

**Directorate for Financial, Fiscal and Enterprise Affairs  
Fiscal Affairs**

The OECD 1999 Survey on Fiscal Design Across Levels of Government

Summary Note

*Summary note prepared for the 2000 Annual Meeting of the Steering Committee on the Fiscal Decentralization Initiative, held in Budapest, on 7 and 8 February, 2000.*

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**Executive summary**

The relationship between different levels of government is one that is continually under review. Policy-makers ensure the expenditure and revenue functions of each tier of government with a view to balancing efficiency, equity and democratic considerations. Over the last decade, the tendency in a number of countries has been to decentralise both expenditure and revenue functions to lower levels of government. Greater autonomy in raising revenues has been given to intermediate and local levels of government.

Setting up of local fiscal systems and intergovernmental financial relations involves multiple and often conflicting economic and political objectives. Practically, it is one of the most complex reform processes in the area of public finance and one that is permanently on the political agenda of both OECD countries and economies in transition.

Yet there is no international, comparative set of information available to support this process. The international comparable statistics on revenue of local autonomy, or what some have called local democracy, are either lacking or insufficient.

Following up on a decision by the FDI, the OECD has initiated a survey on fiscal decentralisation in the emerging economies in Central and Eastern Europe, for the purpose of providing international comparisons on the design of fiscal systems across levels of government.

This document, together with the attached country reports, make up the annual report on the activities of 1999.

The annual report is submitted to the Steering Committee of the FDI for discussion and comment, at the 2000 Annual Meeting.

## I. Introduction - Background

In November 1997, the FDI together with the Council of Baltic Sea States held a conference in Copenhagen, Denmark. The theme of the conference was political and fiscal decentralisation in the countries around the Baltic Sea. The overall aim of the conference was to support the Baltic Sea states in contributing to a viable development of structural reforms and democracy.

In the recommendations for future initiatives, it was stated that:

*“Fiscal decentralisation and indeed local governance are to some extent perceived in various ways across Europe. This has become evident when discussing transfer of experience and know-how, and even more when collecting data material for comparative analysis.*

*At the same time, the need for uniform notion of local governance is becoming more and more evident as the Eastern European countries has undertaken considerable administrative reforms.*

*The conference suggests that the Fiscal Decentralisation Initiative should be encouraged to launch an initiative aimed at establishing a framework for comparative local government analysis. This in order to identify a set of operational indicators for assessment of the development of local self-government. Obviously, this would require a set of flexible and adaptable indicators based on internationally recognised definitions.”*

Economies in Central and Eastern Europe are carrying out a number of activities to complete local and regional government reform initiatives aiming at a decentralised political-administrative structure which will allow for the development of a strong local democracy and viable local and regional government institutions. The experience of other economies -- in CEE as well as western countries -- are invaluable sources of information on the situation of different local government systems and as a comparative basis for assessing local government development in individual countries.

Following up on the recommendations from the conference a number of pre-study activities took place in 1998. Two working seminars were held: one in Copenhagen on March 30, arranged by FDI and USAID, and one in Paris on 31 August - 1 September, arranged by the OECD, with the purpose of identifying and specifying the overall framework for the project.

In 1999 a number of further development activities took place. At an FDI seminar in Paris, 9 March, 1999, the OECD presented an overall framework paper for the project. The paper was agreed on as the general framework for the further development of the project.

During May-September 1999, the OECD developed and tested a draft questionnaire for the survey on Fiscal Design Across Levels of Governments. The test activities took place in Denmark, Hungary and Latvia.

The results of the test activities and the draft questionnaire were presented and discussed at a seminar in Budapest, 14 September 1999. The questionnaire was approved at the seminar as the basis on which future surveys would be carried out.

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The following sections present a detailed report of the activities in 1999:

- Section II presents the overall substantial framework, including concepts of subnational powers on expenditure and revenue decisions.
- Section III sets out the methodological design of the survey, together with the relevant classifications on government finance. The test results on the methodological issues are reported, too.
- Section IV summarises the substantial findings in the test reports. The full reports on the pilot activities in Denmark, Hungary and Latvia are attached as Annexes A, B and C, respectively.

The project activities in 1999 were led by Mr Leif Jensen of the OECD Fiscal Affairs Secretariat. The Ministry of the Interior, Denmark, the Ministry of Finance, Hungary and the Ministry of Finance, Latvia prepared the country reports. The National Association of Local Authorities in Denmark assisted with the preparation of the report on Latvia.

## **II. Fiscal Design across Levels of Government – General policy issues**

It is generally agreed that fiscal decentralisation results in a number of economic welfare gains. Local needs and preferences for public services are believed to be best met by local, rather than national, governments. Letting local needs for services be tested by willingness to mobilise local revenue is assumed to be the most efficient way, in terms of allocation, of organising public finance.

Seen from the national perspective central governments can re-address demands for additional public services to the subnational governments. Under the proper arrangements, the devolution of expenditures can take away local pressure on the national government's budget and stabilise public finances in general. With efficient local tax administrations the devolution of revenues to subnational governments might further enhance the likelihood of successful results in the macroeconomic fields, due to the fact that the subnational levels have had their 'basis of accountability' enhanced.

Bringing the positive political and economic effects of fiscal decentralisation into reality, however, requires a number of prerequisites.

The match between responsibility and competence within the jurisdiction of the subnational government is a fundamental condition. This means that the authorities are vested with real and powerful instruments for setting expenditure targets and making priorities within these targets, just as the revenue sources must be sufficient for covering the fiscal needs. Careful consideration of the mix of expenditure and revenue capacities that are assigned to the subnational levels is needed.

Seen from the subnational perspective, a double set of conditions has to be met. As part of the fiscal objectives, targets are set on public expenditure and general government finance. The national government must -- as the first condition -- implement measures on fiscal discipline and constraints for the subnational governments, just as the relevant mix of revenue sources must be reserved for the national government. Depriving central government of broad and powerful revenue sources and/or expenditure responsibilities structurally diminishes the scope for political manoeuvre for the government, especially in the context of regional groupings where the supranational authority constrains fiscal sovereignty.

National government must also provide subnational governments with the proper background for the local political and economic processes to be put into operation. Schemes for the equalisation of differences in tax bases and expenditure needs are just two examples. This obligation for the national government also includes

the establishment of institutional arrangements for ensuring the allocation efficiency at the subnational level. Incentives for expenditure competition between the jurisdictions, and measures for improving transparency and responsiveness of local operations vis-à-vis the constituencies, are examples in this field.

From the national perspective, the targets for macroeconomic stability and sustained growth imply a need for fiscal consolidation, including disciplined public finance, for all levels of government. This circumstance is often intensified by the economic fluctuations which characterise economies in transition. Regarding transfers, even objectively, well-founded, general transfers have a tendency to cause overspending and loss of financial responsibility. Central governments need of a degree of discretionality in setting the amount of transfers.

When designing the distribution of tax sources across levels of governments, sufficient tax instruments have to be reserved for the national governments, due to redistribution objectives, tax efficiency objectives -- the optimum exploitation of revenue sources -- and the need for financing national policy objectives and national expenditure. A number of factors should be considered when deciding which revenue sources are appropriate for subnational governments. Among factors to be avoided are: mobile tax bases; redistributive taxes; unevenly distributed tax bases; taxes subject to economies of scale; and taxes subject to cyclical fluctuations.

The design of transfers constantly needs to be evaluated in order to encourage revenue mobilisation and cost-efficiency in spending activities, at the subnational levels. For example, special and conditional grants -- with the primary objective of promoting programmes with a national interest -- may take into account measures of expenditure competition and indicators on performance.

Finally, the administrative aspects must be considered. A process of capacity-building is needed at the subnational level, since a lack of brand professionals will prevent the full benefits of fiscal decentralisation materialising, for example, the collection of devolved revenue might be lower than scheduled, endangering, at the same time, the preconditions for subnational governments and the targets for public finances. For the CEE economies in transition, this must be seen in connection with the fact that revenue collection in its present form is in its initial phase of implementation.

## **II.1 Specific design issues to address**

More specifically, fiscal decentralisation as a reform process involves a comprehensive range of considerations:

- Efficient design of fiscal decentralisation: Which functions of expenditures and sources of revenues could advantageously be devolved.
- Match between locally managed expenditures and the corresponding revenues. The acceptable level of vertical imbalance, ensuring at the same time local accountability and fulfilment of the national financial policies.
- The institutional arrangements for ensuring fiscal discipline and budgetary constraints.
- Design of the intergovernmental fiscal relations -- the balance between the need for local autonomy and the national targets on equity, and policy standards for locally provided services.
- Profile of subnational revenues -- composition of revenue base. Taxation vs. user charges.
- Profile of subnational expenditures -- local vs. national public services. National standard setting vs. subnational discretion in provision of public services.

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- The administrative design -- for optimal collection and exploitation of revenues and for cost-efficiency of the provided services.
- Arrangements promoting political accountability -- Transparency and predictability of the local political processes.

There is obvious no single or standard solution to these questions. The actual design of local finance and intergovernmental fiscal relations varies from country to country, reflecting actual decision-making processes and distributions of political power. The country's physical and political geography, and historical and cultural traditions are strong structural determinants of actual design of subnational governments' responsibilities and competencies. Not to mention the configuration of the political system per se -- fiscal decentralisation typically varies between federal and unitary political systems.

The surveys on "Fiscal Design across Levels of Government" will address the balance between the subnational and the national/federal financial interests and considerations, within the context of country-specific characteristics and features.

