibilities devolved to municipalities. Own-source revenues also took a jump in 1998, reflecting the tax room provided to municipalities as part of the services realignment in which the province took over education funding and lowered tax rates. Specific-purpose transfers declined after 1998 because many of the jointly funded programs were devolved to municipalities. The formula for the general-purpose grant changed in 1998 but does not appear to have resulted in a significant change in magnitude.

It thus appears that, at least in one province, devolution has meant a reduction in specific-purpose grants and an increase in own-source revenues made possible by the provincial takeover of education funding.

**Figure 5. Expenditures and selected revenues, constant dollars per capita, Ontario, 1988-2007**



Source: See Table 2.1.

### 12.5. Rationales for transfers

The traditional fiscal federalism literature sets out three main rationales for intergovernmental transfers: vertical fiscal imbalance, horizontal fiscal imbalance, and externalities (see, for example, (Shah, 2007) or (Slack, 2007)). The appropriate grant depends on the underlying rationale. This section evaluates the extent to which provincial-municipal transfers in Canada appear to be designed for each of these purposes or to meet more political objectives.

#### *Vertical fiscal imbalance*

Vertical fiscal imbalance occurs when municipalities have inadequate own-source revenues to meet their expenditure responsibilities. To close the fiscal gap, senior governments can transfer additional revenue-raising powers to local governments, or they can reduce the expenditure responsibilities that local

governments are required to undertake.<sup>152</sup> As a last resort, the fiscal gap can be closed with a general purpose (non-earmarked) transfer. The amount of the transfer allocated for this purpose can be determined in three ways (Bird & Smart, 2002, p. 900): as a fixed proportion of the revenues of the donor government (known as revenue sharing); on an ad hoc basis; or on the basis of a formula (for example, as a percentage of specific local government expenditures or population).

As noted earlier, the use of general-purpose grants in Canada is much less extensive than specific-purpose grants. In terms of revenue sharing, a few provinces share fuel tax revenues with municipalities, but these grants are conditional on being spent on transportation: Alberta shares 5 cents per litre of taxable gasoline and diesel fuel collected in Calgary and Edmonton with those cities; Quebec shares 1.5 cents per litre from fuel taxes collected on motor fuel sold in the Greater Montreal area with l'Agence Métropolitaine de Transport (AMT); and Ontario shares 2 cents per litre with municipalities for transit. In all cases, how the tax is levied, collected, and distributed is unilaterally decided by the province and can be changed at will. In BC, however, Translink (the South Coast British Columbia Transportation Authority) sets the fuel tax rate (currently 15 cents per litre), and the proceeds of this dedicated tax go to Translink.

The only comprehensive non-earmarked revenue sharing program in Canada at the provincial-local level is in Manitoba.<sup>153</sup> The province shares the revenues from five provincial taxes with municipalities: 4.15 percent of provincial income taxes (personal and corporate), 2 cents per litre of provincial gasoline tax revenue, 1 cent per litre of provincial diesel fuel taxes, 10 percent of video lottery terminal revenues, and 100 percent of provincial fine revenues for municipalities that provide their own policing (urban municipalities with a population over 750). With the introduction of the Building Manitoba Fund in 2005, however, the unconditional

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<sup>152</sup> In the Canadian context, there have been several major realignments of services between the provincial and local governments over the last 20 years but only minor changes in the tax sources available to municipalities.

<sup>153</sup> In Saskatchewan, the provincial government will base its municipal operating grants on the value of one point of the provincial sales tax starting in 2009-10.

nature of these grants has been modified: the base amount remains unconditional, but increases over the 2005 base are conditional on being spent on infrastructure.

Given the limited use of general purpose grants and revenue sharing with municipalities in Canada, it appears unlikely that the main rationale underlying provincial-local transfers is to correct the vertical fiscal imbalance.

### *Horizontal fiscal imbalance*

Horizontal fiscal imbalance refers to the difference in resources among governments at the same level: some municipalities are unable to provide an adequate level of service at reasonable tax rates whereas other municipalities can. This inability to provide an adequate level of service may occur because the costs of services are higher, the need for services is higher, and/or the tax base is smaller.

Needs and/or costs may be greater than the average because of geographic location, population density, or other factors. For example, wages and rents are usually higher in cities with high population density, and the cost per unit to provide services increases with increasing population because of congestion (Fenge & Meier, 2001). Needs may be higher for municipalities with a high proportion of low-income households who require affordable housing and social services.<sup>154</sup> Measuring need can be difficult and requires considerable data (Kim & Lotz, 2008).

Equalization grants, based on expenditure needs and fiscal capacity, can ensure that those municipalities with small tax bases and greater costs and needs are able to levy tax rates that are comparable to those of other jurisdictions. Generally, the formula calculates the difference between a standardized expenditure and a standardized revenue base.

Seven Canadian provinces provide general-purpose equalization grants to municipalities. In only two provinces (Nova Scotia and

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<sup>154</sup> Of course, expenditures per capita could be higher because of inefficient spending by some municipalities. If inefficiency is the reason for higher expenditures, then this inefficiency will also be rewarded by the grant.

New Brunswick), the equalization grant formula recognizes both expenditure needs and fiscal capacity; the other provinces only take account of fiscal capacity. In Nova Scotia, equalization grants only include expenditure needs for a few categories -- police, fire, water and sewers – and omit expenditures such as parks, culture, and recreation. The two provinces that include measures of expenditure need in the grant formula differentiate their equalization grants by classes of municipalities because of wide divergences in expenditures and revenue-raising capacities of different types of municipalities. Without these groupings, expenditure levels and revenue-raising capacity would over-emphasize fiscal needs and fiscal capacity, respectively, in the formula, owing to the significantly higher expenditure levels and tax base in the largest cities.

In summary, most provinces provide some form of equalization grants to municipalities, but these do not generally constitute the major component of grants. Equalization is an objective of grant programs in most provinces but it is not the only objective.

### *Externalities*

The benefits (and costs) of some services spill over municipal boundaries (for example, regional highways) and may result in an under-allocation of resources because the municipality providing the service bases its expenditure decisions on the benefits captured within its jurisdiction and not the benefits to those outside. One way to internalize the externalities is to expand the municipal boundary to include all of the beneficiaries of the service. Not only would the boundaries likely be different for different services, however, amalgamation is rarely a popular policy choice (Slack, 2007).

Another way to provide an incentive to allocate more resources to the service generating the externality is a specific-purpose, matching grant (a Pigouvian subsidy that would internalize the positive externality from the local expenditures). The grant should be earmarked for the service which generates the externality. It should be matching to reflect the extent of the externality. The matching rate may be different in different jurisdictions, reflecting that there are greater externalities in some places than in others (Bird & Smart, 2002).

Although the notion of a matching rate to reflect spillovers works in theory, the extent to which the grant will induce municipalities to spend more on the subsidized service depends on the matching rate, the responsiveness of spending to a lower price, and whether the grant stimulates new spending or replaces spending that would have occurred anyway (Bahl, 2000). In practice, governments do not know the magnitude of spillovers for specific services (Bird, 2000), and empirical evidence suggests that the scope of externalities is limited and thus cannot justify the high matching rates that are generally used (Blochliger & Petzold, 2009).

Matching grants require municipalities to contribute a portion of the funds for the service. A uniform matching rate tends to favour richer cities because they are more able to match funds than poorer cities, unless there is an equalization component to the grant. Moreover, a matching grant will only stimulate spending if the municipality has the power over expenditures and the ability to increase taxes (Bird, Ebel, & Wallich, 1995).

There are hundreds of examples of specific-purpose transfers across Canada, many of which are matching. Alberta, for example, provides over 65 specific-purpose grants to municipalities from 10 different provincial government departments. One of these grants is the City Special Transportation Grant, which is a specific-purpose matching transfer that provides financial assistance for high priority transportation capital projects within cities. If approved by a review committee comprised of provincial department representatives and the Alberta Urban Municipalities Association, the province funds 75 percent of the costs with a maximum provincial share for any project of \$3 million.

There are many more examples of specific-purpose, matching grants across Canada, and many have very high matching rates. It is difficult to know if these grants have been designed to address externalities, but given the very high matching rates, it seems likely that this is not the primary rationale.

### *Political rationales*

Transfers are sometimes established in response to successful lobbying by municipal associations (for example, the lobbying by the Federation of Canadian Municipalities for a permanent federal

gas tax transfer). Transfers have also been introduced in response to a public outcry over deteriorating services or infrastructure (as happened when there were problems with water quality and the public demanded higher standards and more funding). But, more fundamentally, provincial governments often use transfers as a way to exert control over how municipalities deliver services.

Provincial governments can deliver local services themselves, they can let local governments deliver the services but regulate how the services are delivered, or they can let local governments deliver the services with provincial regulations and some financial assistance. In most Canadian provinces, the third option has been chosen with a non-matching specific-purpose grant to encourage local governments to provide at least a minimum standard of service (in areas such as road safety, ambulance services, and water and waste water treatment).

Non-matching specific-purpose grants are appropriate to subsidize activities that are a high priority for the donor government but a low priority for the recipient government (Boadway & Shah, 2009). These transfers provide incentives for local governments to act as agents of the donor government. The donor government benefits from local management in providing a service but gets to determine how the service will be delivered. Local governments in this model have been described as the “handmaidens” of the provincial government (Boadway & Shah, 2009).

Provincial-municipal transfers in Canada thus seem largely designed to give provincial governments control over the expenditure and taxing decisions of local governments while, at the same time, appearing to let municipal governments deliver their own services. In essence, local governments in Canada, to a considerable extent, are acting as agents of provincial governments spending provincial dollars on provincially-designated activities (Bird & Slack, 1993, p. 138).

Whether or not they provide funding for municipal services, provincial governments set and enforce service standards that municipalities have to meet. There are standards for fire protection, water and sewerage services, solid waste disposal, building inspection, day care, and housing for the elderly. Provincial regulations for maintenance of municipal highways in

Ontario (Ontario Regulations 239/02), for example, set standards with respect to routine patrolling, snow clearing, treating icy roadways, repairing potholes, repairing shoulder drop-offs, repairing cracks, removing debris, repairing non-functioning lights, repairing or replacing signs, repairing defects in the traffic control signal system and sub-systems, repairing bridge deck spalls, and repairing surface discontinuity.

Why is the provincial control over municipal finances in Canada so pervasive? In part, it is because municipalities are constitutionally creatures of the provinces and, if they go bankrupt, the province generally has to come to their rescue. It is also the case that municipalities provide a wide range of very visible services to their inhabitants (Bird & Tassonyi, 2001). Since most Canadians use these services, it is not surprising that provincial politicians want to guarantee that these services will continue to be provided even though they are financed by local budgets. Indeed, when municipalities have been unable to fund services adequately, the province has generally stepped in with some type of assistance. Municipalities can depend on the province to bail them out, if necessary, but only at the expense of substantial provincial control over every aspect of their finances – expenditures, revenues, and borrowing.

## 12.6. Problems with transfers

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Efficient service delivery requires that those responsible for providing services have a clear mandate, adequate, sufficient flexibility to make decisions, and accountability for their decisions (Bird & Vaillancourt, 1998). Transfers need to be designed so that these conditions are not violated. The literature has identified a number of potential problems with intergovernmental transfers, and examples of these problems abound in Canada.

*Transfers can interfere with the efficient delivery of services.*

Transfers should not discourage municipalities from charging the right price for services: “the basic task in transfer design is thus to get the prices ‘right’ in the public sector – right, that is, in the sense of making local governments fully accountable – at least at the margin of decision-making – to both their citizens and, where appropriate, to higher levels of government” (Bird & Smart, 2002,

p. 899). There is no incentive to use proper pricing when grants cover a large proportion of operating and capital costs. In many provinces, for example, large grants for water treatment plants in the past reduced the incentives of municipalities to use volumetric pricing to reduce the demand for water or to engage in asset management.

*Transfers can distort local decision-making.*

Specific purpose transfers require municipalities to spend the funds according to provincial or federal guidelines and often require municipal matching funds. A matching transfer, by lowering the price of some services, encourages municipalities to spend more on those services.<sup>155</sup> In the presence of externalities, this change in behaviour may be appropriate. Where there are no externalities, however, or where the amount of the grant vastly exceeds the amount of the externality, the resulting distortion in municipal behaviour is inappropriate.

The extensive literature on the flypaper effect (“money sticks where it hits”) suggests that grants will be effective at stimulating local spending in the areas for which they are earmarked, rather than merely crowding out spending that would have occurred anyway (Inman, 2008). Yet, specific purpose grants can be fungible in the sense that, even though they come with strings attached, there is no guarantee that the recipient will spend the funds on what the donor government intended. Fungibility is particularly relevant for large cities that are more likely to be spending on the designated function already. They are less fungible, however, if their receipt is conditioned on meeting performance standards and compliance is monitored.

In Canada, federal transfers for provincial and municipal infrastructure projects under the 2009 Infrastructure Stimulus Fund provide an interesting example of how transfers distort local decision-making. The City of Toronto applied to the federal government for infrastructure funding to pay part of the costs of 204 new streetcars needed to implement its transit plan. The streetcars would be 25 percent made in Canada, mostly at a Bombardier facility in Thunder Bay (a city in Northern Ontario).

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<sup>155</sup> For a comparison of the impact of specific purpose and general purpose transfers to municipalities in Ontario in the mid-1970s, see (Slack 1980).

The federal government turned down the request because it did not meet the criteria. In particular, it was not “shovel ready” meaning that the construction of streetcars could not begin immediately; all of the streetcars would not be built by 2011 (the deadline for stimulus spending); and the jobs created were not in the local economy but rather in Northern Ontario. As a result, the City re-applied to the federal government for stimulus funds for 500 smaller projects that met the criteria.

*Transfers can reduce accountability.*

When two or more levels of government are funding the same service, accountability problems are sure to arise. When residents want to complain about the service, they are not sure which level of government is responsible for the problem. Accountability is blurred when the level of government making the spending decisions (municipalities) is not the same as the level of government that is raising the revenues to pay for them (provincial or federal governments).

Although performance measurement is mandatory for municipalities in Ontario and it is used in some other Canadian jurisdictions as well, it is not generally used to determine if municipalities receiving specific provincial grants are meeting performance standards for those services. Performance measures in Ontario, for example, are designed to assess the efficiency (amount of resources used to produce a given amount of service) and effectiveness (extent to which a service is achieving its intended results) of municipal services. Over 80 performance measures have been constructed for 12 municipal services.

The province requires municipalities to report the results of these measures to taxpayers annually, but provincial funding does not depend on the results. Nevertheless, these measures enhance accountability by permitting municipal elected officials, administrators, and taxpayers to monitor and evaluate municipal expenditures over time and in comparison to other municipalities. Municipalities are also required to submit annual financial information returns (with details on expenditures and revenues) to the provincial government before they receive grant funding. Provincial auditors can perform audits to determine if municipalities have actually spent the grant money, but this is not

a regular occurrence.

Output-based performance measures are used by the federal government as part of its gas tax revenue sharing program, however.<sup>156</sup> Federal gas tax transfers are specific-purpose, non-matching transfers that have to be spent on environmentally sustainable municipal infrastructure, and municipalities receive an amount based on population. To implement this program, very detailed agreements have been prepared with every province (and territory) establishing an allocation formula under which the revenues are allocated to provinces. Funds have to be used to support the desired outcomes of cleaner air, cleaner water, and the reduction of greenhouse gas emissions. Eligible projects and costs are set out in the agreements. Provinces (which receive funds from the federal government and pass them onto municipalities)<sup>157</sup> can withhold payment, reduce payment, return payment, and/or not renew the Memorandum of Agreement with non-compliant municipalities.

Provinces are required to submit an outcomes report to the federal government and provincial residents annually. The content of the report, including indicators to measure results and outcomes, is agreed upon with municipalities but must include information on the degree to which these investments have contributed to achieving the objectives.

*Transfers are rarely stable and predictable.*

The amount of money local governments receive varies from year to year, in part depending on the fiscal state of the donor governments. Lack of predictability makes it difficult for municipalities to plan expenditures. Capital grants, in particular, need to be maintained for sufficiently long periods of time to allow municipalities to sustain capital investments. When grants decline, municipalities have to make up the lost revenue by increasing own-source revenues or reducing expenditures.

In terms of predictability, the sharing of fuel tax revenues in

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<sup>156</sup> Although this grant is referred to as a gas tax transfer, it is actually no longer based on gas tax revenues. Rather, it is fixed at \$2 billion per year (FCM 2008).

<sup>157</sup> In some provinces, funds are distributed by the municipal association.