## II.2 The development of concepts on subnational powers in financial decision-making

A central issue in the evaluation of policies and practices on fiscal design across levels of government is the identification of subnational autonomy or discretion on expenditure and revenue affairs. In this section a framework of concepts and definitions is developed, in relation to the general government finance categories: levels of government, revenues, intergovernmental financial relations, borrowing, expenditure and finally on administrative affairs.

### **Levels of government.**

According to the OECD Revenue Statistics term

Central government includes all governmental departments, offices, establishments and other bodies, which are agencies or instruments of the central authority whose competence extends over the whole territory, apart from the administration of social security funds.

State, Provincial or Regional Government consist of intermediate units of government and includes all units of government exercising a competence independently of central government in a part of a country's territory encompassing a number of smaller localities, apart from state, provincial or regional administrations of social security funds. Intermediate units of government are at present identified in federal countries only, the revenues of regional governments in unitary countries being included with those of local governments.

Local government includes all other units of government exercising an independent competence in part of the territory of a country, apart from local administrations of social security funds. It encompasses various urban and/or rural jurisdictions (e.g., local authorities, municipalities, cities, boroughs, districts, etc.).

This classification will be followed as the general guideline for the survey on fiscal design. However, some form of clarification and specification will be sought, in order to supplement the classification. The classification might seem too general when measuring financial autonomy at the various levels of subnational governments. As an example, a clear distinction between regional, intermediate and local level is missing for unitary countries. For federal countries, the same problem exists when considering tiers below the "state level". This discussion is particularly relevant when focus is on democracy and political

development. The local level of government is naturally closest to the citizens and as such of greatest interest while the existing classification, however, primarily is representing a top-down perspective

These issues will be addressed, as part of the survey.

### **Taxes**

In the OECD classification the term ‘taxes’ is confined to compulsory, unrequited payments to general government. Taxes are unrequited in the sense that benefits provided by government to taxpayers are not normally in proportion to their payments. Data are generally reported on a cash basis, reflecting the actual amount of revenue that is available for the government in the considered period. This is different from the accrual principle where the revenues are summarised by receipts that are accrued in the period considered.

In evaluating local autonomy the essential question concerns the separation of tax revenues across levels of government. This is particularly the case for shared taxes and grants. The OECD Revenue Statistics identifies a system of “Attribution of tax revenues” with the following principles for distribution of revenue between the collecting and the beneficiary government:

“As a general guide tax revenues are attributed to non-collecting beneficiary governments:

- when they have exercised some influence or discretion over the setting of the tax or distribution of its proceeds; or
- when under provisions of the legislation they automatically and unconditionally receive a given percentage of the tax collected or arising in their territory; or
- when they receive tax revenue under legislation leaving no discretion to the collecting government.

A number of more specific rules may be set down as guidelines for the attribution of tax collection among collecting and beneficiary governments.

- The revenue of taxes is not distributed to any government other than that collecting it should be shown as tax revenue of the collecting government.
- The revenue of taxes which a government collects and unilaterally earmarks at its discretion for distribution to another government should be shown as tax revenue of the collecting government.
- The revenue of taxes which a government collects on behalf of another government with the beneficiary government unilaterally determining the amount of the tax or distribution of its proceeds, should be shown as tax revenue of the beneficiary governments.
- The revenue of taxes collected by one government and transferred to another with the amount of the tax or distribution of its proceeds decided upon jointly by both governments, or on the basis of the tax collected or arising in the territory of the beneficiary government is to be shown as tax revenue of the ultimate beneficiary government.
- If a central or regional government authorises or requires local collection of a particular tax, a part or all of which is automatically retained by the collecting government, the local share is shown as tax revenue of the collecting government.”

With the purpose of solving a number of these problems of classification the Working Party no. 2 of the Committee on Fiscal Affairs at the OECD has taken an initiative to develop a new system of classification regarding own taxes of subnational government (SNG).

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Taxes of subnational governments are subdivided into categories of decreasing tax autonomy and then ranked by decreasing order of control, that the SNG's can exercise over this revenue source:

- (a) SNG sets tax rate and tax base
- (b) SNG sets tax rate only
- (c) SNG sets tax base only
- (d) SNG sets tax base for SNG and central government tax(es)
  
- (e) revenue sharing arrangements
  - (e.1) revenue-split can only be changed with consent of SNG
  - (e.2) revenue-split fixed in legislation, may unilaterally be changed by central government
  - (e.3) revenue-split determined annually by central government as part of the budget.
- (f) central government sets rate and base of SNG tax.

The main distinction of the classification is between “a-d” on the one hand and “e-f” on the other.

By revenue sharing, the assessment and collection is undertaken by the national level of government and the distribution of the yields is made across different levels of governments on a predetermined basis. Alternative arrangements for changing the distribution can be identified -- cf. e.1 - e.3. Revenue sharing is to some extent similar to transfers -- collected tax revenue is made available for subnational governments by another level of government. Unlike transfers, however, revenues from shared taxes are traditionally of a (quasi-)permanent nature, with the entitlement to a share in the revenue set by law or even the constitution (typically federal states) and the proportion of the revenue is set as a fixed percentage.

Regardless of the specific arrangements, shared taxes weaken the political accountability of subnational governments. Governments not being allowed to set own tax rate or tax base do not have the incentive of balancing local needs and revenue mobilisation, although the extent of this weakening depends on the political process in play.

The composition of the revenues, by type. In the OECD Revenue Statistics the classification of receipts is generally governed by the base on which the tax is levied:

- Income, profits, and capital gains
- Social security contributions
- Payroll taxes
- Taxes on wealth and property
- Taxes on consumption
- Other taxes.

In the context of subnational governments taxes on personal income, property and consumption are in a number of countries considered as proper types of subnational taxes.

### **Non-tax revenues**

The IMF definition covers on a gross basis receipts of fees and charges paid in exchange for non-capital goods and services which are not of an industrial nature and receipts from departmental enterprise sales to the public whose costs are not separately identifiable. This category includes both payments in exchange for goods and services of a non-regulatory nature and compulsory payments for regulatory services. Fees and

charges out of all proportion to the cost or distribution of government services provided to the payer are classified as taxes rather than in this category.

Subnational governments often have the choice of charging users for the provision of the service. It is generally agreed that user charges represent a very favourable 'institutional characteristic' -- the charge is setting the price for the service and thus testing the local demand or need of it. On the other hand, a number of cases exists where the -- unrestricted application of -- user charges is undesirable, due to the redistributive effects and/or the merit aspects of public subnational services.

When evaluating local discretion revenues (gross and net), they will be classified according to the legal regulation on charges in relation to subnational service production. Such groups are basically:

- A. Activities where the user charge is supposed to match the expenses for the service. The net revenue of these activities must be supposed to be insignificant.
- B. Activities where the charge or the rate is calculated to cover a smaller part of the expenditures. (Services with social benefits, where subnational governments are deficit-financing -- subsidising -- the activities).
- C. Activities which aim at creating a commercial surplus for the subnational government.

For public-owned enterprises the central question is whether these enterprises operate on (forms of ) market conditions or on 'monopoly' conditions.

### **Intergovernmental financial relations**

Insofar as deficit-financing is not allowed the vertical imbalance is covered by grants from the national government.

In the IMF, Government Finance Statistics, the concept of grants covers non-repayable unrequited payments received from other governments or international institutions. Grants encompass reparations and gifts given for particular projects or programmes, for general budget support or for any other purpose. The term grants is utilised here to refer to transfers between governments or international institutions. It may include transfers of the proceeds of taxes levied by one level of government and transferred to other levels of government. This category would also include block grants, all-purpose grants or matching grants which are not given for purposes of fixed capital formation. Grants are distinguished from loans by the absence of an obligation to repay.

The Council of Europe -- Policies with regard to grants to local authorities -- has developed a set of classification on grants, in relation to local autonomy. The main distinction is between general grants and specific grants. Within each category different arrangements can be identified, related to varying policy mandates and -objectives from national government and the specific form of distribution of the grants (degree of discretionality)

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The classification is as follows:

\* **General purpose grants** are those which can be used as if they were the receiving subnational government's own tax revenues. Their use is limited only by the possible distinction between capital and current uses. Sometimes they may be of a capital nature, but they are not meant for specific investment projects for sectors. Shared taxes are not included in this category.

Specific grants, which are earmarked for certain purposes, but the amount of which is so small that they can in no case cover the local expenditure completely and which are distributed according to objective criteria are to be included under this heading.

Related to objective criteria, means grants which are distributed according to some measures of taxable capacity and/or expenditure needs. Also this heading covers grants which have historically been distributed in a certain way and in the case of which legal or administrative limits or established custom are seen as preventing governments from changing the distribution of the grant very much from year to year. Grants related to the recipient's own tax effort are not included here, but under the following heading.

Related also to own tax effort are grants related to objective criteria and to an authority's own tax effort in such a way that an increase in the level of local taxation for a given authority results in an increase in the amount of grant for that same authority.

\* **All other grants** are classified as specific grants.

Conditional grants are those where the amount of grant (seen as revenue for each authority) depends on the expenditure of that same authority. They may be typically a predetermined percentage of the authorities' own expenditure. Note that grants whose overall amount, seen as central government expenditure depends on total local spending are not for this reason to be classified as conditional.

At standard costs means that the percentage refund only covers a certain standard cost or some similar amount. If local expenditure exceeds this amount a reduced grant, or no grant at all, is given.

At actual costs, no limit as to standard costs or the like exists. Note that this included 100 per cent grants. Sometimes such a 100 per cent grant is given because the local authority acts only as an administrative agent carrying out a precisely defined function on behalf of central government.

Under the heading of discretionary grants are included grants which the government may or may not distribute, and which are distributed at the discretion of the government according to the particular circumstances of the authority in question. Normally, there would be no general criteria for the distribution of such grants.

The indicators are summarised in [Table II.1](#)

**Table II.1. Classification of grants**

Country	Level of government	Specific Grants				General Purpose Grant		Total
		Capital	Current or both		Objective criteria			
			Standard costs	Actual Costs	Not conditional	Without own tax effort	With own tax effort	

It should be noted that design of grants arrangements as an instrument of national policy setting must be evaluated closely together with assignment of expenditures. Instead of using specific grants or discretionary grants national governments might obtain the same objectives by setting standards for local services or through other means. Cf. sections on expenditures below.

### **Borrowing**

Borrowing for financing investment outlays has certain advantages as a method of subnational finance. Subnational governments normally have limited fiscal capacity. Distributing the costs of the capital investments over a number of years imply that the taxpayers benefiting from the services are 'fairly' contributing, year by year.

The central issue is the national governments regulation on borrowing -- Regulation on purpose (current expenditures and/or capital installations), on criteria and control mechanisms, on admission to alternative structures of loan-raising, etc.

Key design questions on local autonomy regarding borrowing are:

#### \* Legal restrictions

- Authorisation by central government, provincial government or other bodies?
- Purpose and scope. Current expenditures? Capital installations? Restricted to specific sectors?
- Guidelines/restrictions on terms of loans. The form of redemption, the interest pattern, the term, annuity vs. serial loans, etc.
- Admission to loan markets? National and/or abroad? Special municipal finance institutions?
- Provision of security. National liability? State/provincial guarantees?

#### \* Measures for national control on subnational governments with financial problems

- Supervisory administration: Forms of bailouts for governments in economic crisis?, Can local governments go bankrupt?
- Tax increase? Moratorium? Etc.

#### \* Figures on borrowing and debt by subnational governments

## Summary Note

- For each year: gross and net long-term borrowing; gross and net short-term borrowing; capital revenue, including proceeds from the sale of assets.
- For the end of latest year: long-term debt; short-term debt; and financial assets.

### Expenditures

In the preceding sections, a number of indicators on fiscal design have been described in relation to revenues of subnational governments. Strong local revenue performance probably tends to be positively correlated with local discretion in control of expenditures, but no such relation can be taken for granted.

Similarly, it may be assumed that a large share of subnational government in total government spending is associated with decentralised responsibilities and competencies. Such a relationship can, however, not be assumed to exist automatically or proportionally, since “share of expenditures” not per se is equivalent to local control and responsibility.

Indicators on subnational vs. national control over subnationally executed expenditures must be based on descriptions of the political and administrative framework for the local services, sector by sector.

A first general overview of these conditions can be arranged within the following two headings. To be comparable, however, the descriptions need to be developed specifically for each sector of subnational activities: Public transportation, refuse collection, local libraries, fire fighting, primary education, public health and hospitals as examples. (Cf. also [Table II.2](#))

**Table II.2. General framework for sector -  
specific descriptions of local discretion in providing public services**

	<b>Subnational discretion</b>	<b>National control</b>
<b>Arranging the service – Policy formulation</b>	<ul style="list-style-type: none"> <li>• Admission to set level of and composition of services ?</li> <li>• Discretion in contracting goods and services</li> </ul>	<ul style="list-style-type: none"> <li>• Mandated activities: Rules and standard setting for coverage and service levels. General or specific orientation.</li> <li>• Budget co-operation: Setting general budget frames or specification on targets/sectors.</li> </ul>
<b>Provision of the services</b>	<ul style="list-style-type: none"> <li>• Clearly delineated responsibilities, in relation to other tiers of government</li> <li>• Ownership of enterprises</li> <li>• Discretion in recruitment and pay of personnel</li> <li>• Admission to negotiate agreements and settlements on wages and employment conditions.</li> </ul>	<ul style="list-style-type: none"> <li>• Control by performance- or input indicators</li> <li>• Design of expenditure competitions: Mechanisms for outsourcing, for example.</li> <li>• Rules of economic management: Standardisation of budget- and accounting system, as an example.</li> </ul>

### **Subnational administration and accountability**

As mentioned the subnational administrative capacity and subnational governments accountability vis-à-vis their constituencies make two main prerequisites for the positive outcome of the devolution of spending responsibilities and revenue sources to subnational levels.

Design issues to be addressed will be:

- Identification of the measures taken to ensure the appropriate administrative structures and capacities.
- Measures for fiscal transparency: Public information on government fiscal decisions and activities.
- External, independent control -- Auditing and similar procedures.
- Systematic measures for public participation in the delivery of the services, including client surveys.
- Measures from central government to encourage to administrative development for leaning the services -- Self-regulatory mechanisms and market testing of the services, as two examples.

### **III. Questionnaire for the survey on fiscal design – Methodological issues.**

Following the identification of the substantial framework for the presentation and evaluation of fiscal design across levels of government, a draft questionnaire was developed. This section presents the methodological aspects of the questionnaire and the test results from the three pilot countries.

#### **III.1 The overall design of the questionnaire**

The specific design and arrangements of subnational finance and intergovernmental financial relations, across countries, are set up on two ‘levels’:

- Level 1: Basic government finance statistics for the subnational levels, covering comparative figures on subnational government revenue, including grants and expenditure. The figures will be based on existing international definitions and classifications.
- Level 2: Qualitative country statements on the specific mode of subnational financial decision-making. If possible, alternative indicators of local discretion and autonomy and classifications, which are different from the Level 1 figures, will be given.

The framework required for international comparisons on fiscal design is established through these two dimensions – the consolidated database on fundamental characteristics of local finance and intergovernmental financial relations, and the qualitative, policy-oriented statements on local autonomy.

The two levels are also reflected in the layout of the questionnaire. Each of the five groupings of subnational financial activities – expenditure, tax revenue, non-tax revenue, grants and borrowing – is to be described in relation to both basic statistical classifications and qualitative evaluations on levels of subnational discretion in financial decision-making.

This data structure aims at improving existing international statistics on subnational government finance in a number of ways.

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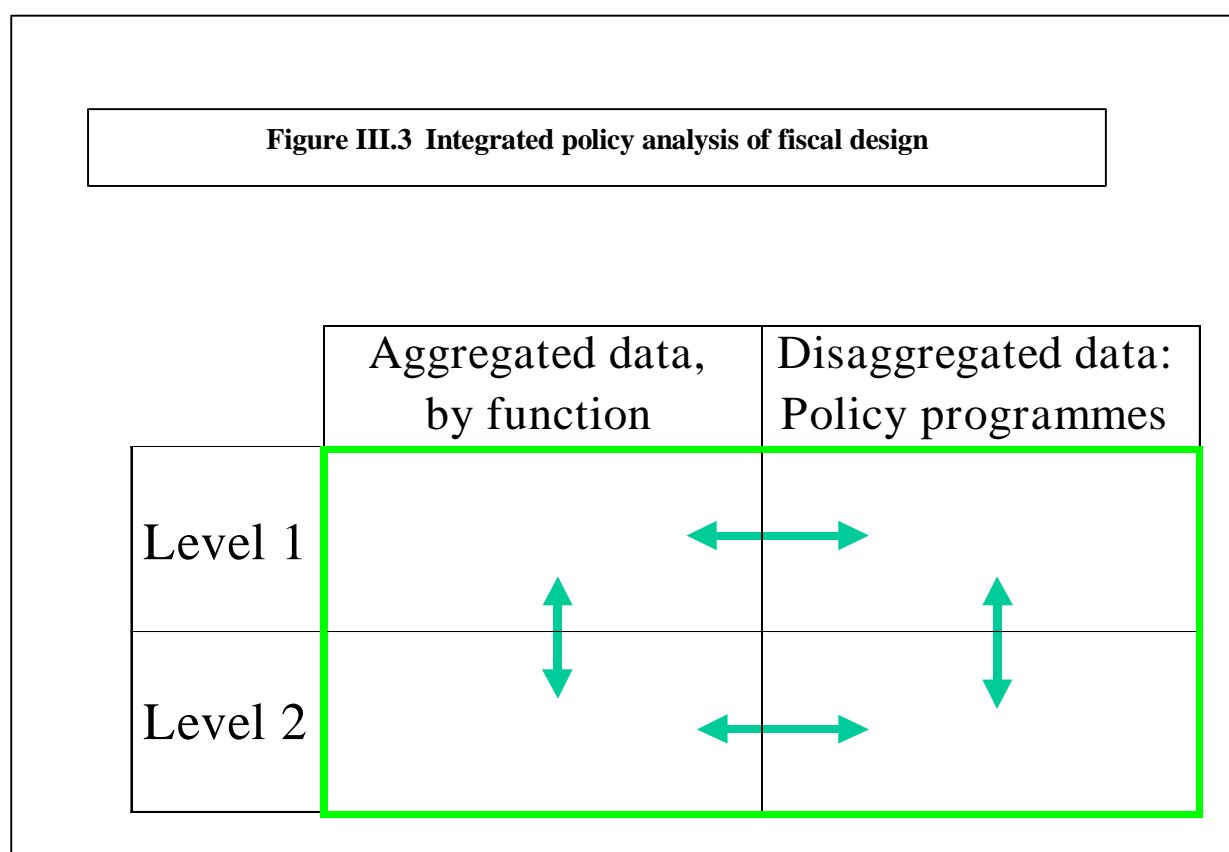
Firstly, data at Level 1 will be divided into additional levels of government with a view to presenting data for federal and unitary states on at least the following similar levels: regional/intermediate, local, and subspecification if relevant. Urban areas/the capital area is an example. The basic structure is illustrated in Figure III.1.