Alberta is a prime example of how donor governments can unilaterally change funding. Since April 2000, the Alberta government has been giving transfers to Calgary and Edmonton for transportation infrastructure equal to 5 cents per litre of taxable gasoline and diesel fuel delivered to service stations in those cities. In October 2001, the province announced that it would reduce fuel tax funding to 4.25 cents per litre as of April 1, 2002. In the end, it relented, but this example shows how vulnerable cities can be to the whims of donor governments (Kitchen and Slack 2003).

### **12.7. Concluding comments**

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Federal and provincial transfers to municipalities in Canada account for less than 20 percent of their revenues, and provincial transfers, in particular, have been declining over the last two decades. At the same time, own-source revenues (mainly property taxes and user fees) have increased as a percentage of municipal revenues. Although these statistics suggest that municipalities are enjoying greater fiscal autonomy than in the past, the reality is that municipalities have been and continue to be heavily dependent on provincial governments.

Most grants are specific-purpose, sometimes matching and sometimes non-matching. Municipalities receive no general-purpose grants from the federal government, and only a small proportion of provincial grants are non-earmarked. Specific-purpose grants are designed to finance specific services at levels and standards which are set by the province. Simply stated, provincial-municipal transfers in Canada are designed to achieve provincial objectives and not to promote local fiscal autonomy.

The design of transfers does not tell the whole story, however. Provincial intervention in local fiscal decisions is pervasive and takes many more forms than simply the use of conditions on transfers. The province limits municipal access to revenue sources -- municipalities are restricted largely to property taxes and user fees. The province mandates the services that have to be provided by municipalities and regulates standards for services (whether the service is mandated or not and whether municipalities receive transfers for the service or not). The province determines borrowing limits and sets rules for borrowing. The province

establishes the geographic boundaries of municipalities and is involved in most other aspects of municipal finance. When it comes to transfers or any other aspect of the municipal finance system in Canada, provincial control trumps local fiscal autonomy and accountability.

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# Chapter 13

## Intergovernmental transfers to local governments in Spain: an assessment of their virtues and perils

Albert Solé-Ollé

### 13.1. Introduction

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In most countries, local governments are important players in the provision of those public services that have a strong impact on the quality of life in a community. Typically, local governments are responsible for refuse collection and recycling, water supply and sewerage, street lighting and maintenance, public transportation, capital improvement construction, police, planning and land use regulations, and recreational and cultural facilities and programs. In some countries, they are also involved in the provision of education, health and social services<sup>158</sup>.

Many scholars and international organizations today advocate the benefits of the provision of these services by sub-national governments (see e.g. the contributions in Brosio *et al.*, 2009). Specifically, local governments are thought to be more accountable and more responsive to local demands and needs (e.g. Seabright, 1995; Faguet, 2004). However, there is less agreement as to how these local services should be funded. Traditional advice from ‘fiscal federalism’ scholars (see e.g. Oates, 1972) recommends relying primarily on property taxes and user charges, but the U.S. experience with the imposition of property tax limitations has demonstrated the problems associated with this approach (see e.g. Downes *et al.*, 1998; Bradbury, 2001). And yet, other major taxes (e.g. income taxes) are often inappropriate given either the size of

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<sup>158</sup> Paper prepared for the Workshop Policies of Grants to Sub-Central Governments: Local Accountability or Control?, Copenhagen, 17-18 September 2009, co-organized by KIPF and the Danish Ministry of Welfare.

local governments or their inability to cope with cyclical fluctuations in revenue (as the recent crisis in California demonstrates). The solution in the end is either the decentralization of minor and inefficient taxes or grant financing.

In these circumstances, general (non-earmarked) inter-governmental transfers serve to attenuate the inefficiencies of local tax systems and (may) help smooth spending and tax policy (Sala-i-Martin and Sachs, 1992, von Hagen and Eichengreen, 1996). In addition to this stabilizing effect, general grants are often used to equalize differences in fiscal capacity and/or spending needs, ensuring that residents in different localities enjoy similar levels of public services (Le Grand, 1976).

These prescriptions, however, are based on the implicit premise that the functional domains of different layers of government are clearly delineated. Yet, in practice, this need not be the case for several reasons. First, constitutions and laws can be ambiguous as to which layer of government has responsibility for which particular policy area. Second, different layers of government might be assigned responsibilities for different aspects of the same policy (e.g. upper layers legislating and lower layers executing the policy). Third, the complexities of many social problems mean that the policies implemented at different layers tend to be interdependent. Fourth, in some policy domains, the layers of government will differ in their knowledge, expertise and administrative capacity. So, in cases where the policies implemented at different layers are genuinely intertwined, effective solutions to social problems require intergovernmental co-operation. (Earmarked) grants are a key ingredient in developing such policies of co-operation.

Seen from this perspective, earmarked grants are not an imposition from the upper layers of government but rather the result of an agreement between layers in an attempt at providing the best solutions to social problems<sup>159</sup>. Of course, in the real world earmarked grants are also used as a control device, reflecting the lack of confidence on the part of the citizenship in the

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<sup>159</sup> See OECD (2007), for a methodological analysis of intergovernmental contracting.

mentioned virtues of decentralization. In fact, some authors have recently warned about the effects of local government corruption on service quality (see e.g. Shah, 2006).

However, recent studies have also tended to emphasize the perils of grant financing. First, grants can create a moral-hazard problem with local governments, being aware that intergovernmental grants serve as an insurance against budget shocks, pursuing overly risky policies (Persson and Tabellini, 1996). This problem is often associated with (earmarked) discretionary grants (e.g. disaster relief, see Wildasin, 2009), but a number of authors claim that it is also present in the case of (general) equalization transfers (see e.g. Buettner, 2009). Second, grants might soften the local budget constraint (e.g. Rodden, 2000; Inman, 2001), creating incentives to run up excessive local deficits that local authorities expect future grants to cover. Here, also, the problem affects both discretionary and equalization grants (Rodden, 2000). Third, grant financing may diffuse accountability (Rodden, 2000) and foster rent-seeking and clientelism (Weingast, 2009; Weingast *et al.*, 2006), thus eroding the very benefits gained from spending decentralization.

Funding with general grants reduces the price of local services and thus the citizens' efforts to control local governments. At the same time, local politicians claim that the poor quality of public services is attributable to the fact that the upper layers fail to provide adequate funds. Funding by earmarked transfers seems even more problematic, since such grants restrict the spending autonomy of local governments, and again allows the blame to be more easily shifted to the upper layers of government (Devarajan *et al.*, 2009). Likewise, depending on their actual design, such transfers are likely to be more prone to manipulation and therefore more severely affected by clientelism (Solé-Ollé<sup>160</sup> and Sorribas, 2008).

With its virtues and perils, any final evaluation of grant financing has to be country specific, with the system ultimately depending on the particular details of the entire local government financing system (see e.g. Rodden *et al.*, 2003). This being the case, in this

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paper we undertake a preliminary evaluation of the Spanish case, focusing on the local government layer. The paper is organized as follows: in section 13.2 we provide a brief description of the organization of local governments in Spain, describing both their responsibilities and their funding system. In section 13.3, we concentrate on the transfer system, describing the main general and earmarked grants received by Spanish municipalities (the main body of local government). In section 13.4 we assess the performance of Spanish grants in terms of the following aspects: (i) equalization power, (ii) role in fiscal adjustment, (iii) effects on intergovernmental co-operation, and (iv) use for rent-seeking and clientelist purposes.

## **13.2. Spanish local government: a brief introduction**

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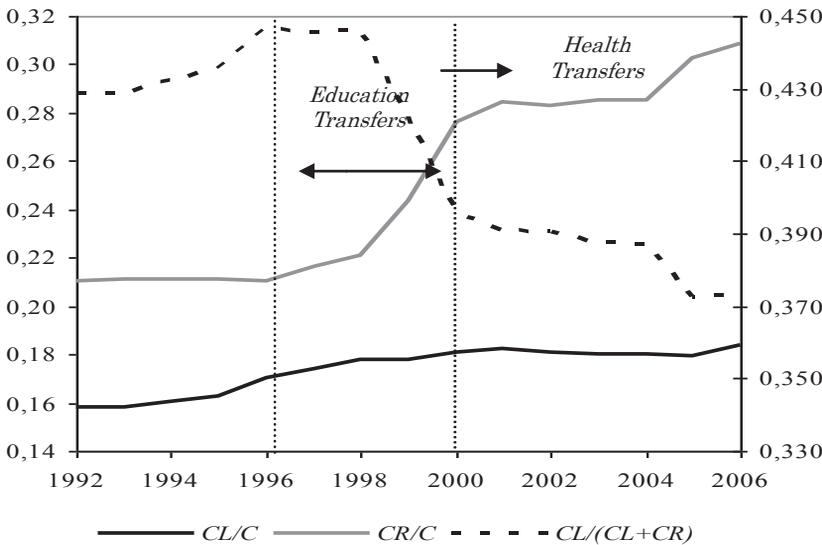
### 13.2.1. Organization of Spanish local government

*What size are they?* Spanish local government bodies are relatively modest in size. In 2006, they accounted for just 18.4% of the total spending (current + capital) of Spain's public administration, not including pensions. This percentage falls to just 13.1% if we restrict our attention solely to the municipalities, the key player at this level of government. This share is very similar to that recorded in Europe's federal countries, such as Germany and Austria (Bosch and Espasa, 2006), but is lower than the figure quoted for federal countries in which education is a local responsibility (e.g. the US, Switzerland and Canada) or for unitary countries without regional governments (e.g. France, UK, and the Scandinavian countries). Spain's share has remained relatively stable throughout the democratic period, with some modest growth since the mid-90s.

Figure 1 below plots this variable for the years 1992-2006, a period following the enactment of the primary law governing local finances (see section 13.2.3. below). Local spending increased from 15.8% in 1992 to the aforementioned 18.4% in 2006. However, this contrasts markedly with the sharp increase in the spending share enjoyed by regional governments (the so-called Autonomous Communities, ACs from now on), whose share grew from 21.1% to 30.9% as a result of the transfer of responsibilities for education and health to some of the ACs that had yet to take control over

these ambits<sup>161</sup>. Figure 1 also plots (left axis) the ratio of local to local + regional spending, which, as a result of these developments, fell from 42.9% to 37.3%. Figure 2 plots the local share of capital spending; note here that local government is the key player, with a share amounting to 27% of public capital spending and 77% of capital spending made by sub-central governments in 2006. During the period 1992-2006, the respective shares of total capital spending increased for both local governments and the ACs, although the share of the latter in sub-central capital spending has also increased slightly since the last round of responsibility transfers.

**Figure 1. Share of local spending on public spending in Spain, period 1992-2006**



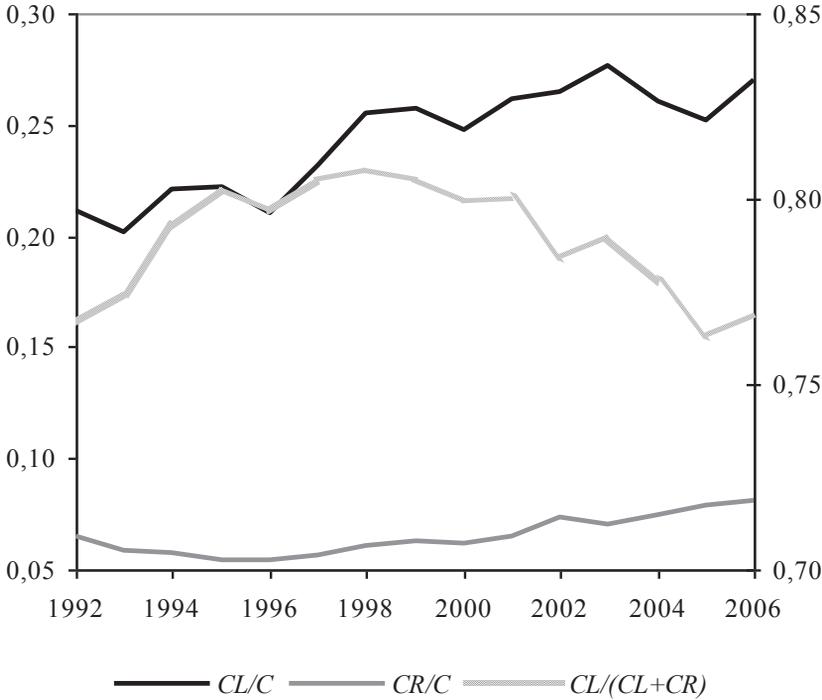
Notes: (1)  $CL/C$ : Total spending (current + capital) by local governments (municipalities + provinces + islands) over total spending by all layers of government (local + regional + central);  $CR/C$ : Total spending by regional governments (autonomous communities, AC's) over total spending by all layers;  $CL/(CL+CR)$ : Total local spending over total local + regional

<sup>161</sup> Following a constitutional provision to this effect, some ACs were granted access to these key areas of spending in the 80s, while the others had to wait until a 1992 pact between the two leading political parties to see the right extended (see Solé-Ollé, 2007).

spending (shown on the right axis).

Source: *Cuentas de las Administraciones Públicas*, from BADESPE, Instituto de Estudios Fiscales

**Figure 2. Share of local capital spending on public capital spending in Spain, period 1992-2006**



Notes: (1) Same than in Table 1 but for capital spending.

Source: see Table 1.

The explanation for the (relatively) small size of Spain’s local government lies in the short list of duties for which it has responsibility, limited to the traditional functions performed elsewhere by this layer but not including those services that consume most resources – namely education, health or social services, which in Spain are the responsibility of the regional governments (see Solé-Ollé, 2007). If we bear this fact in mind, the evolution in, and the performance of, Spain’s local government during this period has been quite positive. To some extent, what has occurred is that Spain’s central-to-regional decentralization

process was so intense during the 1980s and 1990s that it has tended to obscure the changes to the local sector. In fact, as the regional decentralization process appears to be reaching an end, a rising number of voices are calling for a second wave of decentralization towards the tier of local government.

*Who are they?* In addition to the 17 ACs, the Spanish Constitution recognizes two different types of local government body: the municipalities (*Ayuntamientos*) and the upper-municipal governments (*Diputaciones, Cabildos* and *Consells*). The number of municipalities is huge (see Table 1), and they are the main local players, as most of the responsibilities and spending are concentrated at this level (see Table 2). In addition, there are 40 *Diputaciones* with jurisdiction over the corresponding province (*Provincia*), which is also the district used for central legislative elections. There are 50 *Provincias* in Spain, but in ten of them this jurisdiction corresponds exactly to that of one of the ACs, so that the *Diputación* has been amalgamated with the government of the AC.

The main responsibility of the *Diputaciones* is to provide support to the municipalities, a task also performed by ACs (exclusively where there are no *Diputaciones* and concurrently where there are). This is also one of the responsibilities of the *Cabildos* (in the Canary Islands) and *Consells* (in the *Balearic Islands*), which are parallel bodies to the *Diputaciones* on Spain's island ACs. There are ten of these governments - one on each island - which perform other tasks delegated by the corresponding AC. Table 3 illustrates the different characteristics of the municipalities and the other local government bodies; note that *Diputaciones* (and to a lesser extent *Cabildos* and *Consells*) are 'transfer-giving' governments, and the share of transfers in spending rising to 30-40% (depending on the government and spending type), which is quite high when compared to the 10% of the municipalities<sup>162</sup>

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<sup>162</sup> A further key difference between the municipalities and the other local government bodies lies in the method by which these governing bodies are elected. Representatives on the Municipal Council are elected directly, with simultaneous elections being held throughout the country every four years. The elected representatives then vote for the mayor, who chooses his or her executive from among the elected representatives. The representatives sitting on the governing bodies of Spain's provinces and islands are chosen indirectly, based on the results

**Table 1. Local governments in Spain**

Local governments (art. 137 & 141.4 CE)	<i>Number</i>
Municipalities ( <i>Ayuntamientos</i> )	8,109
Upper-municipal governments:	
- <i>Diputaciones</i>	40
- <i>Cabildos</i> and <i>Consells</i>	10
Other local entities (art. 3.2. LRBRL)	<i>Number</i>
Cooperative entities ( <i>Mancomunidades</i> )	997
Counties ( <i>Comarcas</i> )	81
Metropolitan areas	4
Lower-Local entities ( <i>Entidades locales menores</i> )	3,717

Source: Ministerio de Economía y Hacienda (2006): *Las Haciendas Locales en Cifras* (<http://www.meh.es>).

**Table 2. Shares of different local governments on local spending in Spain, year 2006**

	<i>Total</i>	<i>Capital</i>
Municipalities ( <i>Ayuntamientos</i> )	86.32 %	84.51 %
Upper-municipal governments:		
- <i>Diputaciones</i>	10.07 %	11.49 %
- <i>Cabildos</i> or <i>Consells</i>	2.86 %	3.16 %

Notes: (1) Total: non-financial spending (chapters 1 to 7 of the budget); Capital: capital spending (chapters 6 and 7).

Source: Same as Table 1.