<b>Figure III.1 Level 1 – Finance statistics by levels of government</b>			
	<u>Subnational levels</u>		
	(Regional?)	(Capital/Urban areas?)	(Local?)
<ul style="list-style-type: none"> <li>• Expenditure</li> <li>• Tax revenue</li> <li>• Non-tax revenue</li> <li>• Grants</li> <li>• Capital expenditure and revenue</li> </ul>			

Secondly, the aim is to expand and improve the functional distribution of government finance data at Level 1, compared to existing international statistics. By identifying expenditure and revenue by function, issues on subnational finance and intergovernmental financial relations can be addressed in a comprehensive, policy sector perspective. In relation to main subnational policy domains, such as education, health, and social services, integrated information will be given on expenditure, revenue and discretion in subnational financial decision-making. This analytical objective is illustrated in Figure III.2.

<b>Figure III.2 Level 1 - Finance categories by policy programme</b>			
			Local
• Expenditure			4. Education 4.1 Primary
• Tax revenue			
• Non-tax			4. Education 4.1 Primary
• Grants			4. Education 4.1 Primary
• Capital and revenue			4. Education 4.1 Primary

Finally, it is aimed to present a dynamic relationship between levels 1 and 2. Level 1 will constitute the fundamental statistical base of knowledge through the stable figures on subnational government finance, whilst Level 2 will represent relevant policy topics on fiscal reform, which will be selected for analysis and evaluation from year to year. This means that the description and analysis of Level 2 will tend to deal with more disaggregated and detailed data than for Level 1. This dynamic perspective is illustrated in Figure III.3.



### III. 2 Definitions - Subnational finance statistics (Level 1). Levels of government

In setting up the framework of definitions and classifications, the main purpose has been to be in a position to identify subnational payments and receipts on as disaggregated a basis as possible. Consequently, the framework had to be based on two sets of classification systems: the IMF classifications are preferred when setting up classifications on expenditure, non-tax revenue and grants, whilst tax revenue is based on the OECD definitions and classifications. It has also been considered necessary to draw on both sets of classifications for practical reasons, since a number of countries in this survey will report data to the IMF but not to the OECD.

Generally speaking, the OECD statistical publications on Annual National Accounts and Revenue Statistics, and the IMF Statistics on Government Finance are all formulated within the same conceptual framework as the United Nations, A System of National Accounts (SNA). The latest version of SNA (1993) was revised jointly by the United Nations, the IMF, the World Bank, the EU Commission (EUROSTAT) and the OECD.

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The relevant definitions and classifications are stated in the following publications: the IMF, [A Manual on Government Finance Statistics 1986](#) (GFS) and the OECD, [Revenue Statistics 1965-97](#).

As far as tax revenue is concerned, the IMF definitions and classifications are consistent with those of the OECD, cf. [Revenue Statistics](#), Part II, VII. In relation to expenditure, non-tax revenue, grants and accounts on capital items, the general classifications of the OECD National Accounts (based on SNA93) and the IMF Government Finance Statistics are identical, although the actual reported data may differ due to differences in the accounting bases of the two systems.

### **III.2.1 Activities and institutions constituting “general government”**

According to the GFS Manual,

*“The principal function of government is to carry out public policy through the production of non-market services primarily for collective consumption and the transfer of income, financed mainly by compulsory levies on units in other sectors. Thus government performs primarily the functions of supplying public goods and services and fulfilling certain public purposes not for commercial or financial reasons, or, if of a commercial or financial nature, not on a major basis or not primarily for a profit.”*

This functional definition indicates that units or institutions (public enterprises) selling industrial or commercial services or goods to the public on a large scale or a corporate one, fall outside the general government classification. However, a number of borderline cases arise when government institutions perform, in addition to principal functions, minor, subsidiary functions, which are in character primarily commercial. Examples of such activities include departmental enterprises, and the sale of goods and services, which are regulatory in nature.

### **III.2.2 Levels of government**

In the GFS Manual, subnational governments are defined as follows:

**State, provincial and regional governments** are,

*“...governmental units exercising a competence independently of central government in a part of a country’s territory encompassing a number of smaller localities”*

**Local governments,**

*“...consist of governmental units exercising an independent competence in the various urban and/or rural jurisdictions of a country’s territory”.*

In filling in the questionnaire, it is necessary to ascertain whether the separate levels of government can be considered to exist – whether they have sufficient discretion in the management of their own affairs to distinguish them as separate from the administrative structure of another government.

The Manual set up the following negatively-defined criteria for identifying separate tiers of government activities:

*“A dependent government of some broader governmental unit exists where:*

- They depend for all or a substantial portion of their revenue on appropriations or allocations made at the discretion of another government.*
- They lack their own officers.*
- They must submit budget estimates to another governmental entity which may in turn raise or lower the submitted estimates. A separate existence is not precluded, however, by review of budgets by agencies of higher levels of government or review of government budgets in connection with administration of tax limitations imposed by another level of government.*
- Important aspects of their administration are controlled by another governmental entity (e.g. requirements for approval of plans and sites, approval of contracts, supervision of personnel administration, determination of scope and scale of activities and the like). Supervision by a higher level of government is to be distinguished from control by higher levels.”*

Within these criteria, however, a range of subnational governments may exist in each country, expressed by variations in functional responsibilities, economic resources and the size of the governments. Considering each level of government – regional and local levels – a number of different governments may, in this way, exist at the same horizontal level and they may be vertically connected by supervisory arrangements and tax-sharing or grants systems.

The measurement of local financial discretion and the comparisons of fiscal design between countries will clearly benefit from some further specification of subnational governments within the present main classification of regional and local governments. Such identification of sub-levels of government shall naturally be considered in relation to the availability and validity of data.

### **Test results of the definitions of subnational finance and level of government**

*Units of government.* As mentioned in Section III.2.1, the functional definition of government units implies that the primary interest is focused on units which *“carry out public policy through the production of non-market services primarily for collective consumption, and the transfer of income, financed mainly by compulsory levies on units in other sectors”*.

The identification of general government units did not seem to be problematic for the three test countries.

Some borderline problems were, however, identified between government units and units in other sectors. The organisation of public services may differ from country to country just as a number of services, traditionally considered as public policy services, are, to an increasing extent, organised as public enterprises or even outsourced for production in private enterprises. In this context, the Danish test report highlights the issues of the provision of public utility services (the supply of water, gas, and environmental services, for example). They are organised as local public enterprises (often as partnerships with other local authorities), independently of the local Councils in matters of business. Rates for the utilities match expenditure. The Danish report shows that public utility services ‘account for’ approximately 10% of current gross expenditure and revenue; charges, counted as non-tax revenues, make up almost three times the amount accrued from other sources of non-tax revenue.

Similar issues on the borderline units may be identified in Hungary and Latvia. Some services, including social services, are prepared by public enterprises and the links to the local governments – on the political

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lead of the services and on budget/account issues - may not seem quite clear. In the Hungarian report, it is noted that no reporting to central government takes place on these issues.

At the Budapest seminar, these issues on extra-budget activities and local public enterprises/non-financial corporate and non-corporate enterprise sectors were noted. It was agreed to stay within the classification of general government units, as set out in the draft questionnaire. The main reason for this is to ensure comparable data across countries by focusing on the same main public functions/general government units. Furthermore, a number of data reliability and validity problems seem to exist. For economies in transition, a reform of the budget and accounting principles may be needed before data reach the standards and availability needed for international comparative tables.

The Budapest seminar also discussed the possibility of initiating further studies on these topics, which apparently cover some (major) characteristic features of local government, across countries.

*Levels of government.* The three test countries have divided data across the following subnational tiers:

- Denmark identifies two tiers: regional and local government. The capital city authorities have the status of both regional and local governments but, for a mixture of reasons, it has been more convenient to classify them as local governments.
- Hungary identifies one tier: local government. No regional government can be identified according to the classifications. For the local governments, however, obligatory tasks differ between community, county and metropolitan governments. From a technical point of view, the division of data across the sub-categories of local government is possible. In the design of the country reporting it was, however, decided not to divide data further, due to problems this would create with consolidation between the governments at the horizontal level.
- Latvia identifies three tiers of subnational government: rural municipalities and towns, local urban governments (big cities) and regional governments. The regions were considered to constitute a separate tier of government, according to the classifications: own separate and independent budgets, with an indirectly elected political Council and nearly 100% financed by state grants.

As mentioned in the draft questionnaire, the design of the country reporting on levels of government should be decided by considering two opposing goals: a) Evaluation of local discretion on financial decision-making will be enhanced by data split across the highest relevant number of government tiers, versus b) The technical and practical problems of the resulting data reporting. For example, expanding the number of reported tiers from one to two results in a 100% increase in the reported figures and tables.

At the Budapest seminar, it was agreed to keep the original intention as set out in the draft questionnaire: to distribute data across as many tiers of government as relevant and meaningful. The flexibility in the country design of the reporting seems helpful: for reasons of comparison across countries, data might be aggregated – from three subnational levels to two– while keeping the additional information obtained by the three-level reporting available for other analysis.

For the permanent surveys restricting the number of reported tiers to two levels, regional and local government might be considered.

### **III.2.3 Level 1 data: government finance data at the subnational levels. Expenditure**

In the table templates, expenditures are distributed by function and economic category.

**Expenditures by function.** The expenditures are characterised by the traditional COFOG classification from the System of National Accounts, and used by the OECD in the Annual National Accounts, and by the IMF in the Government Finance Statistics. The 14 major groups of function may be broken down into subgroups, reflecting the means or programmes by which the general objectives of government are implemented. Such 2- or 3-digit classifications would be able to report data by level of policy programme or subprogramme. (Cf. Figure III.2-3.)

When completing the standard templates the countries were asked to report the data figures on as disaggregated a level of function as possible, according to data availability and validity.

As a guideline, the most significant fields of expenditure for the level of government in question should preferably be broken down into the functional level of “subgroup”/the level of policy programme. This indicates that a minimum of 6-8 disaggregated functions should be presented.

With a view to providing an introductory overview of the general distribution of responsibilities and powers across levels of government, the countries were asked to include a written description which takes into account the legal basis for the subnational activities. The presentation was to be based on aspects such as:

- Which level is competent. Overall competence / competence shared with other levels.
- General indications on competence e.g. direct or indirect exercise of responsibility; mandated vs. ‘omnipresent’ competence.

### **Test results in relation to the definitions and classification of expenditure**

*The disaggregation of data by function* is set up in the test reports as follows:

- Denmark has set up the Table on Actual status on legal framework in a 2-digit version (identifying, for example: “4.2 Preliminary and primary education affairs and services” and “4.2 Secondary education affairs and services”). The same level of 2-digit functional classification is also used in the tables on expenditure figures. For illustrative purposes, the legal framework is also presented in a 3-digit version, which means, for example, that information for secondary education is given on levels “4.2.1 General programs” and “4.2.2 Vocational programs”. Data were not, however, available at such a disaggregated level, and there was no reporting.
- Hungary gives a 2-digit classification in all tables on legal status and expenditure functions. The classification is sought to present data in policy sectors where local government has a major part of the overall government expenditure.
- Latvia reported data on the general classification of the 14 main sectors (1-digit). In an Annex to the questionnaire, the legal status is broken down into further levels of policy programme and subprogramme. Sub-legal breakdown ought, however, to be supported by data figures reported at the same levels of disaggregation. This was, unfortunately, not possible in Latvia.

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As recalled the main purpose of asking for a detailed breakdown of data on functions – at least trying to present 6-8 main policy programmes at the subnational levels - was to prepare a basis for analysing and evaluating local government discretion in financial decision-making, policy sector by policy sector. (Cf. Table III.2) The test reports show that the 2-digit classification seems sufficient for this purpose, provided that the legal status and the data figures are both reported at this level. In order to avoid too large a set of information and data, a restriction on identifying the 6-8 main policy sectors might be recommended in further surveys.

As part of the test activities, special attention was paid to the questions on *consolidation*. In the evaluation of the proportion of regional and local government expenditure as part of the total general government sector, it is necessary to have consolidated figures for the government system as a whole and for each part of the system. More specifically:

- the consolidation of governments at each level means that intragovernmental transactions are eliminated. For example, transfers between regional governments should only be accounted for by the government who bears the actual expense.
- the consolidation of governments between levels of government means that intergovernmental transactions are eliminated.

It is generally recognised that the complete elimination of ‘double accounting’ is almost impossible. There has to be a relatively pragmatic approach to the issue by seeking to eliminate the substantial parts of the relevant transactions. Generally, it is advised that a number of summary tables be set up, enabling a final cross check of the figures.

During the Budapest seminar discussions on these issues, it was agreed that data in the questionnaire should be kept as gross figures. Figures in the questionnaire on expenditure are meant to show which tier of government is actually “carrying out the tasks”, whilst the identification of “who is carrying the burden” – the financing of the activities– is described by the other indicators (tax revenues, grants, etc). Consequently, figures on expenditure are reported with conditional grants from the central level (and if relevant, also the state/regional level) included for the beneficiary tier (regional/state and local levels) but ‘netted out’ at the central (and regional/state) level.

In order to help with the consolidation of overall government figures, it was agreed to include a number of additional tables in coming surveys, covering: “Data on total revenue, grants and expenditure of General Government, Central Government and all levels of Local Government”; “Consolidated data on revenue and expenditure of General Government, Central Government and Local Government”; “Total revenue and expenditure of subnational governments” and “Consolidated revenue and expenditure of subnational governments”.

In the Danish test report, the consolidation is carried out covering the consolidation both within each level of government and between levels. However, a number of problems seem to exist in the Danish case since the consolidated figures do not add up to the expected balance between expenditure and revenue for each level of government. For further cross checking of the overall figures, a table with the balanced figures has been added to the Danish report.

In the Latvian and Hungarian reports, consolidation of Table 3.2, on the total general government sector, has concentrated on eliminating transactions between levels of government.

### III.2.4 Level 1 data: government finance data at the subnational levels. Categories of revenue.

#### Tax revenue

The classification of tax revenues is governed by **the base on which the tax is levied**. In the OECD Revenue Statistics, the following main groups are identified:

- Income, profits, and capital gains
- Social security contributions
- Payroll taxes
- Taxes on wealth and property
- Taxes on consumption
- Other taxes.

In the test reports, the main groupings were broken down into a 4-digit classification based on the definitions in the OECD Revenue Statistics, part II. It should be noted that the OECD classification is more disaggregated than the IMF's GFS classification. For a comparative list see part II, section J, in Revenue Statistics.

In identifying **own taxes of subnational governments**, their revenue is subdivided into categories of decreasing tax autonomy and then ranked by decreasing order of control that the subnational governments (SNG's) can exercise over this revenue source:

- (a) SNG sets tax rate and tax base
- (b) SNG sets tax rate only
- (c) SNG sets tax base only
- (d) SNG sets tax base for SNG and central government tax(es)
- (e) revenue sharing arrangements
  - (e.1) revenue-split can only be changed with consent of SNG
  - (e.2) revenue-split fixed in legislation, may unilaterally be changed by central government
  - (e.3) revenue-split determined annually by central government as part of the budget.
- (f) central government sets rate and base of SNG tax.

#### Test results on tax revenue

All three test reports include completed tables on tax autonomy and type of tax. None of the test countries indicated that their completion caused any major problems. Hungary mentions that the categories of e.3 and f seem to overlap somewhat. In the Danish report, category b. (SNG sets tax rate only) is supplemented with a note on actual limitations to local decision-making.

#### Non-tax revenue

The **classification of non-tax revenue** is determined by the nature of the base on which the tax is levied, or the kind of action which creates the liability, for example sale or income:

- Entrepreneurial and property income
  - Cash operating surpluses of departmental enterprise sales to the public with a surplus
  - From non-financial public enterprises and public financial institutions
  - Other property income

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- Administrative fees and charges
- Fines and forfeits
- Contributions to government employee pensions and welfare funds within government
  - Employees
  - Employer contributions from other levels of government
- Other non-tax revenues

As seen from the classification, a number of economic relations to non-government activities are included. An Annex to the questionnaire provided a further classification of institutions (departmental enterprises and public enterprises) and the registration of the economic relations in connection with these organisations.

Finally, the reporting countries were asked to distribute the non-tax revenues using the COFOG classification on functions.

### **Test results on non-tax revenue**

In relation to the requested information, the country reports are distributed as follows:

- All three countries reported non-tax revenue by the specified economic categories.
- Non-tax revenue by function was reported by Denmark and Hungary, whilst Latvia lacked the data to be able to provide this information.
- Non-tax revenue from public enterprises (in the form of “percentage of profits made by municipal enterprises”) is reported in the Latvian case, whilst Hungary and Denmark do not have or do not report such information. For Hungary, it is noted that “only revenues directly collected by the local governments or its institutions ...” are reported. In the Danish report, the revenues of the local public enterprises are shown in separate figures, to indicate the volume of gross revenues pertaining to these institutions.
- For Hungary and Latvia, attention is specifically called to the interrelations with central government. Fees and charges in connection with local governments carrying out administrative tasks for central government do not, therefore, constitute a problem of classification. In the Latvian case, however, some kind of tax sharing arrangement seems to exist in the form of “percentages of state duties”. Such fees are not reported in the reports from the other two countries.

As mentioned in section III.2.2 on “units of government”, some further elaboration on the budget and accounting systems in relation to activities taking place in the borderline areas of local government may be needed. Further to this, it is the general impression from the test reports that data on non-tax revenues may be less valid and reliable than data on other categories of local finance and intergovernmental fiscal relations.

## Grants

In the questionnaire, only grants received from other levels of national government were considered.

*Classification of grants in relation to local autonomy.* The main distinction is between general grants and specific grants. Within each category, different arrangements can be identified, related to varying policy mandates and objectives from national government and the specific form of distribution of the grants (degree of discretionality).

The test countries were asked to report according to the classification outlined in section IV.2 (above): general and specific grants, by sub-categories of levels of discretion, and for specific grants, by function.