**Table 3. Shares of transfers on local spending of different local governments in Spain, year 2006**

	<i>Total</i>	<i>Capital</i>
Municipalities ( <i>Ayuntamientos</i> )	10.76 %	10.61 %
Upper-municipal governments:		
- <i>Diputaciones</i>	30.08 %	42.25 %
- <i>Cabildos</i> or <i>Consells</i>	34.86 %	28.66 %

Notes: Total: current (chapter 4) + capital transfers (chapter 7)/ non-financial spending; Capital: capital transfers / capital spending

Source: Ministerio de Economía y Hacienda, *Las Haciendas Locales en cifras*, 2006.

In addition to these three ‘constitutional’ bodies of local government, the law regulating the organization of local

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of the municipal elections in the jurisdiction for this upper tier of government.

government (*Ley Reguladora de Bases de Regimen Local*, 1985) allows the ACs and municipalities to create other local government bodies (see Table 1). Counties (*Comarcas*) are upper-municipal governments created in a few ACs, and they perform tasks delegated to them by the AC. Metropolitan entities are in theory possible, but they have not been developed in practice, due to the hostility of the ACs. Local governments can also enter into co-operative agreements and create an upper-municipal body (the so-called *Mancomunidad*) in order to provide specific services. There are many examples of such groupings, although a number of them are in fact inoperative. Finally, local governments can delegate their responsibilities to lower-local entities, which while high in number are fairly irrelevant in practice.

*Municipal size.* Most of the responsibilities and the bulk of the spending of Spain's local government are concentrated at the municipal level, and given their democratic form of election, municipalities also have the highest degree of political legitimacy. However, most municipalities are too small to be able to provide public services effectively and efficiently. As Table 4 shows, nearly 85% of Spanish municipalities have less than 5,000 inhabitants, and 95% have less than 20,000 inhabitants, proportions similar to those in Germany and among the EU countries lower only than those in France and Austria.

**Table 4. Size distribution of Spanish municipalities, year 2006**

	<i>Municipalities</i>		<i>Population</i>	
	<i>Number</i>	<i>%</i>	<i>Number</i>	<i>%</i>
<5,000	6,853	84.51	6,010,730	13.49
5,000 to 20,000	895	11.04	8,692,664	19.51
20,000 to 50,000	228	2.81	5,786,025	12.98
50,000 to 100,000	74	0.91	5,169,332	11.60
100,000 to 500,000	53	0.65	10,456,384	23.46
500,000 to 1,000,000	4	0.05	2,716,895	6.10
>1,000,000	2	0.02	4,734,202	10.62
<i>Total</i>	8,109	100.00	44,566,232	100.00

Source: Instituto Nacional de Estadística ([www.ine.es](http://www.ine.es))

As a result of their size, the smallest municipalities face considerable challenges in maintaining local administration, and the vast majority of them would not be able to effectively

undertake the responsibilities most likely to be decentralized from the AC (e.g. education). In addition, local fragmentation is common in urban areas, making municipal jurisdictions highly inoperative in economic terms. In these places, high labor mobility and residential mobility generate all sorts of inter-jurisdictional spillovers in local policies (Solé-Ollé, 2006). Both types of problem (diseconomies of scale and spillovers) could be addressed by amalgamating municipalities, but in Spain this is simply anathema. However, it remains true that the small size of Spain's municipalities allows local interests to be represented effectively.

*Municipal regulation.* Contrary to the situation in federal countries, Spain's municipalities are not there simply to do the bidding of the ACs. According to the Constitution, the main competences in terms of the organization, delegating of responsibilities and funding of the municipalities (and other local government bodies) lie with Spain's central government. In practice, the ACs are only able to regulate minor aspects such as municipal amalgamations, metropolitan and county governments, and their financial control. This would not appear to be particularly apposite, given (as we shall see below) that local responsibilities tend to conflict with those of the ACs.

The main opportunities for the delegation of new responsibilities to the municipalities (or for any other form of intergovernmental co-operation) lie with these two layers of government. Despite this, in the event of an AC seeking to initiate a major decentralization project (e.g. education), it would be severely restricted as regards the type of funding mechanisms it could design (since local taxes and general equalization grants are regulated by the central government), and would have to focus its efforts on earmarked grants.

Similarly, with more than 8,000 municipalities, the central government has its work cut out trying to come up with an organizational design that can respond to the peculiarities of the many different types of municipality. Perhaps the main reason for this situation is the municipal fear of regional interference; municipal political elites seem to prefer to manage a largely autonomous government (albeit with few responsibilities and poor levels of funding) than a bigger and more efficient organization

subject to the supervision of the AC.

13.2.2. - Responsibilities and revenues of Spanish municipalities

*Municipal responsibilities.* The basic law regulating the organization of local government in Spain (*Ley Reguladora de Bases de Régimen Local*, 1985) differentiates between two kinds of municipal responsibility. On the one hand are the so-called ‘compulsory responsibilities’ (art. 26), which the municipality is obliged to provide to its residents and which grow in number with population size, as illustrated in Table 5 below. Note that these are very traditional responsibilities assumed by local governments elsewhere.

**Table 5. Spending responsibilities of Spanish municipalities**

	<i>Responsibilities</i>
All municipalities	Public lighting,
	Street cleaning,
	Refuse collection,
	Water supply,
	Paving of local roads,
	Food and drink control
Municipalities with:	
- Population > 5,000	Parks,
	Libraries,
	Marketplaces,
	Solid waste treatment
- Population > 20,000	Fire protection & emergencies
	Social services,
	Sport facilities,
	Slaughterhouse
- Population > 50,000	Urban passenger transport,
	Environmental protection

Note: (1) These are the so-called ‘Compulsory’ responsibilities. Source: Local Government Act, 1985 (“Ley Reguladora de Bases de Régimen Local”).

On the other hand are the ‘municipal’s own responsibilities’, which are areas in which the municipality is allowed to intervene, inasmuch as the AC has not passed a specific law limiting local action. Thus we find instances of concurrent responsibilities. In some cases (e.g. local police, childcare, care for the elderly and recycling), the municipalities provided the service quite autonomously until the AC enacted legislation. In other cases, it is difficult to constrain local action by implementing regional

legislation and so, in practice, both layers perform the task (e.g. culture and sports). This lack of clarity blurs accountability, and the two layers of government (i.e. municipality and AC) become embroiled in a permanent blame-shifting game.

The municipalities typically argue that their proximity to the citizens obliges them to provide the services that are the competence of the ACs, but the latter do not provide any funding to meet these burdens. However, given their low resource level, the municipalities tend to implement high-quality services, which however only provide low coverage. As a result, the municipalities claim that they are doing a good job, but that the service cannot be extended to all the population because the AC fails to provide adequate funding. Thus, in Spain, conflicts over responsibilities tend to become conflicts over funding. Studies commissioned by Spain's Federation of Municipalities (FEMP) estimate that spending on such responsibilities amounts to around 30% of all non-financial spending.

In fact, this figure is being used by the FEMP to lobby the central government for more general funds. Although the claim is legitimate, the figure is probably over-estimated, as not all this spending is attributable to unfunded mandates. Indeed, a large share is generated by spending in areas that are not the exclusive competence of the AC and where the AC has decided not to intervene yet. The solution is perhaps not to provide more central funding to the municipalities, but rather to reach a co-operative arrangement between the AC and the municipalities regarding the best way to provide and fund each service. Earmarked grants and inter-governmental contracts could play an important role here.

*Municipal revenues.* Spain's municipalities obtain a substantial share of revenues from their own sources (nearly three fifths of non-financial revenues, see Table 6), but transfers also play an important role (two fifths of non-financial revenues). In addition, approximately three fifths of the municipalities' own revenues come from local taxes, one fifth from user charges and fees and one fifth from revenues generated by local assets. The main local tax is the property tax, which generates approximately half the local tax revenue.

The property tax is a tax paid on the assessed value of land plots and structures owned both by residents and businesses; valuation is performed by a central government agency, but the proportional tax rate is fixed by the municipal council. The other local taxes are the vehicle tax (*Impuesto sobre Vehículos de Tracción Mecánica*, IVTM), the construction tax (*Impuesto sobre Construcciones, Instalaciones y Obras*, ICIO), the local business tax (*Impuesto sobre Actividades Económicas*, IAE) and the land transactions tax (*Impuesto sobre Incremento del Valor de los Terrenos de Naturaleza Urbana*, IIVTNU). The first two of these taxes generate approximately 15% of total tax revenues each, while the last two generate around 10% each<sup>163</sup>.

**Table 6. Revenues of Spanish municipalities, year 2006**

<i>Revenue source</i>	<i>%over Taxes</i>	<i>% over Own.rev.</i>	<i>% over Non-fin.rev.</i>
Property tax	48.99	29.63	17.31
Vehicle tax	14.39	8.71	5.08
Business tax	9.36	5.66	3.31
Construction tax	17.48	10.57	6.17
Land transactions tax	9.78	5.92	3.46
. Taxes	100.00	60.49	35.33
. User charges and fees		19.06	11.13
. Asset revenues		20.44	11.94
. Own revenues		100.00	58.40
. Transfers			41.60
Non-financial revenues			100.00

Note: (1) Property tax: *Impuesto sobre Bienes Inmuebles* (IBI); Vehicle tax: *Impuesto sobre Vehículos de Tracción Mecánica* (IVTM); Business tax: *Impuesto sobre Actividades Económicas* (IEA); Construction tax: *Impuesto sobre Construcciones, Instalaciones y Obras* (ICIO); Land transactions tax: *Impuesto sobre Incremento del Valor de los Terrenos de Naturaleza Urbana*

<sup>163</sup> The vehicle tax is a tax paid by residents owning a vehicle, and the tax base depends on a combination of horsepower and age. The construction tax is paid by owners of constructions currently being built in the jurisdiction of the municipality, and they are charged a proportional tax on the project's budget. The business tax is a presumptive tax charged on all firms (individuals or corporations) doing business in the municipality; the tax rate is proportional and the tax base is estimated using objective parameters (surface area, electricity power, number of workers, and sector of activity). The land transactions tax is paid by the seller of a plot of land (empty or built-on); the tax rate is proportional and the tax base is estimated on the assessed value of the property and the number of years since purchasing.

(IIVTNU): Asset revenues: include Building licences, Selling of land plots, Charges to developers and Concessions; Own revenues: Taxes + User charges and Prices + Asset revenues; Transfers: include both current and capital transfers; Non-financial revenues: Own revenues + Transfers.

Source: Same as Table 2.

A few comments are in order. First, for each of these taxes the local council can choose the tax rate, subject to minimum and maximum tax rates set by the central government. This tax freedom and these limits were established by the main law regulating municipal finances (*Ley Reguladora de las Haciendas Locales*, passed in 1988 but not applied until 1990). This law introduced the same minimum tax rates for all the municipalities, but allowed the maximum tax rates to rise in accordance with population size, on the premise that larger municipalities have more mandatory responsibilities. A subsequent reform to this law in 2002 provided the introduction of a maximum tax rate that was to be equal for all municipalities.

Second, during the years following the implementation of this law, Spain's municipalities have been quite active in using their tax autonomy, accepting the political costs that these decisions necessarily entail (see Solé-Ollé, 2003). Third, the main tax change to have occurred during this period was the reform of the business tax in 2000, which saw the quashing of the tax for all individual firms and companies with sales below a million euro. This reform measure reduced the number of tax returns by 90% and business tax revenues by 50%. Fourth, all these taxes are somewhat rudimentary, their calculation being based on fairly rough parameters. As such, they are frequently accused of being unfair and are particularly unpopular. In the case of the property tax, the main problem concerns the political costs of undertaking reassessments of value; because of this difficulty, reassessments are delayed for many years, which further undermine the fairness of the tax and hinders its use. Fifth, some of these taxes are quite volatile, providing markedly higher revenues during periods of boom, but few funds during recession. This is the case of the two taxes linked to the building industry, namely the construction tax and the land transactions tax. Moreover, most of the asset revenues are also related to the building industry<sup>164</sup>.

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<sup>164</sup> Specifically, Spain's municipalities obtained nearly 3,000 million euro in 2006

## 13.2. Transfers to local governments in Spain: basic facts

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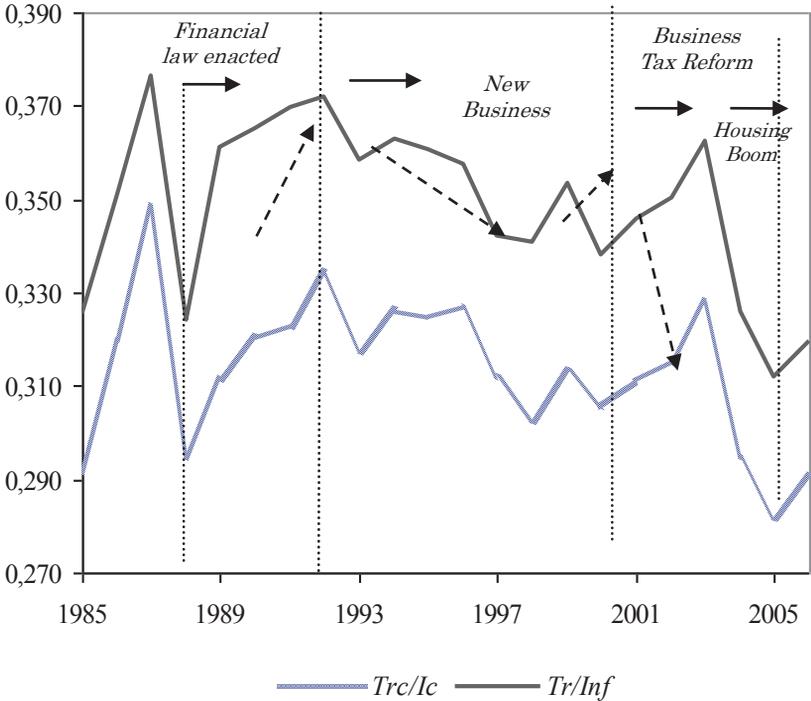
### 13.2.1. Some recent trends

*How important are they?* In 2006, total transfers to local government represented 32% of non-financial revenues, and this figure was even higher for the municipalities (37.3%). In the case of current transfers, the numbers are similar: 29.0% and 34.2 for all local government bodies and the municipalities, respectively. Thus, grants can be said to represent roughly a third of local revenues. This proportion is among the lowest in the EU, being similar to those of Denmark, France and Germany, with only Sweden, Austria and Finland reporting substantially lower shares (Bosch and Espasa, 2006). Capital spending is funded in a similar proportion by capital transfers: 29.3 and 33.1% in the case of local government as a whole and the municipalities.

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from selling part of the land plots that developers are obliged to cede to the local council. They also obtained nearly 1,300 million euro from charges to developers. This, added to the 4,000 million from the two taxes described above, makes a total of 8,394 million euros, which is 20% of their own revenues and 33% of tax revenues, exceeding the revenues derived from the property tax (7,394 million). These volatile revenues are justified by the need to fund the investment costs associated with urban expansion; in fact, in 2006 these revenues were able to fund 70% of all local capital spending. With these revenues as good as vanishing due to the current real estate crisis, municipal capital spending is set to drop abruptly. The municipalities that channelled part of these resources to the current budget could face even more severe difficulties.

**Figure 3. Share of transfers (total & current) on local revenues in Spain, period 1985-2006**



Notes: (1) *Tr/Inf*: Total transfers (current + capital, chapters 4 and 7 of the budget) to local governments (municipalities + provinces + islands) over non-financial revenues (chapters 1 to 7 of the budget); *Tr/Ic*: Current transfers over current revenues (chapters 1 to 5). (2)

Source: Ministerio de Economía y Hacienda (several years): *Liquidación de los Presupuestos de las Corporaciones Locales*.

Figure 3 illustrates the evolution in the share of total transfers in non-financial revenues for the period 1985-2006 for the aggregate local government bodies. This share has been relatively stable, fluctuating from a minimum of 31% in 2005 to a maximum of 38% in 1987. The figure also shows the share of current transfers in current revenues, which shows a similarly stable trend. Despite the overall stability, various changes can be described. The period 1985-88, prior to the enactment of the main local financial act (*Ley Reguladora de Haciendas Locales*, 1988), was particularly unstable. During the eighties, the incoming socialist government in

Madrid sought to repair the enormous funding problems of the municipalities, which were operating under the same financial framework as their pre-democratic counterparts. The central government's initial strategy, consisting of giving more tax autonomy, met with a number of problems (mainly the opposition of the Constitutional court) and was delayed until the enactment of the aforementioned law in 1988. In addition, as we will see below, the main unconditional transfer was not tied to the evolution in central revenues up to that time.

The period following the enactment of the law saw a marked increase in transfers to local government, reflecting the commitment of the central government to the project. After the new local business tax was adopted in 1992, the share of transfers began to fall, thanks to the extra revenue provided by this tax and to the effects of growing tax autonomy. This drop in the share of transfers in overall revenues continued until the reform of the business tax. As described above, this reform reduced business tax revenues by 50%. This loss, however, was compensated by an additional transfer from the central government in the years that followed, resulting in an increase in the share of transfers. Finally, the last period coincides with the real estate boom, which produced an abrupt increase in certain taxes and in asset-related revenues, which grew at a much faster rate than transfers<sup>165</sup>.

*Where do they come from?* Table 7 illustrates which layers of government provide these transfers. We can deduce that for local government as a whole, current transfers are provided primarily by the central government (57.3%) and to a lesser extent by the ACs (25.5%) and *Diputaciones* (10%). Capital transfers originate mainly from the ACs (51.5%), but also from the *Diputaciones* (15.3%), central government (12.2%) and other agents (21%) including, for example, the EU. These proportions are very similar for the municipalities, but differ for the other local government bodies. Most current transfers received by the *Diputaciones* are

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<sup>165</sup> As we explain below, some transfers, such as the main unconditional transfer received by the municipalities, are tied to the growth in the central government's revenues. Central taxes (i.e., income tax, VAT, excises) are typically much more sensitive to economic growth than are local taxes, but less so than taxes related to the building sector (e.g. construction tax, land transaction tax, in the case of local government, and the wealth tax and gift and death tax, in the case of the ACs).

provided by the central government (84.6%), while capital transfers to this tier come in similar proportions from the ACs, the central government and other agents. In the case of the *Cabildos* and *Consells*, most capital grants come from the ACs, although substantial current grants are also provided by the central government.

**Table 7. Transfers to local governments by grantee and grantor, year 2006**

<i>Current transfers</i>					
<i>Grantor</i>	<i>Central gov.</i>	<i>AC</i>	<i>Diputación</i>	<i>Other</i>	<i>Total</i>
<i>Grantee</i>					
Municipalities	51.8	27.7	13.8	6.6	100
Upper-municipal governments					
- Diputaciones	84.6	9.6	0	5.8	100
- Cabildos or Consells	39.5	54.2	0	6.3	100
All local governments	57.3	25.5	10.7	6.5	100
<i>Capital transfers</i>					
<i>Grantee</i>	<i>Central gov.</i>	<i>AC</i>	<i>Diputación</i>	<i>Other</i>	<i>Total</i>
Municipalities	9.8	51.9	18.4	19.8	100
Upper-municipal Governments					
- Diputaciones	29.9	38.8	0	31.3	100
- Cabildos or Consells	10.9	72.7	0	16.3	100
All local governments	12.2	51.5	15.3	21.0	100

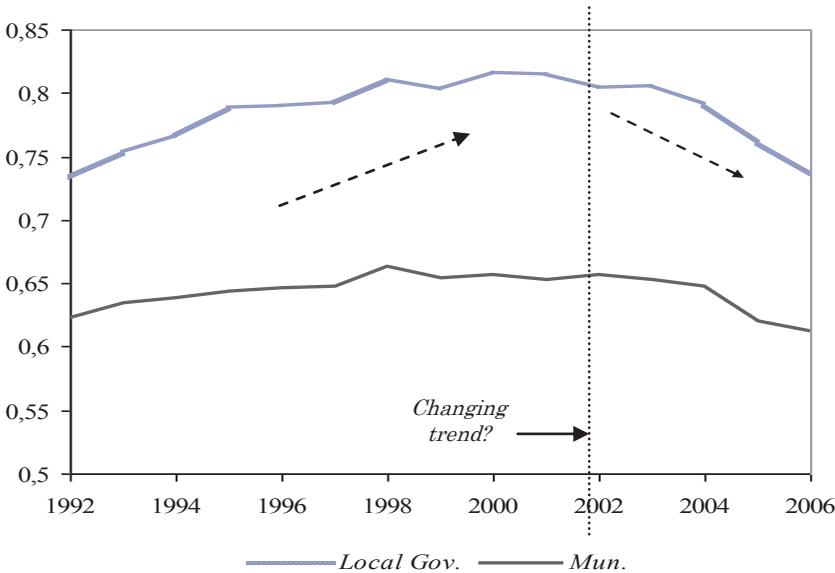
Notes: Share of the transfers coming from each grantor (in columns) on transfers received by each grantee (in rows), expressed in %.

Source: Same as Table 2.

*What kinds of transfers are assigned?* Most current transfers are non-earmarked, with virtually all current transfers from the central government being of this kind. For example, in 2006, the central government assigned approximately 10,000 million euros in grants to the municipalities. Of this total, 92.2% corresponded to the principal unconditional transfer received by this tier: a revenue-sharing grant known as *Participación en los Tributos del Estado* (PTE). The remaining amount included compensation for the abolition of the business tax (6.7%), compensation for local tax revenue lost due to fiscal benefits mandated by the central government (0.5%), and a special grant subsidizing public

transport in big cities (0.6%). Most current transfers from the ACs are earmarked. These are transfers with open tenders sometimes appearing regularly (same time each year), but sometimes not. The overall amount of funds is allocated yearly in the course of the budget process, and to gain access to this money, the municipality needs to apply first. Most ACs also assign certain non-earmarked current transfers in the form of revenue-sharing grants or special grants to ensure that certain municipalities receive sufficient funding. However, since responsibility for the general local funding system rests with the central government, the ACs do not provide substantial funds to these programs<sup>166</sup>.

**Figure 4. Shares of non-earmarked grants on current transfers in Spain. Period 1992-2006**



Notes: (1) Share (in %) of non-earmarked grants on current transfers (chapter 4); PTE computed as definitive outlays.

Source: Same as Figure 3.

Figure 4 illustrates the trend followed by the share of these non-

<sup>166</sup> For example, in 2006 the unconditional grant provided to municipalities by the ACs of Catalunya (Fons de Cooperació Local de Catalunya, FCLC) amounted to only 4% of the funds received by the Catalan municipalities from the central revenue-sharing grant (Participación en los Tributos del Estado, PTE).

earmarked transfers as a proportion of current transfers during the period 1992-2006. The grey line plots the share of the entire local government sector, and the black line the municipalities' share. The shares are very stable throughout the period. However, in both cases (although more markedly so in the former), the share of unconditional grants grew slightly towards the end of the century and then fell, a trend which is very similar to that identified in a recent report (Blöchinger and Vammalle 2009).

A possible explanation for the growth in the first sub-period could be the increased amount of funds provided by the central government, associated with the enactment and application of the main municipal financial law. The explanation for the more recent decrease is less clear, though it might reflect the use of earmarked grants for funding the delegation of certain responsibilities from the ACs to the local sector. No data are available to assess the validity of this claim, but we can find examples of (possibly) limited quantitative relevance. For example, during that period, the AC of the Balearic Islands created the new island governments, known as the *Consells Insulars*, and transferred some responsibilities to them which were funded by earmarked (non-matching) grants of an amount equivalent to the former cost of the services transferred to each island.

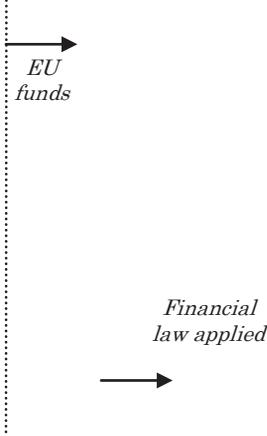
It is not clear, however, that this explanation is actually relevant, since in Spain it is quite common to use specific grants as a mere temporary device to fund transferred services. After a few years, all these specific grants are usually amalgamated into one unconditional grant, which is precisely what this AC did at the end of the period<sup>167</sup>. Other examples are to be found in the decentralization of social services in some ACs. For example, as a result of a popular initiative in the Catalan parliament, the government of this AC was forced to introduce a program that

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<sup>167</sup> This procedure has been applied throughout the decentralization process of the eighties and nineties in favor of the ACs. All the responsibilities transferred during the first half of the 1980s were initially funded by earmarked grants that covered the previous cost of the service. All these grants were amalgamated in 1986 into a single revenue sharing grant with equalization properties. Likewise, subsequent responsibilities decentralized to some of the ACs were first funded by earmarked grants and later consolidated into the general grant once they had been devolved to all the ACs.

substantially increased the supply of childcare. The AC decided to rely on the municipalities (which were the main actors involved in providing these services up until that time) for the provision, funding a third of the (standard) costs for each child by an earmarked grant.

**Figure 5. Share of capital transfers in total transfers (current + capital) in Spain, period 1992-2006**



Notes: (1)  $Trk/(Trk+Trc)$ : Capital transfers over total transfers (current + capital) to local governments (municipalities + provinces + islands);  $Trk/Ke$ : Capital transfers over capital spending (chapters 6 to 7) shown on the right axis.

Source: Same as Figure 3.

All capital grants, irrespective of the tier of government allocating them, are earmarked. No general funds are provided in Spain to pay for facilities and infrastructure, although current funds can be saved for this purpose<sup>168</sup>. Given their high degree of conditionality, the share of capital transfers in total transfers is also indicative of the relative weight of earmarked grants. Capital transfers represented approximately 20% of all grants in 2006. As Figure 5 shows, this share increased dramatically at the end of the 1980s (from 13% to 20%, which presumably reflected the introduction of EU funds) and then fluctuated during the rest of the period before reaching this level again at the end of the period. This impression is corroborated by looking at the share of capital transfers in capital spending. This also increased abruptly at the beginning of the period (from 14% to 32%) and then decreased slightly.

<sup>168</sup> We provide more details on the workings of these grants in section 2.3 below.

Whatever the case is, this figure shows that the share of earmarked transfers most often reflects the introduction of new programs that are different in nature rather than the result of an explicit decision to change one type of grant for another. .

### 13.2.2. Revenue sharing grant

The main unconditional grant received by Spain's municipalities is a revenue-sharing grant known as *Participación en los Tributos del Estado* (PTE). This grant was created soon after the establishment of the new democratic councils in 1979 (albeit under a different name, *Fondo Nacional de Cooperación Municipal*, FNCM). During the eighties, the amount of funds to be devoted to this program was determined annually during the budget process. However, from the outset the grant was universal, automatic and allocated by formula. The 1988 financial law recognized these principles and pegged the size of the fund to the development in central revenues.

To this end, the amount of money is fixed every five years and then updated every year using the growth rate recorded by central taxes. A certain amount was then deducted for Barcelona and Madrid (and also for the municipalities belonging to the metropolitan area of Barcelona). Next, an allocation formula was applied for the other municipalities. This formula underwent two reforms during the period - in 1999 and 2003. Table 8 below shows the structure of the formula applied in each of these periods. The formula used is a polynomial, with three or four variables (depending on the period) and weights adding up to 100%.

**Table 8. Revenue-sharing grant (PTE) allocation formula. period 1992-2006**

	<i>Before 1999</i>	<i>1999-2002</i>	<i>After 2002</i>
Weighted population share (1)	70%	75%	75%
- Weight < 5,000 inh.	1	1	1
- Weight 5,000 - 20,000 inh.	1.15	1.15	1.17
- Weight 20,000 - 50,000 inh.	1.3	1.3	1.3
- Weight 50,000 - 100,000 inh.	1.4	1.4	1.4
- Weight 100,000 - 500,000 inh.	1.5	1.5	--
- Weight >500,000 inh.	2.85	2.8	--
Fiscal effort share (2)	25%	14%	12.5%
Inverse fiscal capacity (3)	--	--	12.5%
School units (4)	5%	--	--
Eligible municipalities (5)	All	All	All less >75.000 inh. + tourism

Note: (1) Resident population x weight. Weight increasing according to population size. (2) Ratio between local tax revenues from the three main taxes (property, vehicle & business) and potential local tax revenues (those obtained if applying the maximum tax rates allowed by law). (3) Inverse of the ratio of local tax revenues per capita on average local tax revenues per capita of the corresponding population size bracket. (4) Number of public school classrooms. (5) Since 2003 municipalities >75.000 inh. and tourism municipalities are funded by a share of revenues from the income tax, VAT & excises on tobacco and alcohol + a lump sum fund (*Fondo Complementario de Financiación*, FCF), computed as the difference between PTE and tax sharing revenues in a base year.

Source: *Ley Reguladora de Haciendas Locales* (1988 & 2002) and own elaboration.

The main variable used is the weighted resident population, with increasing weights according to population size. Before 1999, the weights were 1 for residents in municipalities with fewer than 5,000 inhabitants, rising steeply to 2.85 for residents in cities with more than half a million inhabitants. This meant that the population fund allocated nearly three times as much funding (per capita) to big cities as it did to small municipalities. The rationale underlying this formula was spending responsibilities (and other needs or costs) increasing with size. As we discuss below (see section 13.3.1), however, the empirical evidence suggests that this is not in fact the case. Following the recommendations of an expert working group, this weight was (slightly) reduced to 2.8 in 1999-2002. Note that after 2002, the upper weight was fixed at 1.4 for the 50,000 to 100,000-population bracket. This does not mean that the problem has been solved, but rather reflects the fact that larger municipalities are no longer eligible for this transfer. Since 2003, municipalities with more than 75,000 residents and tourist municipalities are funded by a share of revenues from income tax, VAT and excises on tobacco and alcohol, plus a lump sum fund (*Fondo Complementario de Financiación*, FCF), computed as the difference between PTE and tax sharing revenues in the base year, which increases annually with central revenues.

The second variable used is fiscal effort, computed as the ratio between local tax revenues from the three main taxes (property, vehicle and business) and potential local tax revenues (those obtained when applying the maximum tax rates allowed by law<sup>169</sup>).

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<sup>169</sup> Remember that before 2003, maximum tax rates grew with population size, meaning that two municipalities of different sizes but with the same per capita

The weight of this variable was 25% before 1999, but it fell to 14% in 1999-2002 and subsequently to 12.5% after 2002. The alleged reason for this was the lack of effectiveness in increasing municipal reliance on taxes. The third variable, with a 12.5% weight, is the inverse of fiscal capacity and was introduced in 2002 on the recommendation of an expert working group that warned against the lack of equalization power of the grant.

This variable has been computed as the inverse of the ratio of local tax revenues per capita derived from the three main taxes, on average local tax revenues per capita of the corresponding population size bracket. However, as we show in section 13.3.1, both the small weight attached to this variable and the way it is computed mean its equalization power remains very low. Finally, the last variable is the number of public school units, given a 5% weight before 1999. Municipalities are responsible for providing plots of land for building public schools and for maintaining their infrastructure and, as such, there is some basis for this variable. However, some experts claim that this is a minor source of spending needs compared to other influences (e.g. poverty, immigration, dispersion), so removing it would seem justified.

The application of this formula generates a very low degree of dispersion in per capita revenues from this transfer, at least in municipalities of equal size. Of course, larger municipalities obtain more per-capita resources (see Bosch and Solé-Ollé, 2005). Likewise, because of the fiscal effort variable before 2003 and because of the subsequent inverse of fiscal capacity, tax-base-rich municipalities obtain (slightly) lower per-capita transfers. A complete evaluation of the equalization power of this grant will follow in section 13.3.1.

### 13.2.3. Capital grants

As discussed above, all capital transfers in Spain are earmarked. The most important programs of this type are in the hands of the ACs and the *Diputaciones*. Both tiers of government run local public works programs that aim to co-operate in the provision of

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tax bases and same tax rates (same per capita tax revenues) would have presented different values for this variable, the smaller of the two having to make a greater fiscal effort as it had a higher maximum tax rate.

facilities and services of municipal competence. The justification for the intervention of the higher tier of government is related to the need to avoid spillovers and so to better exploit economies of scale. These transfers are disproportionately directed to small municipalities, which in some cases have limited expertise and technical capabilities.

The design of most of these programs is largely similar. First, the amount of money made available typically depends on the annual budget decisions, although the planning horizon for some programs is biannual or even term-of-office. Second, on occasion municipalities are allocated a minimum amount of funding to be received over the year and/or the planning horizon. The aggregation of these minimum amounts for all municipalities is often much lower than the overall amount of funding, which gives the grantor a considerable scope of action. Third, the municipalities need to present projects in response to regular open invitations, which are published at the beginning of each planning horizon.

These projects may or may not be funded and, in any case, the funds are earmarked not only for capital spending but for the specific project presented. If the project is accepted, a proportion of the costs is covered by the grantor; the municipality can apply to other institutions for more funding, but the total funds obtained will fall short of the full project costs. Fourth, the criteria used to compute the minimum municipal transfer (where one is to be made), to select the projects to be funded, and to choose the funding rate are usually published in the corresponding legislation and specified in the open invitation. However, more often than not they are rather vague. The decision as to which projects will be funded is publicized, but it is not always easy to ascertain the exact motives for each decision. The degree of discretion in the allocation of these transfers is thus rather high. Fifth, although at times the laws and calls make explicit reference to local autonomy (recall that the facilities and services funded are a local responsibility), the AC tries to direct funds towards regional priorities. The way the AC achieves this is by setting its selection criteria according to the type of project presented or by channelling a proportion of funds to specific programs related to its own policies.