**The test reports indicate that:**

- All three countries are able to divide the grants according to the classification and by function.
- Latvia identifies some problems with the classification of specific grants by standard or actual costs: for grants to Rural Authorities and Towns, this means that approximately 25% of grants remain unreported in the tables; and “investment grants” are reported as current grants. A better solution would probably have been to classify them as capital grants. Since the investment grants are reported separately, adjustment is possible for comparative purposes.
- In the Hungarian report, the standard classification is supplemented by a general (and alternative) presentation of the system of grants. The Hungarian system of local finance, including the grants system, is still under formation and a rough classification as suggested in the questionnaire might involve some misinterpretation of the actual situation, for example, most of the Hungarian grants are classified as general grants since “local governments are free to decide on the use of these grants” whilst the related allocation of general grants is “based on the number of those benefiting from, and commensurate with, local government services on schools, hospitals, etc.”.

### III.2.5 Capital accounts -- Borrowing

**Capital expenditure.** Capital expenditures are payments for the acquisition of fixed capital assets, strategic or emergency stocks, land, or intangible assets, or unrequited payments for the purpose of permitting the recipients to acquire such assets, compensating the recipients for damage or destruction of capital assets, or increasing the financial capital of the receipts.

#### *Subgroups of capital expenditure*

Acquisition of fixed capital assets. This category covers payments for purchase in the market, or for production within government, of new or existing durable goods to be used for non-military, productive purposes. It encompasses only expenditure for goods with both normal lives of more than one year and more than a minimum significant value.

Purchases of stocks. This category covers payments for the purchase of strategic and emergency stocks, stocks purchased by market regulatory organisations within government, and stocks of grain and other commodities of special importance to the government.

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Purchases of land and intangible assets. This category includes payments for the purchase of land, forests, inland waters, and subsoil deposits, but not structures or construction works situated thereon.

Capital transfers to other levels of national government. Capital transfers consist of unrequited government payments, neither generating nor extinguishing a financial claim, made for the purpose of permitting the recipients to acquire capital assets, compensating the recipients for damage or destruction of capital assets, or increasing the financial capital of the recipients. General purpose grants, used for current and capital purposes, should be shown as current grants.

### Capital revenue

Sales of fixed capital assets. This category covers government sales of fixed capital assets including residential and non-residential buildings and other construction, transport equipment, machinery, and other equipment.

Sales of stocks. Included here are government sales of stocks of strategic materials, emergency stocks, and stabilisation stocks sold by market regulatory organisations within government, that is unincorporated organisations without large-scale sales to the public, and stocks, grains and other commodities of special importance to the government.

Sales of land and intangible assets. Sales of land, forests, inland waters, and subsoil deposits but not structures or similar construction works situated thereon.

Capital grants from other levels of government. This heading covers grants made for the purpose of paying for the acquisition or construction of new or existing durable goods with a normal life of more than one year and more than a minimum significant value, to be used for non-military, productive purposes. This would thus include grants for the construction of roads, dams, irrigation work, hospitals, schools, stadiums, cultural or recreational centres, or other buildings, or the acquisition of other capital equipment.

**Borrowing for capital purposes.** A government's borrowing activities may include a number of financial transactions seeking to cover the financing of its general activities. In this survey, only long-term borrowing, on the capital markets as opposed to the money markets, is considered. The length of the loans sets the operational distinction between the two markets. Loans for more than one year are taken up in the capital markets, whilst transactions for less than one year are handled in the money markets.

### Test results in relation to capital expenditure, revenue and borrowing

- All three countries reported capital figures by the requested categories on expenditure, revenue and borrowing.
- Only Hungary distributed the capital accounts by function. In the Danish report, it is stated that “Due to the rules concerning borrowing, it is not possible to allocate to different expenditure categories”. The Latvian report mentions problems with the statistical procedures.
- Both Hungary and Latvia report problems with distributing borrowing figures by capital or current purposes. Latvia reports figures on total borrowing, including capital borrowing. In the Hungarian report, it is noted that the subnational governments traditionally operate with one, consolidated fund, which means that borrowing operations for development or capital purposes may be difficult to distinguish from borrowing for current finance purposes. Consequently,

Hungary presents its total borrowing, including for capital purposes, differently from the two other countries: two separate boxes were prepared (see Boxes 7.3 and 7.4 in Annex B).

#### **IV. Substantial findings in the pilot reports**

With a view to demonstrating the scope and magnitude of the questionnaire, a number of substantial results from the three test reports are presented in this section. This presentation gives an indication of which part of the questionnaire is well-targeted for identifying central questions on fiscal design across levels of government.

Selected figures on local government have been summarised in relation to two main aspects: current expenditure and current revenue. The reported figures on regional government are not discussed. The Latvian figures on “Rural Authorities and Towns” and “Capital or Urban Areas” have been added together to give figures on “local government”. The figures in the tables have been taken from the country reports (Annexes A – C) - when this is not the case, the source has been indicated.

The main purpose of the country reports was to test and discuss methodological issues of the draft questionnaire. For a number of reasons, the following presentation does not give the complete background for comparing the fiscal design of local governments in the three countries. The figures are, to some extent, incomplete, due to the above-mentioned problems on consolidation and ‘units of government’. Furthermore, the figures are reported for just one year. Cyclical movements, and extraordinary events and decisions may be represented in the figures and, as such, disrupt the more structural and long-term elements. Finally, the three test countries may not constitute the ‘best choice’ for comparative purposes: Denmark has a consolidated design of intergovernmental financial relations, developed throughout decades, whilst Hungary and Latvia are emerging economies with a number of large design decisions still to be taken.

#### IV.1 Expenditure design

**Table IV.1** Current local government expenditure by function, as a percentage (A) and as share (B) of general government expenditure

		Denmark		Hungary		Latvia	
		A	B	A	B	A	B
1	General public services	6.4	25.2	13.4	43.2	11.4	21.1
2	Defence		-	0.1	0.3	0.2	0.6
3	Public order & safety	0.5	8.5	1.0	6.2	1.7	5.5
4	Education	18.8	42.9	32.4	48.3	47.2	60.9
5	Health	3.1	10.0	19.9	28.8	1.4	2.7
6	Social Security & Welfare	56.4	44.2	14.8	9.6	7.6	4.3
7	Housing & community amenities	0.6	14.6	7.9	92.4	13.2	69.0
8	Recreational, cultural & religious affairs	4.6	53.5	4.3	28.3	5.3	37.8
9	Fuel & energy	-			-	0.3	66.4
10	Agriculture, forestry, fishing & hunting	0.1	4.8	0.8	5.3	0.1	0.1
11	Mining, manufacturing & construction, except fuel & energy	0.1	12.0	0.1	11.7		
12	Transportation & communication	4.6	33.4	1.3	9.1	6.7	19.8
13	Other economic affairs	3.3	29.6	2.1	19.0	0.3	6.5
14	Other functions	1.5	3.9	2.1	2.3	4.5	8.5
15	<b>Total</b>	100.0	30.9	100.0	19.9	100.0	18.1
	Current total government expenditure. Consolidated % of GDP	51.9		56.4		44.9	
	Current local government expenditure. % of GDP	16.1		11.2		8.1	

*Source:* Figures on GDP: OECD, National Accounts. For the Latvian figures on GDP: Statistical Yearbook of Latvia, 1999, CSB of Latvia, 1999.

The size of the local government sector – taken as a proportion of GDP – varies considerably between the countries. In Latvia, the expenditure amounts to 8% of GDP, in Hungary 11% and in Denmark 16% i.e. twice as large as in Latvia. The proportion of total government expenditure of which local authorities dispose, follows the same pattern across the three countries: in Denmark, the local government has a share of 31%, compared to 18-20 % in Hungary and Latvia.

Local government expenditure as a proportion of total expenditure, by policy sector, gives some interesting results. “Education” is, to a large extent, decentralised in all three countries: in Latvia, local governments account for 61% of overall government expenditure, in Denmark and Hungary, the share is 43% and 48%, respectively. At the same time, “Education” accounts for a large share of the local budgets: from approximately 20% in Denmark to almost 50% in Hungary and Latvia. It is quite a different situation for “Social Security and Welfare”: in Denmark, local government accounts for 44% of the total government expenditure, and this policy field is by far the greatest local sector, making up 56% of the local current budget. In Hungary and Latvia, the share of the overall government expenditure is 10% and 4%, respectively. “Housing and community amenities” gives the opposite picture: local government in Hungary and Latvia is the main tier of government in this field, with shares of total expenditure of 92% and 69%, respectively. The policy sector as such, however, is not that dominant, accounting for 8% in Hungary and

13% in Latvia of the overall budget. As a final example, Hungarian local government plays a major role in the health sector, unlike the situation in Denmark and Latvia. To some extent, this is due to the absence of a regional tier in Hungary's public sector.

In the test questionnaire the countries were also asked to evaluate discretion in local expenditure decision-making. The summary presentation is given in relation to the major design issues which were behind the specific questions in the questionnaire:

*Clarity in the expenditure assignment*

As indicated in Table 3.1 in the test reports, all three countries report on overlapping and shared tasks between the tiers of governments. However, this apparent similarity covers very different situations in the three countries. Hungary and Latvia report a number of outstanding problems/issues which constitute a major obstacle in ensuring overall efficiency and local political accountability.

In Latvia, local governments are carrying out compulsory tasks (of a permanent or temporary nature) and voluntary tasks. The allocation of tasks is often not explicitly allocated to a particular level of government, since the sector law only states that "...self-governments are responsible for the implementation of certain tasks." (Annex C, p.7). To this can be added, that "In general there are no output controls of local government service provision", just as "There are very few norms within some sector areas, e.g. education, welfare and environment, but in general the services level is decided by the local governments" (p. 14).