To provide a better understanding of these programs, I will describe two of them in more detail below. I have selected two Local Work Plans executed in Catalunya, one of Spain's ACs. The first, the Single Plan of Works and Services (*Pla Únic d'Obres i Serveis*, PUOSC), is managed by the AC's government, and it matches the above description very closely. The second, the Barcelona Network of Quality Municipalities (*Xarxa Barcelona Municipis de Qualitat*, XBMQ), is managed by the *Diputació de Barcelona*, and has been designed (at least in theory) along lines different from those usually adopted in more traditional programs, and according to intergovernmental contracting principles. These two programs are concurrent, so the municipalities of the province of Barcelona can apply for both. The Local Work Plans (*Planes de Obres Locales*) of the *Diputaciones* were the main programs until some ACs started to claim that they should be granted legal responsibility for coordinating and managing all the funds assigned to such purposes in their respective jurisdictions.

Thus, in Catalunya, the AC passed a law in 1987 unifying all the region's Local Public Work Plans, including those run by the AC and by each of the four *Diputaciones*. The new unified plan (i.e. the PUOSC) was funded out of the resources previously assigned by the *Diputaciones* for that purpose, from the money the AC now received from central government, and with supplementary funds originating from the AC's general budget. However, the strongest *Diputación*, that of Barcelona, opted out of the new program, preferring to await the ruling of the Constitutional Court as to the legality of the AC taking this responsibility away from it. The decision was delayed until 1998 when the Court in fact held that the ACs could actually run such programs, but that the *Diputaciones* could continue to fund co-operation with local governments on the condition that they set up entirely new programs. It was partly for this reason that the *Diputación of Barcelona* implemented a new approach.

*A traditional grant program: Catalunya's PUOSC.* This program is financed by funds from the *Diputaciones* (actually only those that choose to participate) and from the AC. Today, the planning horizon is a five-year period, but funding is allocated bi-annually. The allocation of funding for the PUOSC is carried out in a number of steps. First, the amount of money budgeted for any given year is

allocated to different programs (the most important being the General Program), but the law provides for funding to other specific programs. The law establishes a 15% reserve of all funds to be allocated to programs covering the geographic jurisdictions of the *Diputaciones* and the Counties (*Comarcas*), and a further 10% for emergency relief. In addition, some of the funds are also allocated to programs that reflect the priorities of the AC government.

**Table 9. Allocation criteria for a traditional grants program: The case of the AC of Catalunya (Pla Unic d'Obres i Serveis. PUOSC)**

a) Primary allocation by county	
- Number of residents (Higher weight big mun.)	- Number of houses (Higher weight big mun.)
- Number of municipalities	- Number of towns
- County land area	- Mountain county
- Unemployment rate	- Personal income
- Municipal tax revenues	
b) Minimum municipal transfer	
- Fixed amount	- Number of residents
c) Project selection	
<i>Type of project:</i>	
- Compulsory municipal responsibilities	- Urgent projects
- Project complementary to AC's policies	- Supra-municipal projects
<i>Municipality's traits:</i>	
- Fiscal capacity	- Grants in previous calls
- Fiscal effort	- Proximity to Power plants
- Number of residents	- Municipal amalgamations
- Number of towns	- Special regime municipalities
<i>Actual provision level</i>	
d) Funding rate (50% maximum)	
- Type of project	- Fiscal capacity
- Supra-municipal projects	- Municipal amalgamations
- Municipality's traits	- Disaster relief (100% maximum)

Notes: (1) According to the Law 23/1987, fixing the criteria for funding the PUOSC and the basis for selecting and funding the projects.

Second, as illustrated in Table 9, there is a primary allocation of the General Program by county (*Comarca*), which applies certain objective criteria provided for by law, including for example the

number of residents or number of municipalities. If this allocation is not taken up by the projects presented by the municipalities of that county, the excess funding is lost. The criteria adopted in taking this step, as defined by law, are extremely vague. The open call typically established the criteria with more clarity<sup>170</sup>. Third, there is a minimum transfer for each municipality, which is the minimum aggregate amount of funds it can obtain during the planning period from all the funded projects. Of course, in order to obtain this minimum, the municipality has to present sufficient projects that meet the minimum formal prerequisites (e.g. a written technical project, sufficient own funding to match the transfer). These minimum transfers are computed as a fixed amount plus an additional per capita sum. Clearly, on their own these minimum transfers do not account for the whole of the transfer program budget.

Fourth, the municipalities must present their projects to the County government (*Consell Comarcal*), which in turn prepares an assessment report that is used by the AC government when making its decision. In that report, each project is evaluated on the basis of the criteria stated in the call, and which should adhere to those laid down by law (and presented here in Table 9). There are three main groups of criteria: (i) Type of project, (ii) Municipality traits, and (iii) Current level of provision. The first two groups include many specific criteria. Note, however, that the way they are defined by law is too vague to ensure objectivity in their application. In some of the calls (e.g. in 2000-03), the criteria established by law are translated into more specific terms, and a

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<sup>170</sup> For example, in the calls for the period 2000-03 the county allocation (CoA) was calculated using a formula based on: number of municipalities with less than 20,000 residents (N-20), number of municipalities with more than 20,000 residents (N+20), and population in municipalities with less than 20,000 residents (P-20). The exact formula was:  $CoA = 8,750 \times (N-20) + 38,750 \times (N+20) + 1.5 \times (P-20)$ , where the weights were measured in pesetas. Note that the three criteria form part of the law but, at the same time, the range of criteria provided by the law is much wider.

fixed number of maximum points are assigned to each<sup>171</sup>. However, in more recent calls (e.g. 2004-07 & 2008-12), the articles containing the selection criteria make direct reference to the law. Finally, the funding rate for each project also depends on a set of criteria and, in line with the description above, they are specified with varying degrees of clarity in each call.

*Intergovernmental contracting: Barcelona's XBMQ.* During the period 1988-1999, the *Diputació de Barcelona* ran its own program of capital transfers, called the Plan of Co-operation with Local Administrations (*Pla de Cooperació amb l'Administració Local*, PCAL). This plan was implemented using a traditional grant program and was very similar to the PUOSC implemented by the AC administration. Forced to shut this program down and to set up a completely new one, the *Diputació de Barcelona* opted for a different organizational model based on intergovernmental contracting.

Table 10 summarizes the main differences between the two models (see below). On the one hand, the traditional grant model is: oriented towards the design of the bureaucratic procedure used in awarding and managing the transfer; the relationship between actors is hierarchical; decision-making is unilateral; the aid received is only financial; and the working system is based on several fragmented programs. By contrast, the intergovernmental contracting model is: oriented towards the meeting of goals established in the contract; the relationship between actors is based on equality and collaboration; decision-making is bilateral and bargained (since the proposal for collaboration originates from within the local entities); the municipality can receive different kinds of aid (financial but also technical advice, since the intervention is integral); and the working system is transversal.

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<sup>171</sup> For example, the 2000-03 call awards a maximum of ten points to projects related to the municipalities' compulsory responsibilities, five to the supramunicipal projects, four to projects that are complementary to the AC's policies, five to emergency projects, eight to municipalities with high fiscal effort, and from two to ten points decreasing with population size (Decree 74/2000, of the Call of the PUOSC 2000-03, Generalitat de Catalunya). Note that even in this case there is sufficient scope for subjective interpretation.

**Table 10. Comparing two different transfer models: Traditional grant programs vs. intergovernmental contracting**

	<i>Traditional Grant program</i>	<i>Intergovernmental contracting</i>
Orientation	Towards the procedure of awarding and managing the grant	Towards the accomplishment of goals established in the contract with the compromise of evaluating the policy
Relationship between actors	Hierarchical. There is a grantor institution in front of an applicant and ultimately grantee	Equality and collaboration. Both layers are contracting parts in a process which takes into account both will and interests between them
Decision-making	Unilateral. The grantor awards a grant based on an application (this application is the only signal of local autonomy)	Bilateral and bargained. Bottom-up: proposal for collaboration originating in local entities as a manifestation of their autonomy
Kind of aid	Based on economic transfers	Integral intervention: economic aid, but also project writing Execution of public works. Technical advice. Cession of goods and equipment
Working system	Divided in programs and bureaucratic, since grants are managed in a fragmented way often by different units which compete amongst them	Networking transversal system. There is only one contact between the different units of the grantor and the local government.

Source: Diputació de Barcelona (2009).

Table 11 describes the organization of the XBMQ. The first step involves establishing the program's goals, and the instrument to achieve that is the General Contract, known in Spain as the *Protocol General* (see below). This document is very general and its implementation requires, first of all, that the municipality signs it<sup>1</sup> before it can be developed further in the form of a Specific Contract (*Conveni Específic*). The second step involves implementing co-

<sup>1</sup> For the period 2004-08, 311 municipalities and up to 486 local government bodies and other local entities (e.g., public societies, consortia) have signed the Protocol General XBMQ.

operation between the two layers, and the instruments applied in this process are: (i) the needs register (where each municipality submits all the projects for which it seeks funding from the *Diputaci3n*), (ii) the contracting forum or *Mesa de Negociaci3n*, where both layers of government sit and negotiate the exact details of the contract, (iii) the pre-agreement register, which includes all the political undertakings agreed with the various municipalities, (iv) the activities register, which includes a list of all the projects to be implemented within the specific program horizon (in this instance, a four-year period, which coincides exactly with the term of office of both the municipalities and the *Diputaci3n*), and (v) the specific contract, which translates the political agreements arrived at earlier into a legally binding document.

**Table 11. A capital transfers program based on intergovernmental contracting: The case of the Diputaci3n de Barcelona (Xarxa Barcelona Municipis de Qualitat. XBMQ<sup>(1)</sup>)**

Step:	Instruments:	Tasks:
1) Goal setting	- General contract <sup>(2)</sup> ( <i>Protocol General XBMQ</i> )	- Local government's approval
2) Implementation	- Needs registry - Contracting forums ( <i>Meses de Concertaci3n</i> ) - Pre-agreements registry - Activities registry - Specific contracts	Submission of needs with ranking Process of assessing and bargaining the pre-agreements Process of legal formalization of activities Execution and follow-up
3) Evaluation	- Public report - Observatory of XBMQ	- Publishing the report - Closing the contract

Notes: (1) *Xarxa Barcelona Municipis de Qualitat* can be translated into English as the Barcelona Network of Quality Municipalities. (2) We use the term contract to refer to a *Conveni*, which in Spain is a document that specifies the duties of the parties (here two layers of government) in developing a concrete activity or program. A *Conveni* marc or *Protocol General* is a similar to a *Conveni* (hence the term General contract) but is very general and global; it establishes the umbrella where the contractual relationship of the parties will evolve; further development is needed in form of specific contracts (*Conveni especifc*) which specify the responsibilities of each part regarding the activities to be developed (see Sol3-Oll3, 2007. and MAP, 2002).

Source: Diputaci3 de Barcelona (2009).

The main virtue of this new model would seem to be that the relationship between the two layers of government is less bureaucratic. This allows both the needs of the municipality and the policy preferences of the *Diputación* to be better satisfied. Note that in the Traditional Grant model, the upper layer seeks to influence the type of projects that are to be implemented through the allocation of funds towards specific programs and through the criteria established for project selection. The municipality has no voice in this process, and the only means of funding what it considers to be priority projects is to examine the call and to try to adapt the project to the criteria set by the grantor. Occasionally this means that municipalities request funds for projects that their citizens do not consider a priority or that they have to change the design of the project simply to please the grantor. A more effective strategy for both the municipality and the *Diputación* would be for each party simply to sit around a table to communicate their goals and then reach an agreement (or otherwise) as to what projects should be implemented and what funding can be made available. This is precisely what the XBMQ does. Of course such a process is more time-consuming, as at the beginning of the term of office, the *Diputación* has to organize a separate meeting with each of the local governments under its jurisdiction.

### **13.3. Transfers to local governments: a preliminary assessment**

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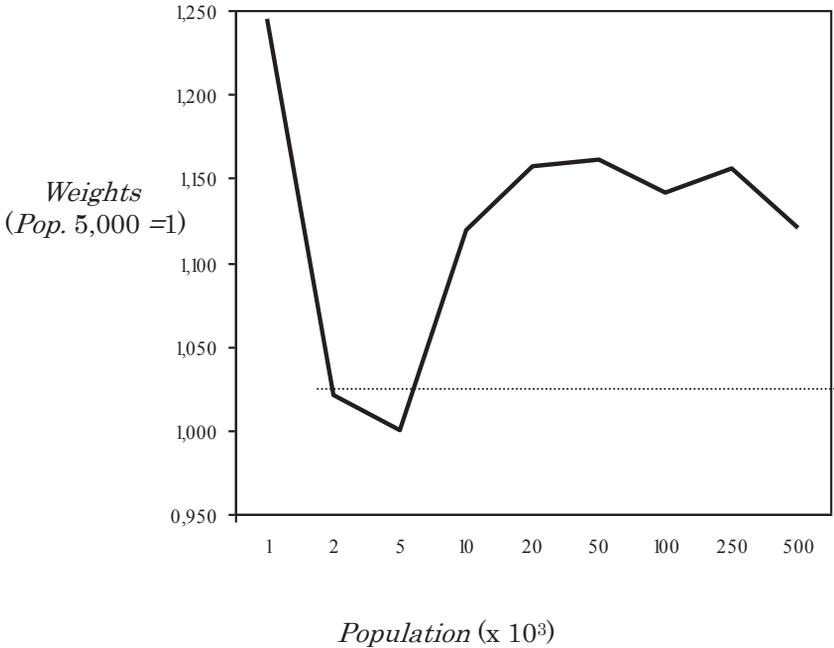
In this section I will make a preliminary assessment of the virtues and perils of transfers to Spain's local governments. I will focus on the various elements identified in the introduction, and ask the following questions: (i) Do transfers actually serve to equalize differences in spending needs and/or fiscal capacity? and thus, do they help guarantee equal access to local public facilities and services across the country? (ii) What role do the transfers play in the adjustment of local budgets to the different types of unforeseen fiscal shocks? Do they, for instance, lead to poor financial management, fostering excessive spending and deficits?; (iii) Do transfers help improve the effectiveness and efficiency of public spending, helping to overcome the intergovernmental coordination problems derived from spillovers, the lack of scale economies or inappropriate local administrative capacity?; (iv) Are these transfers affected by the rent-seeking efforts of local politicians and by clientelism?

### 13. 3.1. - Equalization power

*Needs equalization* Besides the resident population, there are other municipal characteristics that influence the spending needed to guarantee a given level of service provision. Among these, we could cite: (i) the number of potential users (e.g. socio-demographic groups, non-resident population, daily visitors, or employment), or other variables defining the scale of the service (e.g. land area); (ii) variables influencing unit costs, including for example population size, dispersion, and wages; (iii) the level of responsibilities. As outlined in section 13.2.2, the main unconditional transfer (PTE) does take into account needs differences by including resident weightings which increase with population size. However, research undertaken by Bosch and Solé-Ollé (2005) shows that actual per capita needs present a very different profile to that which is implicit in the weights used in the formula.

The estimated per capita needs-to-population profile is shown in Figure 6. Note that per capita needs go down for numbers of inhabitants up to 5,000 and then increase for numbers up to 50,000, reaching a maximum of 1.17, and remain constant at larger population sizes. This pattern differs from the one that is implicit in PTE weightings, which increase from the smallest population sizes, reaching very high weights for medium-sized, and in particular, for very large cities (with a maximum of 2.8 after 1999). As such, the PTE seems to be biased against the smallest municipalities and to support the larger ones.

**Figure 6. Estimated population weights**



Notes: (1) Population weights are equal to 1 for the base category (5,000 residents). (2) These weights are estimated by fitting a piecewise linear function to non-financial spending per capita after controlling for a wide set of potential confounding variables.

Source: Bosch and Solé-Ollé (2006).

Contrary to the situation with current transfers, capital transfers flow disproportionately to the small municipalities. Clearly this makes sense given the fixed costs of many capital projects, and there does not seem to be any evidence that the bias towards small municipalities goes beyond the degree of scale diseconomies observed. Table 12 below shows the results of estimating two equations explaining both capital transfers per capita and capital spending per capita<sup>173</sup>. Note that the inverse of resident population is a statistically significant determinant of both transfers and spending, and it is the variable having the highest explanatory power in the case of spending. By comparing the first two columns

<sup>173</sup> The table is drawn from a report commissioned by the Diputació de Barcelona, evaluating the appropriateness of minimum municipal transfers as computed for the XBMQ (see Solé-Ollé and Sorribas, 2007).

it can be seen that the coefficient of this variable is much higher in the case of capital spending than in the case of capital transfers, which can be interpreted as evidence that these transfers only compensate for part of the scale diseconomies of small municipalities.