In Hungary, the problems are, to a large extent, connected with the structure and size of local governments. A very sub-divided structure of local government exists (for almost half of the local governments, the number of inhabitants is less than 1 000 people). Within this structure, however, all local governments are, in principle, attributed the same set of duties and responsibilities. There is no regulation of the tasks for the "smallest" governments (constituting by far the largest share of the population), which implies that such governments "unilaterally can transfer the institutions performing the local services to the county local governments" (Annex A, p. 9). To some extent similar to Latvia, the Hungarian reports says that the "local government itself decides – on the basis of the population demands and depending on its financial possibilities – which duties it shall perform, to what extent and in which manner" (p. 17).

In the Danish contribution, no issues on local government expenditure assignments are raised. On the other hand, there is a clear indication of the role and mandate for local governments for each policy sector, set out by law or ministerial decree, defining the norms and standards required in the field in question. Variations across policy sectors seem considerable – see as examples, "secondary education", "welfare affairs and services" and "social security affairs and services". The variations reflect the political considerations on the proper distribution of responsibilities across tiers of government and establish the proper foundation for ensuring local political accountability.

*Capacity for cost-efficient management of expenditure (local service provision)*

For all three test countries, local discretion on public management decisions seem comprehensive. In general, no, or very insignificant, restrictions on methods for providing the services exist.

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### *Central-local budget co-operation*

In all three countries, local governments draft, adopt and implement their budgets independently of central government.

Some formal mechanisms on budget dialogue seem to exist in all three countries. For obvious reasons, Denmark has the oldest and most comprehensive system of co-operation of the three countries. The system consists of voluntary agreements between central government and associations of local governments, covering, amongst other things, joint declarations on expenditure and revenue targets and agreements on local government borrowing and investment. Issues on the system of state financing of the municipalities and the framework conditions for the delivery of the local services may be covered in the agreements, just as sector-specific targets on service output or capacity may be agreed upon.

The principles of the Latvian system, as a process of co-operation, are to a large extent similar to the Danish ones. As an example, a specific mechanism for expenditure compensation when tasks and responsibilities are transferred across levels of government is established in both countries. However, the main focus in Latvia, in recent years, has been on the design of the equalisation system for differences in tax base and expenditure needs across local governments.

In Hungary, the budget dialogue seems to be integrated into the legislative process of the draft general budget which the central government presents to Parliament.

In Denmark, agreements were reached in 1998, covering a period of four years. In Latvia and Hungary, the budgets and the general budget specifications are set on an annual basis. For Hungary, the process ends fairly late in relation to the prioritisation process in the local government councils.

As discussed in Chapter III, the questionnaire was designed to address subnational government activities at a disaggregated level, by combining information on revenue and expenditure for specific sub-sectors of local activity (See also Figure III.2.) Table IV.2 presents the sub-sector on primary education.

**Table IV.2 Issues of fiscal design: “Pre-primary and primary education affairs and services”**

	<b>Denmark</b>	<b>Hungary</b>
Local expenditure as a proportion of total local expenditure	15.7	18.8
Local expenditure as a proportion of total government expenditure on primary education	83.9	62.5
Proportion of expenditure covered by specific grants	-	6.0 (63.6) <sup>1)</sup>
Proportion of expenditure covered by non-tax revenues	-	5.0

*Notes:* Figures on Latvia are not available.

<sup>1)</sup> 63.6% of the expenditure on primary education is covered by specific grants and by general grants dedicated to this local expenditure need. See Annex B, Table 6.3.

As seen from the Table, the Danish model implies a high level of decentralisation of government expenditure to local government, combined with the “generalised” form of financing by taxes. The mandate and the role of local government is set out in the sector law and includes that, “Within standards stipulated by legislation concerning education programs, etc. local governments can set the level of service, capacity, expenditure norms, etc. There is no access to claim user payment...” (Annex A, p. 47).

In the Hungarian case, local governments cover almost 2/3 of total government expenditure, which is financed by general means but also by earmarked sources. The regulation from the central level is as follows: “The act on public education defines the compulsory number of hours for teachers, the requirements and parameters for class organisation, including possibilities for splitting into groups, time frameworks for occupying pupils, ..., etc.” (Annex B, p. 17).

Similar presentations on large sub-sectors of local government services can be prepared from the country reports.

## IV.2 Revenue design

Table IV.3 Local government. Profiles of current revenue

	Denmark		Hungary		Latvia	
	Profile	“Own revenue”	Profile	“Own revenue”	Profile	“Own revenue”
Tax revenue	70.6		32.0		66.2	
• “Own taxes”. Categories A-D		68.6		13.7		0.0
Non-tax revenue	4.2	4.2	20.8	20.7	14.1	14.1
Grants	25.2		47.2		19.7	
• General grants		11.6		37.2		5.8
Total	100.0	84.4	100.0	71.6	100.0	19.9

*Note:* The figures are compiled from tables in Sections 4 to 6 in the country reports. There are some additional current revenue sources making up the overall finance for local governments. For Hungary, see Annex B, Box 6.1, and Section 7, including Table 7.4. For Denmark, see Annex A, Table 3.2.4

In Table IV.3, current revenue for the three countries is divided into tax revenue, non-tax revenue and grants. In addition, “own revenue” is identified by revenue categories – according to the classifications set up in the ‘Level 2 sections’ above. As an example, tax revenue for local governments in Hungary make up 32% of total current revenue while own taxes only account for approximately 14%.

Tax revenue accounts for the dominant part of total revenue in Denmark and Latvia. Non-tax revenue is a major source of finance in Hungary and Latvia, while grants account for almost twice as large a proportion in Hungary as in Denmark and Latvia. The revenue profiles of the three countries can be compared to those

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of OECD Member countries (Revenue Statistics, Table 195)<sup>1</sup>. It appears that few unitary countries have a profile like Denmark and Latvia, with tax revenue accounting for such a high proportion. The unweighted average for all OECD Member Countries, in 1996, was 42.5%. Hungary is much closer to the average profile, though the proportion of grants is somewhat higher and the proportion of tax revenue somewhat lower than average.

In addressing the issue on local autonomy over revenue sources, the concept of ‘vertical fiscal imbalance’ is traditionally introduced. The concept of vertical fiscal imbalance expresses the actual balance of interest within a national jurisdiction, by the ratio of intergovernmental grants over total subnational revenues, or intergovernmental grants over total subnational expenditures (on the assumption of balanced budgets). In Table IV.3, the vertical imbalance for Denmark, Hungary and Latvia is 25%, 47% and 20%, respectively, indicating that Latvia is “the most decentralised” of the three test countries, followed by Denmark and Hungary. The unweighted average of vertical fiscal imbalance for unitary OECD Member Countries<sup>2</sup> is 38%. Denmark and Latvia are at a level similar to that of unitary countries like Finland, Spain and Sweden, whilst Hungary may be compared to Italy, the Netherlands and Portugal.

With the classifications on own revenue sources, as developed in the questionnaire, the evaluation of local autonomy can be more thoroughly addressed than with the concept of vertical fiscal imbalance. As shown in Table IV.3, Denmark and Hungary have quite a similar profile, with 84% and 73%, respectively, of revenue sources to be counted as own revenue sources. For Latvia, the proportion is 20%, due mainly to the fact that “...local governments have no right to set tax rates because the existing taxes are state taxes” (Annex C, p. 19) and that, to a large extent, grants are classified as specific grants, leaving little discretion for local financial decision-making. Even when tax revenue is considered alone i.e. so that general grants are not classified as an own revenue source, the pattern is maintained, though not as distinctly as with the total revenues.

In the following sections, further test results are presented, on the specific revenue sources of taxes and grants.

Table IV.4 Tax revenue. Classification by type of local autonomy. Percentage.

	<b>a</b>	<b>b</b>	<b>C</b>	<b>d</b>	<b>e.1</b>	<b>e.2</b>	<b>e.3</b>	<b>f</b>
Denmark		97.1				1.8		1.1
Hungary		42.8					57.2	
Latvia								100.0

Note: The classification on local tax autonomy is defined as follows:

- (a) SNG sets tax rate and tax base
- (b) SNG sets tax rate only
- (c) SNG sets tax base only
- (d) SNG sets tax base for SNG and central government tax(es)
- (e) revenue sharing arrangements
  - (e.1) revenue-split can only be changed with consent of SNG
  - (e.2) revenue-split fixed in legislation, may unilaterally be changed by central government
  - (e.3) revenue-split determined annually by central government as part of the budget.

<sup>1</sup> Figures in Revenue Statistics cover all subnational governments (regional and local levels) whilst the figures on the test countries only cover local government.

<sup>2</sup> Cf. footnote 1.

(f) *central government sets rate and base of SNG tax.*

As referred to in section II, Fiscal Affairs has carried out a study on local autonomy, covering 19 OECD Member countries (OECD Tax Policy Studies, No.1, 1999). The results of the study show a dispersed pattern of local government tax revenues by type of local autonomy. The Danish test results can be grouped with other Nordic countries, such as Finland and Sweden, but also with Japan and Belgium (federal country). The Hungarian profile is close to countries like Poland and Germany (federal country) while the Latvian profile seems unlike any other country in the OECD study.