**Table 12. Determinants of capital transfers and capital spending in Spanish municipalities <sup>(1)</sup>**

	<i>Capital transfers/pop</i>	<i>Capital spending /pop.</i>		
<i>Spending needs:</i>				
1/Population	15.605 (15.56) ***	109.164 (14.87)***	35.395 (3.05) ***	37.603 (3.43)***
Growth in population + Houses	-.	-.	-.	6.16 (3.83)***
Growth in employment	-.	-.	-.	3.77 (1.60)
<i>Resources:</i>				
Fiscal capacity/pop.	-.	-.	0.301 (3.60) ***	0.213 (2.62)***
Capital transfers/pop.	-.	-.	0.935 (6.86) ***	0.938 (7.30)***
Debt	-.	-.	-0.277 (2.68) ***	-0.282 (-2.90)***
Resident income/pop.	-.	-.	0.015 (3.67) ***	0.004 (1.06)
R <sup>2</sup>	0.611	0.589	0.838	0.858
F-statistic	242.13***	221.14***	156.91***	129.35***

Notes: (1) Sample of 200 municipalities of the province of Barcelona during the term of office 2000-04. (2) Capital transfers: capital transfer from the *Diputaci3n de Barcelona*. Capital spending: chapters 6 and 7 of the budget. Population: resident population in 1999. Growth of population + Houses: growth rate of resident population + number of urban units 2000-04. Growth of employment: growth of full-time wage earners during the same period. Fiscal capacity: computed using the average tax system for the municipalities of the sample and appropriate tax base indicator for each local tax. Debt: net debt in 1999. (3) Equations estimated by Ordinary Least Squares with standard errors robust to heteroskedasticity. (4) t-statistic in parenthesis. \*, \*\* & \*\*\*: parameter statistically different from zero at the 90%, 95% and 99% levels.

Source: Sol3-Oll3 and Sorribas (2008).

But what about other elements unrelated to population size? As discussed above, the PTE does not take them into account.

However, an empirical study conducted by Solé-Ollé (2001) shows that in practice, spending needs depend on a great variety of factors. Taken together these factors account for a substantial share of the variation in spending. Specifically, factors such as the number of daily visitors, of tourists, employees, immigrants and poor people, and the dispersion of the population have a very marked effect on some spending categories<sup>174</sup>. Thus it must be concluded that in general, Spanish non-earmarked grants are not sensitive to specific needs factors. This is not difficult to understand, since the formula is applied by more than 8,000 municipalities and the diversity of situations is very high. In fact, there is no single variable in the analysis reported by Solé-Ollé (2001) that can account for a considerable proportion of this variation in spending.

Let us turn to examine capital transfers. Do they take into account differences in needs factors other than population size? If we examine the municipality traits used for the selection of capital projects (see the example in Table 9 above), only the number of towns emerges as an additional needs variable. However, occasionally specific programs are devoted to certain types of municipality presenting special needs<sup>175</sup>. It could be argued that even without any formal criteria, the grantor is sensitive to those projects that municipalities justify as being essential on the grounds that current facilities are clearly insufficient. Whatever the case, the only needs variables (apart from the inverse of population) found in the study conducted by Solé-Ollé and Sorribas (2007) were *Growth in Population and Houses* and *Growth in Employment* (see Table 12). None of the level variables (measured in 1999) reported as being significant needs factors in Solé-Ollé (2001) in the case of current spending were statistically significant

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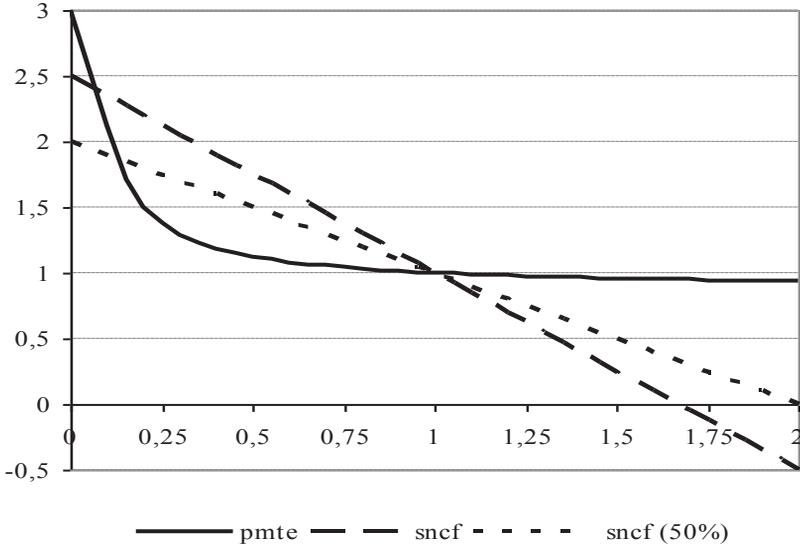
<sup>174</sup> Spending needs factors on the one hand, and fiscal capacity and transfers on the other, each account for roughly 45% of the variation in cross-sectional spending, the remainder being explained by political and institutional traits. These results were obtained from a cross-sectional regression of current spending versus needs, resources and other factors, using a sample of 100 municipalities from the province of Barcelona for the year 1996 (see Solé-Ollé, 2001, for details).

<sup>175</sup> For example, in the 2008-12 call of the PUOSC there is a special program for municipalities with sprawled housing and another for mountain municipalities. In fact, the regression analysis in Solé-Ollé and Sorribas (2008) finds that capital transfers are higher in municipalities with more urbanized area per capita.

in the case of capital spending. This suggests that no large infrastructure disparities existed at the beginning of the period analyzed (i.e., 2000-04), but that the enormous urban expansion experienced during those years meant that the existing capital stock was insufficient. Thus, there is little evidence that capital transfers are actually allocated according to specific needs factors, apart from the new demands associated with urban growth. Moreover, it is unclear whether upper layers of government should pay part of the costs of urban expansion, since this might encourage the natural tendency of Spain's municipalities to overexpand (Solé-Ollé and Viladecans, 2007).

*Fiscal capacity equalization* Traditionally, the main unconditional transfer (PTE) did not contain a fiscal capacity equalization component. The only component that contributed partially to this end was the fiscal effort variable, since municipalities with low tax bases typically charge higher tax rates. The analysis performed in Solé-Ollé (2001) for 1996 confirms this almost complete absence of equalization power. The introduction of the variable, the inverse of fiscal capacity, in 2002 should have modified this outcome. However, the weight assigned to this variable was quite low (12.5%), and so the reduction in fiscal capacity disparities is very low at reasonable values of the fiscal capacity index, the reason being the non-linear relationship between both variables (see Figure 7).

**Figure 7. Comparing the PTE to a fiscal capacity equalization transfer**



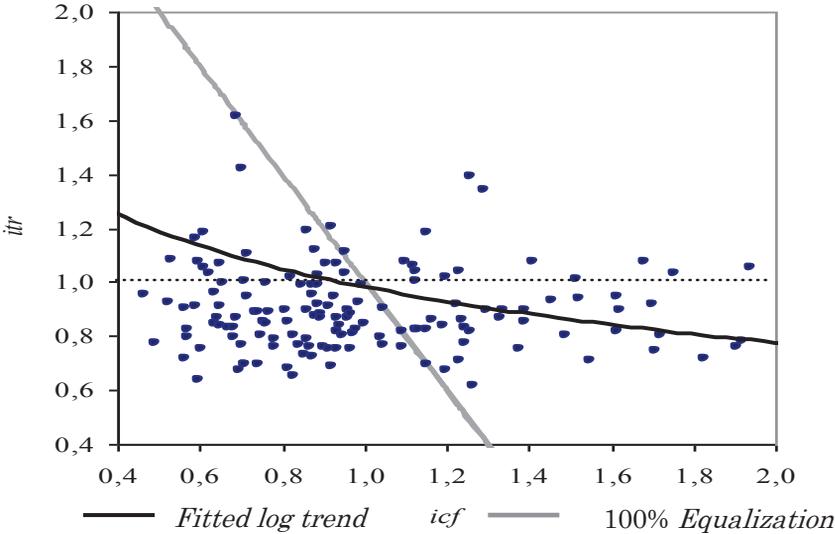
Note: (1) pmte = Participación en los Tributos del Estado (PTE), which is the main unconditional transfer received by Spanish municipalities. Sncf = 100% fiscal capacity equalization transfer. Sncf (50%) = 50 fiscal capacity equalization transfer. The three transfer schemes are expressed in index (average =1) and plotted against an index of fiscal capacity per capita (average =1); see notes to Table 12 for a description of its calculation. Source: Solé-Ollé (2009).

Figure 7 also shows why in the relevant range of values (fiscal capacity index higher than 0.5), the slope of the function is very low (it equalizes at around 10% of fiscal capacity disparities) and, in any case, it is much lower than the 100 and 50% equalization lines, which correspond to a typical equalization grant where fiscal capacity enters linearly but with a negative sign<sup>176</sup>. Figure 8 below illustrates this effect with real data corresponding to the current transfers received by a sample of municipalities in the province of Barcelona during the period 2000-04. It shows that the slope of the fitted line is in fact much lower than that of a 100% fiscal capacity

<sup>176</sup> In other words: Index of transfers per capita = (α Per capita needs index - β Per capita fiscal capacity index), where α and β are weights that depend on the average degree of tax autonomy, see Solé-Ollé (2001).

equalization transfer.

**Figure 8. Comparing current transfers to a fiscal capacity equalization transfer**



Note: (1) *itr* = current per capita transfers in index; *icf* = fiscal capacity per capita in index; data originating from a sample of 200 municipalities of the province of Barcelona.

Source: Own preparation.

Thus, Spain’s non-earmarked transfers do not equalize, but can the same conclusion be drawn for the country’s earmarked transfers? In general, capital transfers also present a very low equalization power. The criteria used for the selection of projects typically include both fiscal capacity and fiscal effort (see Table 9). The analysis reported by Solé-Ollé and Sorribas (2008) shows that capital transfers are in fact higher in municipalities where the property has a low assessed value (the tax base for the property tax, Spain’s main local tax), and lower where the property tax rate is highest, albeit these variables added very little to the explanatory capacity of the equation. However, plotting capital transfers per capita against the fiscal capacity index (using the same database as the one employed in Figure 8) results in a positive rather than a negative slope. The two findings can be

reconciled on the grounds that the effect of fiscal effort in this case can counteract that of fiscal capacity, given that the former is typically higher when the fiscal capacity is low. Moreover, the money received from capital transfers needs to be matched with a local contribution amounting to at least 50% of the cost (with some exceptions, see Table 9), which has the effect of reducing the amount of funding solicited by the fiscally poor.

This lack of equalization power has not been a problem in the past, given the kind of services delivered by Spanish municipalities. However, care should be taken in future with this aspect of the transfer system in case the municipalities continue to gain more control over the provision of social services.

### 13.3.2. Fiscal adjustment

How do municipalities react when experiencing a budgetary shock that generates an unforeseen deficit? Do they adjust some of the components in order to balance the budget again or do they let the deficit grow in an uncontrolled manner? How many years are required for this adjustment to be made? Does the burden of this adjustment fall entirely on the municipalities' own budget instruments such as their spending and taxes? Or, is an adjustment possible only when higher layers of government provide more transfers? Which transfers are more important for achieving this adjustment? Do the municipalities respond to shocks that affect them all at the same time (such as the current economic crisis), to idiosyncratic shocks, or to both? Finally, does adjustment via transfers provide incentives to mismanage local public finances?

Recent research seeks to address these questions by using tools previously employed by macroeconomists (i.e. VARs and Impulse Response Functions). The studies by Buettner and Wildasin (2006) and Buettner (2009) report that both US and German local governments do adjust after different types of budget shocks, but that transfers from higher layers of government are needed to ensure adjustment is made. The share of transfers in adjustments to revenue shocks is quite modest in the US, but much higher in Germany. Buettner (2009) suggests that this is due to the role played by fiscal capacity equalization grants and speculates that the reason is that German municipalities rely so heavily on the

highly volatile local business tax.

A similar analysis conducted by Solé-Ollé and Sorribas (2009) for Spain resulted in a number of different findings. First, as it is the case in the US and Germany, local budgets do adjust after a shock, so the authors conclude that the Spanish system of local finances is viable. Second, in Spain grants do not respond to a shock in revenues, which is rather absorbed by cuts in spending. This result is consistent with the low equalization power of both current and capital grants (see section 13.3.1). Third, the response of grants to spending shocks is much higher in Spain than in the two other countries. Fourth, the adjustment is similar in the case of both general and idiosyncratic shocks, although grants are slightly more responsive to an idiosyncratic shock, even responding in such circumstances to a revenue shock. Fifth, capital grants are more responsive than current grants to spending shocks.

The former are also more responsive to shocks affecting small municipalities. Overall, the authors conclude that the differences between Spain and the other countries are probably due to the greater reliance on earmarked capital grants in Spain. Finally, the authors speculate that this greater reliance on grants might have given rise to another type of moral-hazard problem: additional infrastructure needs generated by population growth are funded by higher tiers of government, which induces municipalities to foster urban expansion without considering the full fiscal consequences of such policies.

### 13. 3.2. Intergovernmental cooperation

Spanish municipalities are quite small, which means that most of them face severe diseconomies of scale and lack the necessary administrative (and in some cases financial) capacity to provide certain facilities and services. This small municipal size, coupled with a high degree of mobility of both people and businesses, also generates considerable spillovers between neighbouring municipalities. An unclear division of responsibilities and/or the intertwined effects of policy instruments resting with different layers cause vertical coordination problems between the municipality and the AC. Hence we need to consider whether the actual design of Spanish transfers to local governments helps solve these problems of co-ordination?

Theoretically, both the ACs and the *Diputaciones* run intergovernmental cooperation programs, the aim of which is to cope with such problems. The main instruments available to implement such policies are the transfer programs, and most of the transfers are earmarked capital transfers. Indeed, some of the traditional grant programs employ specific criteria during their selection process with this purpose in mind. For example, the PUOSC (see Table 9) takes into the account the fact that the project might be a supramunicipal plan, and that the municipality might be an amalgamation, and it pays particular attention to disaster relief and municipalities exposed to externalities from power plants. However, the effectiveness of including these criteria is unclear. The other analyzed program, XBMQ, which is based on a model of intergovernmental contracting, seems better suited to deal with such coordination problems. Given that the projects are selected after a process of bargaining with each municipality, the grantor should be in a better position to identify which projects are most likely to generate benefits that may spread to other municipalities.

However, yet another purpose served by these transfers is the funding of projects that best meet the local needs and demands of each municipality. Here, it is quite obvious that the bureaucratic procedure used to identify the best projects for funding (in theory in order to fulfil the coordination purposes described above) interferes seriously with local autonomy. A local politician puts it this way:

“The system of grants to municipalities is disastrous. The money contributed by the *Generalitat* (i.e. the AC government) and the *Diputaciones* is very high. But there are two problems. On the one hand, there is the earmarking of most transfers; this means they give you the money to do something specific, something that they want, and then on top of that you have to contribute a large share yourself. Sometimes, this can make sense, I’m not saying that this system should be completely abolished; but often an ‘enlightened’ individual who has never set foot in the municipality decides from her office to subsidize projects that are of absolutely no interest or that are not a priority for the

local council. And many of them end up doing things simply because they are subsidized, without there being a need for them or without their having been identified as a priority; it is like buying in the sales (...). The worst one is the PUOSC, which is a joke. The PUOSC funds municipal investments, sometimes providing no more than a very small share; what's more, they tell you what you have to do, and what not to do, what is good and bad for you, what you need and what you don't..."(<http://blocs.mesvilaweb.cat/sbaulida>)

In general, the procedure followed in selecting these projects does not ensure that those projects which are eventually implemented are the most appropriate, nor does it guarantee that these projects represent a net payoff to society. In theory, the use of transfers based on intergovernmental contracting, such as those provided by the XBMQ, can attenuate these problems. By sitting down together and negotiating the needs that require funding, the grantor is better able to identify the projects that satisfy local demands and needs. The General Contract of the XBMQ places considerable emphasis on the compatibility of respecting local autonomy and the need to coordinate local policies. Of course, one thing is theory and another practice, and so far the evidence is insufficient to draw definitive conclusions as to the differential performance of the two types of grant.

### 13.3.3. Rent-seeking and clientelism

The second problem is described as follows by the same local politician as above:

"The other problem is the 'old boy network' and the 'partisanship' of grantors. Nobody dares meddle with this issue for fear of being blacklisted and receiving less than they usually receive, but the reality is that the criteria of having a 'friend in the right place' and being a 'member of the party' weigh much more heavily than they should in the awarding of transfers" (<http://blocs.mesvilaweb.cat/sbaulida>)

This problem is exclusive to earmarked transfers. A number of key elements in the design of these transfers facilitate their

discretionary use. First, there is the vagueness of the criteria used for selecting capital projects to fund and for establishing the matching rate (Table 9). In some calls these are presented in detail, but in others they refer simply to the general principles provided in the legislation. Second, a substantial amount of funding is reserved for disaster relief, for urgent interventions, and for other discretionary actions. Third, the use of minimum transfers is not sufficient to avoid this behavior, given that their aggregate amount is usually much smaller than the overall amount of funds eventually awarded.

These problems can potentially be even more acute in the case of transfers based on intergovernmental contracting. Such transfers are the result of a bilateral contract between the municipality and the grantor, and thus no comparison is made with the grants awarded to the other municipalities. In this case, no selection criteria are specified in the General Contract. In theory, contracts are negotiated bilaterally, the agreement can be freely accepted by the municipality, and this should not be *a priori* subject to any specific constraint. But the reality is that by bargaining bilaterally with each municipality the grantor is more likely to offer funds where they are most politically productive as a party. In order to avoid excessive criticism, the *Diputació de Barcelona* also calculates a minimum aggregate transfer for each municipality, but here again this amount falls well below the total amount of funds being distributed.

The literature on the political economy of grant allocation refers to the behavior described above by our local politician as ‘clientelism’ (Weingast *et al.*, 2006). This is a situation where a politician controlling the instruments of power (in this case the upper layer allocating grants) threatens citizens (residents of a community) by saying that they will be punished (in this case by receiving less transfers) if they do not support the municipal candidate belonging to the same party<sup>177</sup>. There is some informal evidence that this argument is at times discussed in small municipalities during local

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<sup>177</sup> This theory also provides a positive explanation for the increase in the use of earmarked grants (or in any case their survival): grantor governments will be reluctant to transform earmarked into non-earmarked grants (or even worse, into tax decentralization) because this will erode their power to punish/reward municipalities (see e.g. Weingast *et al.*, 2007).

electoral campaigns. Put quite simply the argument is: “this guy is the candidate we prefer, but he won’t be able to extract funds from the grantor government, because it’s controlled by the opposition.”

There is a very clear-cut empirical prediction associated with such behavior: a municipal government aligned with the upper-layer grantor (i.e. controlled by the same party or coalition) should receive more transfers than a municipal government that is not so aligned. Recent research undertaken by Solé-Ollé and Sorribas (2008) shows that this is indeed the case in Spain. Aligned Spanish municipalities receive on average 40% more capital transfers per capita than unaligned municipalities. We should stress, however, that this empirical regularity is consistent with other theories besides ‘clientelism’. For example, aligned municipalities could receive more transfers simply because, by belonging to the same party, they have more policy preferences that are similar to those of the grantor. In this case, the municipality will be more inclined to apply for projects and it will tend to select the type of project that is most likely to be funded. Thus, the unequal allocation of funds may simply be a reflection of the ideological differences that exist between parties.

Current grants are less amenable to such discretionary use. In practice, it is extremely difficult for a grantor to give special treatment to one individual municipality. Yet, in the case of PTE, there have been a couple of exceptions to this rule. The cities of Cádiz and Sta. Coloma de Gramenet enjoy a special status that entitles them to more funding. The reason for this is their low level of fiscal capacity coupled with a restricted land area that impedes any future economic developments that might solve their financial problems. While this is true, there are other municipalities in Spain that have similar problems but which do not receive the same level of funding. As described above, the PTE has a very low equalization power, so the formula does not solve any disparities in fiscal capacity. The special status was awarded after rent-seeking efforts by the mayor of Cádiz, who at that time was aligned with the right-wing government in Madrid. The same status was eventually awarded to Sta. Coloma de Gramenet (governed by a left-wing mayor) to avoid accusations of partisanship. The PTE formula, like any other formula, can be manipulated to give preferential treatment to certain groups of municipalities. There

are suspicions that this is what has happened in Spain in the case of its big cities. Recall the higher population weighting employed in the formula since 2002; this was probably a reflection of the municipalities' higher rent-seeking capabilities. The situation has been criticized by many experts and politicians in medium-sized and small municipalities. But the 2002 reform split the system in two – thus, municipalities with more than 75,000 residents and tourist cities that are now financed by tax-sharing and a lump-sum grant have become completely separated from the smaller municipalities. Although the change was revenue-neutral in the first year, and although it has provided more or less the same resources since then, the separation of the system insured big municipalities against the possibility of a reform of the formula and a reduction in their population weighting.

### **13.4. Conclusion**

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Local governments in Spain are relatively small bodies. The municipalities, the main player in the local system, are numerous; yet their responsibilities are somewhat limited and often coincide with those of the ACs. Despite this, local governments remain fairly autonomous bodies, their transfers representing approximately a third of their revenues, and they retain control over all their local taxes. Most of their current taxes are non-earmarked, while all their capital transfers are specifically earmarked project grants. The municipalities, in particular the smallest in size, are heavily dependent on these transfers to fund their capital spending.

Overall, Spain's local transfer system suffers from a number of weaknesses. First, it is not effective in reducing disparities related to either spending needs or fiscal capacity. This lack of equalization power has not been especially problematic in the past, when the services provided were non-redistributive, but it should be taken into careful consideration as the municipalities increase their involvement in the provision of social services (e.g. care for children and the elderly). Second, transfers play only a limited role in the adjustment of local budgets to revenue shocks, but they are important in helping local authorities faced with spending shocks. Capital transfers would appear to be particularly important for this purpose. Given that capital spending is

primarily influenced by population growth, we speculate that the involvement of higher layers of government in local infrastructure funding might have fostered urban expansion. Third, it is unclear whether project transfers actually help in coping with the coordination problems affecting Spain's local sector. What is clear, however, is that these projects interfere considerably with local autonomy and result in the selection of projects that are not valued quite so highly by the citizens. Fourth, there is strong evidence that co-partisans enjoy a disproportionate allocation of earmarked capital transfers, casting some doubt on the fairness of procedures used in selecting such projects. Given these concerns it would be interesting to consider the possibility of: (i) increasing the amount of unconditional funding to municipalities, (ii) increasing the equalization power of these grants and clarifying their effects, and (iii) limiting the amount of funds allocated as capital transfers while seeking to improve the transparency of the allocation process.

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# Chapter 14

## Earmarked general grants and general earmarked grants in the Netherlands

Hessel Boerboom and Peter Huigsloot

### Abstract

In the Netherlands the main resources available to local government consist of general and earmarked grants. The possibilities for Dutch municipalities and provinces of generating non-redistributed own income, for instance, on the basis of local taxes, are limited.

This paper discusses the following issues:

- the number of earmarked grants in the Netherlands is decreasing. Earmarked grants are partly converted to general grants and partly compiled into wide-target earmarked grants;
- new types of general grants have been established, especially in terms of execution time and varying ways of allocation;
- in some policy areas (urban renewal, social care), both general and earmarked grants form the resources available to local government;
- restrictions in the freedom of spending are increasingly related to laws, rules, covenants and other agreements between national and local government and not to general or earmarked grants;
- earmarked grants are increasingly acquiring the features of general grants: in regard to reporting and accountability, in regard to conditional spending, and in regard to applied methods for the selection of allocation criteria;
- general grants are increasingly acquiring the features of earmarked grants: in regard to the selection of allocation criteria by policy area and in regard to their conditional,

- temporary character;
- this convergence of general and earmarked grants is the result of a changing institutional environment consisting of the new views of present-day politics versus conventional theory and the significance of laws, rules, covenants and other agreements between national and local governments<sup>178</sup>.

## 14.1. Introduction

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### 14.1.1. Decentralisation and convergence in the practice of general and earmarked grants

Despite dissimilarities based on social, physical and regional structures, the Netherlands have high ambitions regarding the equalisation of services. All municipalities and provinces, despite their divergent social, physical and regional features, must possess the financial potential to realise an equal level of services, emphasising not uniformity but equality.

Equal levels of services are supposed to be realised according to the municipal and provincial autonomy. The autonomy of municipalities and provinces has increased during later years as the result of a reduction in the number of earmarked grants and the decentralisation of tasks for which financial means are provided by general funds (municipal fund) or by earmarked 'wide-target' grants. This is the case, for example, of the decentralisation of school accommodation, benefits within the recent Social Support Act (benefits for domestic care, for the disabled), and employment and income benefits.

Meanwhile, the Netherlands are experiencing converging features

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of general and earmarked grants, such as conditions, duration, reporting and accountability and in regard to the methods applied in compiling the allocation. This convergence is the result of a periodical maintenance and monitoring system including an annual scanning of the developments in local government spending in relation to the allocation system.

Restrictions imposed by the central government in regard to the composition of services and spending are realised in particular by means of legal instruments (laws, general rules of government) rather than by means of financial instruments.

#### **14.1.2. Limited possibilities of generating own income**

The high ambitions as to the equalisation of services have also resulted in limited possibilities for Dutch municipalities and provinces to generate own income that is not redistributed, for instance on the basis of local taxes. The fact that municipalities have their own earmarked resources is taken into account when general grants are allocated by the municipal and provincial funds.

Municipalities and provinces are only capable of generating their own income by applying higher rates of property or road taxes than the central standard on which the municipal and provincial funds are founded.

The municipal fund, for instance, corrects dissimilarities between municipalities in valuing property by means of a negative allocation formula. This negative allocation formula varies between municipalities from 6% up to almost 30% of the overall funds. Municipalities, moreover, are supposed to be able to cover approximately 4% of their overall spending from other independent resources, including in particular revenues from investments, participations or land exploitations.

Besides these independent general resources, municipalities are also authorised to charge cost-effective contributions to private individuals (administrative charges, taxes or duties, etc.) based on the provision of specific services. Waste collection levies, sewerage charges, charges for services provided by the population register and issue of building and other permits are examples of this kind of contribution.

### 14.1.3. The subjects of this paper

In this paper on ‘earmarked general grants and general earmarked grants in the Netherlands’, the following subjects are introduced:

- a survey of the general and earmarked grants in the Netherlands (section 2);
- developments in the use of general and earmarked grants (section 3);
- convergence in the use of general and earmarked grants (section 4);
- the institutional environment as a background of the convergence (section 5).

The central aim of this paper is to focus on the general and earmarked grants to municipalities. However, when relevant, we will also discuss experiences relating to the provinces and sub-municipal areas of Amsterdam and Rotterdam.

## 14.2. Survey of general and earmarked grants in the Netherlands

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### 14.2.1. General grants: municipalities

#### *Volume of general grants, earmarked grants and own municipal income*

At present, the allocation of general funds to municipalities (approximately 16 billion euro) is somewhat higher than the allocation of earmarked funds (approximately 12 billion euro). The municipal own income (in particular from taxes, investments and charges) amounts to approximately 30% of the overall municipal funds.

The size of allocated means varies significantly among municipalities, both in regard to general funds and earmarked grants.

#### *General grants: the clusters of the municipal fund*

The most important instrument for the allocation of general funds, the municipal fund, is based on a system of objective criteria applied to each municipality. Only the four largest cities receive supplementary grants because of their exclusive tasks as large

cities.

The general grants of municipal funds are legally founded in the Allocation of Finances Act (most recently amended in 2008).

The municipal fund distinguishes between 14 clusters of expenditure, subdivided into four – logically organised – compartments:

- the public area compartment includes the clusters of public parks and gardens, roads, water and sewerage;
- the buildings and environment compartment includes the clusters of public order and security, museums etc., public housing, spatial planning and urban renewal, physical environment and garbage collection;
- the public services compartment includes the clusters of education, employment and income, social care (including disabled and childcare), art, sports and entertainment, and civil registry;
- the local government cluster.

*The specific importance of general grants in regard to varying types of municipalities*

The nature and intensity of tasks in the clusters differ among municipalities as a result of various social, physical and regional structures. Depending on their composition, the tasks and costs included in a cluster depend on features of respectively the physical structure (i.e. the condition of the soil, low or high density, and quality of buildings), the social structure (i.e. the composition of the population), and the regional structure (i.e. services in particular for art and entertainment used by citizens from outside the municipality).

**14.2.2. General grants: provinces**

The general and earmarked grants for provinces are also legally founded in the Allocation of Finances Act.

As opposed to the circumstances applying to municipalities, the volume of the allocation of general funds to provinces (1.2 billion euro) is somewhat lower than the volume of the allocation of earmarked means (approximately 1, 7 billion euro).

The provincial fund consists of five clusters: government, social services, physical environment, road and waterways infrastructure and spatial planning (nature, economy and housing/urban renewal).

The provincial own income (in particular from taxes and power company shares) amounts to approximately the same level as the general provincial funds. Own income from power company shares has been booming in recent years, resulting in significant inequality in spending prospects between provinces. This has given rise to public debate about reductions and redistribution.

#### **14.2.3. General grants: sub-municipal areas**

In the two largest cities in the Netherlands, Amsterdam and Rotterdam, some 40% of total general grants from these municipalities plus the income from property taxes are distributed among the sub-municipal areas (500 - 600 million euro) by means of sub-municipal funds. The latter have characteristics similar to those of the municipal fund; yet they have been adapted to differences in tasks and features of social and physical structure between municipalities and sub-municipal areas.

#### **14.2.4. Earmarked grants**

The legal basis of earmarked grants is also laid down in the Allocation of Finances Act. In article 15a, lid 1, earmarked grants are defined as: any contribution out of the state coffers that by or on behalf of the involved minister is conditionally provided to provinces and municipalities for the benefit of a specific area of public interest.

In 2009, approximately 80 earmarked grants are available to municipalities, differing in various features: continuous versus temporary, wide-target versus narrow-target, objective allocation criteria versus budgets, all as a result of historical factors.

#### ***The distribution of earmarked grants among departments***

The distribution of earmarked grants among departments is as follows:

**Table 1. The distribution of earmarked grants among departments in 2009**

Ministry	number of earmarked grants	amount (in billions of euro)
Interior and Kingdom Relations	6	96
Economic Affairs	7	90
Finances	-	-
Youth and Families	5	1.322
Justice	5	1
Agriculture and Fisheries	3	511
Education, Culture and Science	10	928
Social Affairs and Employment	9	8,130
Transport, Public Works and Water Management	6	2,130
Housing, Spatial planning and the Environment	13	602
Health, Welfare and Sport	7	111
Housing and urban development, Communities and Integration	11	1,347
<b>Total</b>	<b>82</b>	<b>15,268</b>

The earmarked grants with the largest payments are:

- Ministry of Social Affairs and Employment:
  - income support on the basis of the Work and Income to Labor Act (WIA): 3.7 billion euro
  - participatory budget amount (employment promotion): 1.8 billion euro
  - Sheltered Employment Act (WSW): 2.4 billion euro
- Ministry of Transport, Public Works and Water Management
  - traffic and transport: 2.0 billion euro
- Agriculture and Fisheries
  - investment budget rural areas: 0.5 billion euro
- Housing and urban development, Communities and Integration
  - investment budget urban renewal: 0.4 billion euro
  - social, integration and security: 0.9 billion euro
- Youth and families
  - youth care: 1.3 billion euro
  - youth and family centres: 0.3 billion euro
- Health, Welfare and Sport
  - Social relief and addict care: 0.3 billion euro

### ***The allocation among municipalities and provinces***

The above earmarked grants are directed at both municipalities and provinces:

- municipalities exclusively: income support on the basis of the Work and Income to Labor Act (WIA); participatory budget

amount (employment promotion, Sheltered Employment Act (WSW); social, integration and security; youth and family centres, social relief and addict care;

- provinces exclusively: investment budget, rural areas;
- both provinces and three general law areas (municipal cooperation around the large cities); traffic and transport, youth care;
- both (mainly) large cities and provinces: investment budget, urban renewal.

***The specific importance of earmarked grants in regard to varying types of municipalities***

Although earmarked grants are directed towards municipalities, they are not of similar relevance to all municipalities. Broadly speaking, earmarked grants tend to consist of financial rules that are not important to all municipalities, but rather of particular or exclusive importance to those specific types of municipalities that are responsible for the fulfilment of specific regional tasks or experience specific urban problems.

The following situations occur:

- grants exclusively provided to general law areas around the three largest cities based on their fulfilment of provincial tasks: traffic and transport; youth care;
- grants provided to 45 municipalities based on their fulfilment of regional tasks: social relief and addict care;
- grants mainly provided to 31 cities on the basis of urban problems: investment budget urban renewal; social, integration and security;
- grants provided to all municipalities, taking into account the dissimilarities in social problems which result in a relatively large share for the benefit of the larger cities: income support on the basis of the Work and Income to Labor Act (WIA); participatory budget amount (employment promotion); Sheltered Employment Act (WSW); youth and family centres.