Table IV.5 Classification of local taxes by tax base. Percentage

	Denmark	Hungary	Latvia
1000 Taxes on income, profits & capital gains			
1100 Individuals	91.2	49.6	75.3
1200 Corporations	1.8		
1300 Unallocatable as between 1100 & 1200			
2000 Social security contributions			
2100 Employees			
2200 Employers			
2300 Self Employed			
2400 Unallocatable as between 2100, 2200 & 2300			
3000 Taxes on payroll and workforce		0.6	
4000 Taxes on property			
4100 Recurrent taxes on immovable property	6.0	5.7	23.0
4200 Recurrent net wealth taxes			
4300 Estate, inheritance & gift taxes		0.7	
4400 Taxes on financial and capital transactions			
4500 Other non-recurrent taxes on property		6.9	
4600 Other recurrent taxes on property		3.5	
5000 Taxes on goods and services			
5100 Taxes on production, sale & transfer of goods & Services			0.8
5200 Taxes on use of goods			
5300 Unallocatable as between 5100 & 5200			0.9
6000 Other taxes			
6100 Paid solely by business		32.4	
6200 Paid by other than business, or unidentifiable	1.1	0.7	
<b>Total</b>	100.0	100.0	100.0

The tax revenue profile, by tax base, of the three test countries can be compared with the general pattern for OECD unitary Member countries (Revenue Statistics, Table 135). In relation to the Danish case, the predominance of personal income as a tax base is “a Nordic characteristic”, with proportions of total

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revenue covering from 80-99%. No other OECD country has the same high proportion of tax revenue accounted for by personal income, and the unweighted average of personal income tax for unitary countries is 32% of overall revenue. In Hungary, the proportion of personal income tax is above average and in line with a country like Poland. The proportion of other taxes, making up almost one third of the revenue, is, however, a unique, Hungarian characteristic. The tax in question is a local business tax, paid on business operations and connected to the headquarters that is located within the territorial jurisdiction of the local government. Compared to the unweighted averages of both 5000 and 6000 category taxes - 6% and 8%, respectively - the Hungarian proportion of 32% is remarkable. Property tax is traditionally a major local tax, with an unweighted average for unitary OECD countries of 33% of the overall revenue. As shown in the Table, property tax plays a certain role in Latvia but a disproportionately smaller role in both Denmark and Hungary.

### *Non-tax revenue – Institutional framework on local discretion*

The proportion of non-tax revenue of total revenue in Denmark, Hungary and Latvia varies considerably, the share being 4%, 21% and 14% respectively. It should be noted that some statistical problems were identified in this area. Major activities in Hungary take place in government-owned enterprises and service rates from these activities are not accounted for. A full presentation of non-tax sources is not given in the Danish report since “a wealth of user charges and fees, etc. is to be found in regional and local government”.

The institutional framework for local government discretion in setting the base and rate for non-tax revenues is somewhat different between the countries.

- In Latvia, “local governments have the right to introduce local duties, to determine their amounts, to make decisions about their rates and about exemptions from payment of the duties” (Annex C, p.47). An array of areas is set up where local governments have the right to introduce duties and payment. Some kind of right exists in relation to collecting state duties in a number of fields. The revenues are paid to the local government budget, and “there are no controls on the size of the revenue” (p.47). The legal regulation of non-tax revenues is done in connection with the general framework laws on local government.
- In Denmark, and to a large extent Hungary, too, regulation is given by sector-specific laws. As a main principle, the rates may, at the most, match the costs of production of the services. Certain limits are set on the rates, for redistribution purposes– see, for example, the regulations on child-care services and care for the elderly (Annex A, p.70). The same set of principles is applied in Hungary in connection with the social and educational services. For a number of additional areas in Hungary, however, local governments are free to set charges on a “market basis”(Annex B, p.30) with no specific restrictions laid down by central government.

The design of the grant systems gives a major contribution to the evaluation of local government discretion over the provision of local affairs and services. Consequently, the summary of the test reports, as presented in Tables IV.6 and IV.7, has to be seen in connection with the already-referred-to expenditure in Table IV.1.

Table IV.6 Profile of current grants. Percentage

Country/ Year	Specific Grants			General Purpose Grant			Total
	Current			Objective criteria			
	Conditional		Not Conditional	Without own tax effort	With own tax effort	Discretionary	
Standard Costs	Actual Costs						
Denmark 1996	1.5	52.5	-	44.6	-	1.4	100
Hungary 1996	18.0	2.2	1.1	78.2	0.5	-	100
Latvia 1998	70.5	-	-	29.5	-	-	100

*Note:* The figures on specific grants for Latvia have been adjusted for investments grants of Lats.4.49 million. See Annex C, Table 6.1.2.

The countries differ to a large extent on the distribution of grants between general and specific grants. In Hungary general grants make up the main part of the grants while in Latvia the opposite situation is found: Specific grants account for 71% of total grants. In Denmark the distribution is more even with 54% on specific grants and 46% on general grants.

In both Denmark and Latvia the specific grants are concentrated on few sector areas. In Denmark 98% of specific grants is meant for the Social Security and Welfare services and this sector covers 57% of the overall local expenditure. The specific grants matches approximately 55% of the expenditure on social security affairs and services whilst on social welfare affairs and services the proportion is as low as 1%. In Latvia a similar concentration can be identified: 97% of specific grants go to the Education sector. A sector which accounts for 61% of the overall expenditure and the grants covers approximately 30% over this. The other policy functions of local government in Denmark and Latvia are practically financed by 'generalised' revenue sources: tax revenues and general grants. In Hungary, on the contrary, the specific grants are dedicated for a number of main sectors: education, social services, public order and safety, health services and general public services.

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**Table IV.7 Specific current grants by function. Percentage**

		Denmark		Hungary		Latvia	
		Conditional		Conditional		Conditional	
		Standard Costs	Actual Costs	Standard Costs	Actual Costs	Standard Costs	Actual Costs
1	General public services	0.4		6.1		2.0	
2	Defence						
3	Public order & safety			11.3			
4	Education	0.1		26.0		97.6	
5	Health			8.6			
6	Social Security & Welfare	1.4	96.8	19.3	10.3		
7	Housing & community amenities	0.2		2.0			
8	Recreational, cultural & religious affairs		0.4	1.5			
9	Fuel & energy	0.1				0.2	
10	Agriculture, forestry, fishing & hunting						
11	Mining, manufacturing & construction, except fuel & energy						
12	Transportation & communication	0.1		3.1			
13	Other economic affairs	0.2		6.3		0.3	
14	Other functions						
15	<b>Total</b>	100		94.5*		100	

*Note:* Total Hungary: the remaining 5.5% of the specific grants are reported as “non-conditional” on function 8 “Recreational, ...” The figures on specific grants for Latvia have been adjusted for investments grants of Lats.4.49 million. See Annex C, Table 6.1.2.

## V. Concluding comments

Economies in transition need methods for monitoring and evaluating their ongoing reform processes of government finance, including fiscal design across levels of government. As mentioned in the opening sections, international data to compare decentralisation policies across countries seem to be insufficient or even non-existent. Economies in transition do not have internationally consolidated data on fiscal autonomy and the actual design of fiscal relations to look to for policy guidelines and inspiration for reform processes. Guidance for these countries on where to concentrate their reform efforts must, to a large extent, be based on national figures and reform experiences.

The substantial framework presented in Chapter II, and the methodological design of the survey, as presented in Chapter III, identify relevant international statistics to assist fiscal reform processes. Central aspects of fiscal design across levels of government are presented on a comparative basis: government finance statistics, distributed by further levels of government and by policy sectors (Level 1), and concepts and definitions on expenditure and revenue powers of the subnational governments (Level 2). See also Figures III.1 – III.3.

The substantial “results”, as presented in Chapter IV, demonstrate the comprehensiveness of the survey design. Comparative data are given on general design issues like the chosen fiscal mix across levels of

government, and the distribution of tasks and expenditure responsibilities across tiers of government. Comparative data and country evaluations on local autonomy are also distributed by policy sector and by the relevant government authorities, making international data available for considerations on reforms on the health sector, the environment sector, education services, etc.

The actual design of the fiscal systems and the ongoing reform considerations in Hungary and Latvia may exemplify this issue. As indicated in Chapter IV, the two countries have a number of similar ‘problems’ to consider in the completion of the subnational government reforms. The outstanding institutional issues in relation to the assignment of expenditure was referred earlier, in this respect. The two countries, however, have chosen different reform strategies in their fiscal mix across levels of government, just as the design of revenue and expenditure responsibilities by policy sectors varies considerably. With the results of the survey, comparative data are now available for the reform considerations, in the two countries, in these divergent fields.

For future surveys on fiscal decentralisation, a number of methodological lessons were learned. As referred to in Chapter III, the main results were as follows:

- On the coverage of data, the international general classifications are maintained as the general framework. The OECD will ensure co-ordination with similar data reporting on subnational government finance that already takes place to international organisations. A co-ordination forum exists in relation to OECD Revenue Statistics, where the IMF and the EU Commission are represented, just as a number of co-ordination activities take place in relation to the general government finance statistics
- Regarding the levels of government, data on two subnational levels is considered as sufficient, in most cases.
- For the evaluation at the subnational level of their proportion of general government expenditure and revenue, more data is needed than foreseen. A requirement for consolidation of expenditure figures between levels of government was noted.
- Data reporting on “Level 1 and Level 2”. The analytical distinction proved helpful though there were some difficulties in providing targeted reports on Level 2. In future surveys, efforts may be directed at ensuring the reliability and validity of Level 1 data.
- Figures on non-tax revenue and figures on capital accounts were identified as ‘difficult to report on a validated and reliable basis’. This meant that the data in some cases was not distributed by function, as foreseen.

In the preparation of the questionnaire for future surveys, these methodological results will be reflected, together with efforts to simplify and edit the questionnaire, in general.

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