### 14.3. Developments in the use of general and earmarked grants

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#### 14.3.1. Introduction

The Netherlands have seen new developments in the use of general as well as earmarked grants. The present section presents a survey of these changes:

- regarding general grants: the introduction of cost-orientated indicators in the municipal and provincial fund; the introduction of integration grants and of decentralisation grants as new forms of general, non-earmarked grants;
- regarding earmarked grants: a decreasing number of earmarked grants, a development towards 'wide-target' grants; the collective earmarked grant.

#### 14.3.2. General grants

The following developments have altered the features and applications of general grants.

##### *The introduction of cost-orientated indicators in the municipal and provincial fund*

An important condition of the allocation criteria is their accuracy in following the alterations in municipal financial needs, also in terms of time. A plausible connection must therefore be made between the development of financial needs on the one hand and the changes in allocation criteria caused by exogenous factors on the other.

The cost differences related to exogenous factors qualify in principle for being refunded. As 'cost drivers' they have to be expressed in indicators of the municipal fund. This does not apply to differences in costs related to policy and organisation.

The 'cost-orientated' municipal and provincial fund indicators were introduced at the end of the last century and the beginning of the present.

The introduction of this type of indicators coincided with the distinction between clusters in the municipal fund and the provincial fund (see section 2). Because the indicators were separately developed for each cluster, a strong connection has been

created between the criteria for distribution and the appropriate spending categories.

### ***The introduction of integration grants***

The integration grants are a tool to introduce extra budgets for new tasks in the municipal and provincial funds. When it is decided to add certain extra budgets to the municipal and provincial funds on a structural basis, this is often used by integration grants. This type of grants is applied when there is a lack of new and objective cost-orientated ways of allocating in the short term, or in the case of a transitional regime.

If a structural cost-orientated distribution is available, the extra budgets are distributed by means of the regular criteria of the municipal fund.

The integration grant is a general, non-earmarked grant that however uses temporary allocation criteria. When an integration grant is introduced, it must be clear at which date it has to be transformed into a regular general grant. At that date, the temporary indicators have to be transformed into structural, 'objective' allocation criteria.

In 2009, the integration grants made up around 9% of the total general grants of the municipal fund and 3% of the provincial fund.

### ***The introduction of decentralisation grants in 2008***

A decentralisation grant is introduced when the government still does not know if and when extra budgets will be added to the general grants of the municipal fund. A decentralisation grant can also be used as a policy incentive of a temporary nature.

The stimulus for decentralisation grants is to encourage the use of general, non-earmarked, grants rather than earmarked grants and comes into force the very moment a decision has been made to decentralise tasks and budgets. In the past, the use of earmarked grants was often given preference due to lack of flexibility in the use of general grants. Moreover, the introduction of decentralisation grants is connected to the government policy to reduce the number of earmarked grants (see below). Since the introduction of this type of grant, 25 decentralisation grants have

been established, making up some 1% of both the municipal and the provincial fund.

### 14.3.3. Earmarked grants

#### *Decrease in the number of earmarked grants during the last decades*

In the last couple of decades, the number of earmarked grants has decreased significantly, starting at more than 500 in 1980 and ending under 100 today. The main reduction took place between 1980 and 1998, starting at more than 500 and ending at slightly more than 100. Between 1998 and 2004, the number of earmarked grants rose again to 160.

As from 2004, the policy has been to reduce the number of earmarked grants or to cluster existing earmarked grants as much as possible into 'wide-target' grants. Starting at 160 earmarked grants in 2004, the number has been reduced to 82 in 2009. The aim is to reduce the number even further to just a few dozen.

Along with the aim to restrain the introduction of new earmarked grants, there is a rule that new grants must get explicit approval from the Council of Ministers.

#### *The significance of 'wide target' grants*

The reduction in the number of earmarked grants did not coincide with a corresponding reduction in the amount of the related allocation. The amount connected with the earmarked grants decreased more slowly, starting at around 18 billion euro in 2004/2005 and reduced to around 15 billion euro in 2009.

In most cases, existing small earmarked grants were clustered into wider ones. The number of allocated earmarked grants did not actually decrease significantly. This means that the number has been reduced in particular by creating wide target grants.

Other explanations of the reduction in the number of earmarked grants were the introduction of the abovementioned decentralisation (general) grant and the collective earmarked grant.

### ***The collective earmarked grant***

In an attempt to reduce the bureaucratic costs of numerous minor earmarked grants, the collective grant was introduced in 2008. The collective grant is a clustering by department of minor earmarked grants. Budgets covering less than 10 million euro per year become subdivisions of the collective grant.

At present, four departments use a collective grant within their fields. It is expected that there will be eight collective grants, which will make it possible to cancel 30 earmarked grants.

## **14.4. Convergence in the use of general and earmarked grants**

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### 14.4.1. Introduction

In the Netherlands, differences in the use of general and earmarked grants could be described in terms of the way of allocation and the connection to financial needs, as well as in terms of time, of conditions of spending, of the way of adaptation, of input arrangements, of the way of justification, and of the steadiness or flexibility of the adaptation. All these differences have been narrowly related to a balance on the managerial level.

The abovementioned changes in the use of general and earmarked grants, however, have led to a certain degree of convergence in the use of general and earmarked grants.

This convergence is manifesting itself in a two-way direction:

- strong relationships between the expenditures of lower-level governments paid out of general and earmarked grants;
- a convergence in the features of general and earmarked grants.

### **14.4.2. Strong relationships between the expenditures of lower-level governments financed by general and earmarked grants**

In order to establish several services, municipalities and provinces depend on both general and earmarked grants.

To give an impression of the background of this interrelationship, a couple of examples are described below.

*Large city problems (urban renewal and budgets for social, integration and security)*

The Netherlands have an earmarked grant for urban renewal. The major part of this earmarked grant (over 80%) is provided directly

to 30 municipalities and upwards. In regard to the remaining more than 400 municipalities, the remainder of the earmarked grant is paid to the provinces, which then redistribute the earmarked grants to the municipalities.

Along with this earmarked grant, municipalities also receive funds for urban renewal through the general grant from the municipal fund (as a component of cluster public housing, spatial planning and urban renewal). The same criteria apply to the general grant as to the earmarked grant. The basic assumption is thus that municipalities cover some 20% of the total costs by means of the general grant.

In the other components of the budgets for large city problems related to social aspects, integration and security, similar forms of interrelationship between general and earmarked grants exist.

Because of these interrelations and new views in politics (see section 5), the intention is to add the earmarked grants for urban renewal and for 'social, integration and security' to the general grant from the municipality fund (initially by way of an integration or decentralisation grant).

#### *Social care, public mental healthcare and addict care*

Within the services for social care, public mental healthcare and addict care, a distinction is made between local and regional tasks. Local tasks are subdivided into the general grant of the municipality fund; in particular the cluster social care is such a subdivision. All municipalities are supposed to bear such costs from the general funds.

In respect to regional tasks, some 45 municipalities receive an earmarked grant. This earmarked grant, however, is not intended to cover all costs, but only about two-thirds of the total amount of costs. The regional municipalities are supposed to bear the remaining costs out of their general grants.

As of 2010, the earmarked grant has been added to the municipal fund by way of an integration grant.

### *Public order and security*

In the case of public civil order and security (fire brigade and contingency services), most of the required funds (some 90%) are allocated through the general grant from the municipality fund (by way of the cluster public order and security). However, developments are in process to organise the fire brigade and contingency services on a regional scale. To achieve this, so-called security regions are being set up, in the form of cooperation between municipalities.

These security regions receive the remaining 10% required funds directly from the ministry of the Interior and Kingdom Relations by way of an earmarked grant. This grant has similar allocation criteria as those of the general grant of the municipality fund. Along with the earmarked grant, security regions collect contributions from the involved municipalities. The volume of these contributions varies in accordance with the division of tasks between the security regions and the municipalities.

### *Employment and income*

Municipalities receive funds for promoting employment and income support partly through two earmarked grants and partly through the general grant of the municipal fund.

The general grant is particularly intended to finance execution costs, while the earmarked grants are intended to cover the remaining costs (such as income supplements).

### *Road infrastructure and public transport*

In respect to the provision of regional roads and regional public transport, the provinces and the three general law areas (including Amsterdam, Rotterdam and The Hague) receive finances from a wide-target grant. This grant is allocated in a general sense on the basis of objective criteria and partly in the line of projects (concerning the largest projects).

Moreover, the intention is that provinces and the three general law areas contribute 50% of the investment costs for new or improved regional roads out of their own funds. As regards investments in new public transport infrastructure, their contribution is 5%.

### ***Background of interrelations between general and earmarked grants***

In addition to the above arrangements, different backgrounds of interrelations between general and earmarked grants can be identified:

- the earmarked grant is connected with regional components in the provision of services. The earmarked grant is supplementary to the general grant for local services. The supplementary earmarked grants can be directed towards all municipalities (directly or by provincial intervention), to general law areas, to the 30 to 45 largest municipalities, or to security regions);
- large city problems, which are expressed in supplementary earmarked grants ;
- historical background such as the division of roles between specific ministries (earmarked grants) and the municipal fund;
- the availability of own general funds (in particular those of provinces) for providing own contributions.

### **14.4.3. Convergence of the features of general and earmarked grants**

Besides the abovementioned interrelations in the use of general and earmarked grants, the developments described in section 3 in the use of general and earmarked grants have also resulted in convergence of features: earmarked grants are increasingly showing evidence of general grant features, and general grants are increasingly showing evidence of earmarked grant features.

#### ***General grant features of earmarked grants***

Earmarked grants show evidence of the following features of general grants:

- with respect to conditions of reporting and accountability. These conditions are more general and less earmarked, and increasingly combined with other earmarked grants (see section 5);
- with respect to conditional spending: with the broadening of the earmarked grants into wide-target grants, the degrees of freedom in ways of spending are expanding. In the case of certain earmarked grants, it is even possible to spend part of

the funds on purposes outside the scope of the grant. Along with the broadening of the grants, the lower-level governments have more possibilities for reshuffling existing expenditures within the scope of the grant;

- with respect to applied methods for the compiling of the allocation. Usually there are related ways to compile an allocation: through similar objective indicators for the allocation (urban renewal, fire brigade and contingency services) or through financial arrangements that supplement each other (social care, public mental healthcare and addict care; employment and income);
- by introduction of collective earmarked grants.

### ***Earmarked grant features of general grants***

General grants are increasingly showing evidence of some earmarked grant features. Some examples of this are listed below:

- the introduction of interrelated services clusters in the municipal and provincial funds which have their own cost-orientated indicators (see section 2);
- the introduction of highly target-orientated indicators in municipal and provincial funds, such as ‘students in special and secondary schools’, ‘the number of persons drawing benefits’ (municipal fund) or the length of provincial roads (provincial fund);
- the introduction of the integration and decentralisation grants within the municipal fund.

### ***The significance of the institutional context to restrictions in the spending of general and earmarked grants***

Restrictions in the freedom of spending are to an increasing extent provided by laws, rules, covenants and other agreements between national and local governments instead of being related to (earmarked, general) grants. This institutional context will be illustrated in the following section.

## **14.5. The changing institutional environment as a background of the convergence**

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### 14.5.1. Introduction

In the preceding section we described the convergence between general and earmarked grants. This development is connected to a changing institutional environment.

In this section the focal point is on the different aspects of this changing institutional environment as the background of the convergence:

- new views of present-day politics versus the conventional theory on the use of general and earmarked grants;
- the development that laws, rules, covenants and other agreements between national and local government provide an increasing number of implicit restrictions in the freedom of spending by local governments compared to the rules for spending general or earmarked grants;
- the incorporation of earmarked grants in the Allocation of Finances Act and the significance of periodical maintenance;
- the significance of the use of (interrelated) objective, cost-orientated indicators for general and earmarked grants;
- more equal conditions for reporting and accountability between general and earmarked grants.

### **14.5.2. New views of present-day politics versus conventional theory**

#### *Conventional theory*

According to the conventional theory concerning the choice between general and earmarked grants, the following distinction is made:

- general grants are supplied in the situation of: autonomous lower-level governments; full freedom of policy and spending; no ministerial responsibility;
- earmarked grants are supplied in the situation of: no autonomy of lower-level governments but co-governance of national and lower governments; no freedom of spending, some freedom of policy; ministerial responsibility.

***The views of present-day politics: effective lower-level governments and a reduction of executive and administrative costs***

Present-day politics have different views on the conditions of effective lower-level governments and in regard to a reduction of executive and administrative costs:

- lower-level governments are more effective when they have full responsibility and possibility to provide services. This means that even in the situation of co-governance, lower governments should have a large degree of freedom in policy and spending. The background of this way of thinking is the search for an optimal scale in the provision of services along with a proper forecast on local circumstances;
- this optimal scale in combination with a large degree of freedom in policy and spending must lead both to a reduction of the executive costs of the government and a reduction in the administrative costs of private individuals, companies and other non-governmental institutions.

The above views also imply the use of general grants beyond the use of earmarked grants, even when there is a situation of co-governance, and an intended reduction in the differences between general and earmarked grants.

**14.5.3. The significance of laws, rules, covenants and other agreements between national and local governments**

The reduction in the number of general grants and an intended convergence in the use of general and earmarked grants are also a result of the development that laws, rules, covenants and other agreements between national and local government to an increasing extent constitute the restrictions in local government spending, compared to the rules for spending earmarked grants.

These laws, rules, covenants and other agreements may also result in more and less constraints in the freedom of spending.

Examples are:

- the integration of different existing laws and other rules into one comprehensive ‘umbrella law’, which leads to a reduction of earmarked grants, the introduction of ‘wide-shaped’ earmarked grants, or the adding of earmarked grants to the general grant

of the municipal or provincial funds. Examples of such ‘umbrella laws’ are the Social Support Act (WMO) and the Work and Income to Labor Act (WWI);

- some ‘wide-target’ earmarked grants are conditional on co-financing with lower governments. Examples are the earmarked grants for traffic and transport, the investment budgets for rural areas and the earmarked grants concerning large city problems.

#### **14.5.4. The incorporation of earmarked grants in the Allocation of Finances Act and the significance of periodic maintenance**

##### ***Incorporation of earmarked grants in the Allocation of Finances Act***

Another background factor of the increasing convergence is the incorporation of earmarked grants in the Allocation of Finances Act, especially the content of article 2 of this Act.

The provisions of this article are as follows: if new central government policies result in a change of tasks or activities of lower-level governments, they are bound to provide a well-founded quantified indication of the financial implications of these changes. There is also an obligation to indicate how (by means of general grants, earmarked grants, and other ways) the financial implications can be resolved.

##### ***Periodical maintenance***

The convergence of general and earmarked grants is also a result of the system of periodical maintenance and monitoring.

The process of periodical maintenance and monitoring includes an annual scanning of the development of spending against the allocation system, occasionally supplemented by more detailed research into the background of differences between the expenditures of municipalities and the effect of the allocation system.

If relevant, this process of scanning and more detailed research is equally related to the general grants and to the relevant earmarked grants, and to the interrelation between both types of grants.

#### **14.5.5. The significance of the use of (interrelated) objective, cost-orientated indicators in general and earmarked grants**

Narrowly related to the significance of periodical maintenance, the use of (interrelated) objective, cost-orientated indicators in both general and earmarked grants has led to convergence in these two types of grants.

An important condition for the allocation criteria is their accuracy in following the alterations in municipal and provincial financial needs, also in terms of time. The more a plausible connection has been made between the development of financial needs and the changing allocation criteria (being the result of exogenous factors), the less relevant is the use of earmarked grants instead of general grants. This applies even more in combination with the views of present-day politics regarding effective lower-level governments and a reduction of executive and administrative costs.

#### **14.5.6. More equalised conditions of reporting and accountability between general and earmarked grants**

The aim to diminish governmental executive costs and the administrative costs of private individuals, companies and other non-governmental institutions has led to new arrangements in the way lower governments account for the spending and effects of earmarked grants.

Central to these new arrangements between the central government and lower governments is the principle of single information, single audit (SISA).

The principle of SISA has the following characteristics:

- the central government constrains the need for own information out of earmarked grants;
- single information: the request for information by the central government is related to the request and moments of accounting of the municipalities and provinces themselves;
- single audit: the financial control of the central government leads to the financial control of the earmarked grants by the municipalities and provinces themselves;
- once a year the municipalities and provinces send the SISA-information to the central Minister of Interior and Kingdom

Relations. In the case of collective earmarked grants, the concerned Minister is only permitted to ask the municipalities or provinces for policy information when it concerns a period of more than one year or at the end of the duration of the earmarked grant.

The principle of SISA has led to more equalised conditions of reporting and accountability between general and earmarked grants and as a result to a further convergence of the two types of grants.

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# General Grants versus Earmarked Grants Theory and Practice

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