
OECD Experience on Municipal Finance under Federalism: Implications for India

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Outline of Presentation

- Municipal finance in federal countries in the OECD:
 - Local government expenditures
 - Local government revenues
 - Local government taxes
- Implications for local governments in India

Local Government Expenditures, Selected OECD Federal Countries

| | Local government expenditures as % of GDP, 2007 |
|-------------|---|
| Australia | 2.3 |
| Austria | 7.4 |
| Belgium | 6.9 |
| Canada | 7.2 |
| Germany | 7.2 |
| Spain | 6.4 |
| Switzerland | 9.7 |

Source: International Monetary Fund, *Government Finance Statistics*, Yearbook, 2008, Table 7 and OECD, *Revenue Statistics 1965-2008*, 2009, Table 36

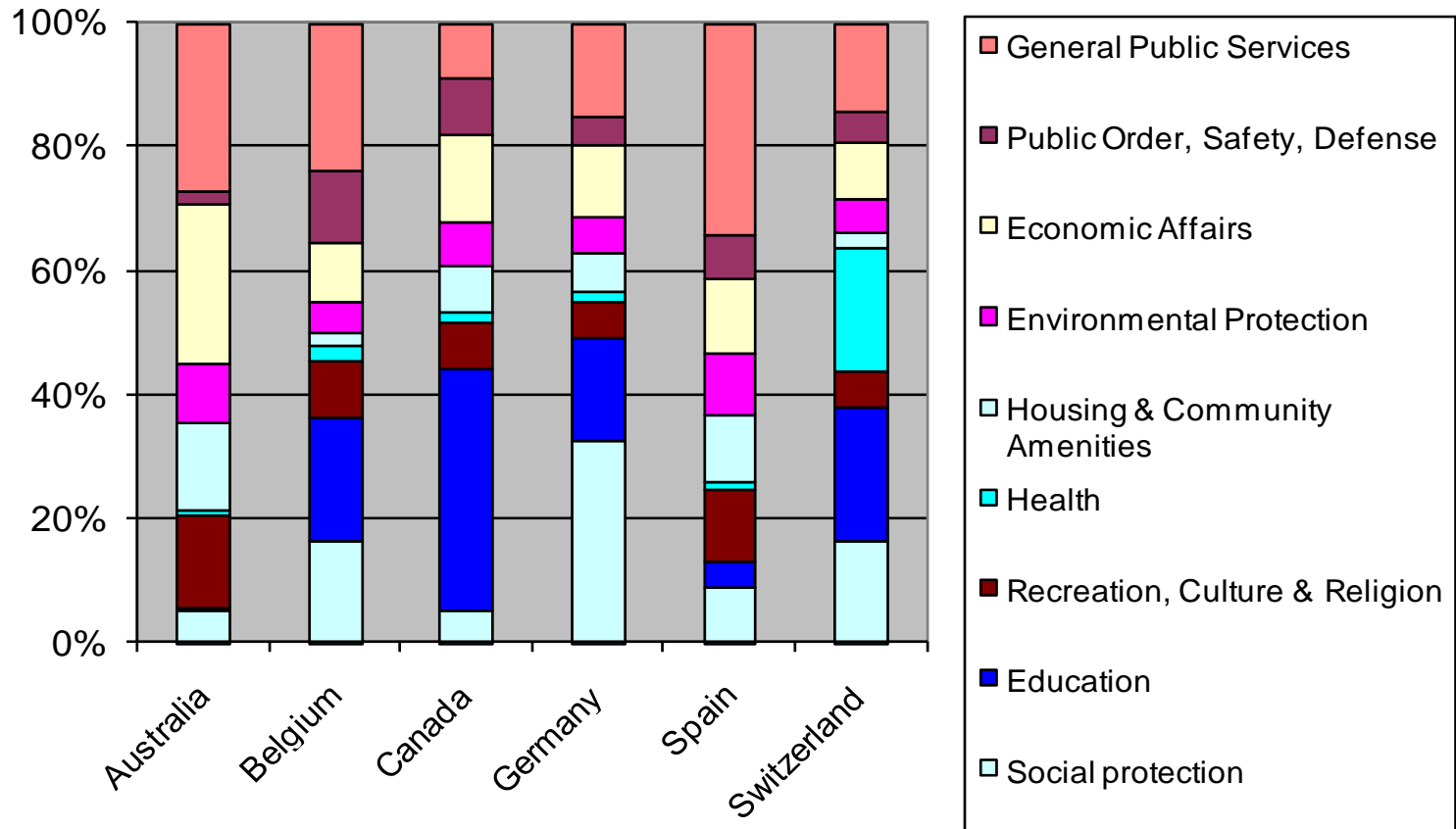
Local Government Expenditures, Selected OECD Federal Countries

| | Local government expenditures as % of total government expenditures, 2007 |
|-------------|---|
| Australia | 5.7 |
| Austria | 13.6 |
| Belgium | 11.2 |
| Canada | 15.6 |
| Germany | 14.8 |
| Spain | 13.6 |
| Switzerland | 22.0 |

Note: Information for Belgium and Switzerland is for 2006

Source: International Monetary Fund, *Government Finance Statistics Yearbook, 2008*, Table 7

Distribution of Local Government Expenditures, Selected Federal Countries, 2007



Source: International Monetary Fund, *Government Finance Statistics, Yearbook, 2008, Table 7.*

Local Spending Responsibilities

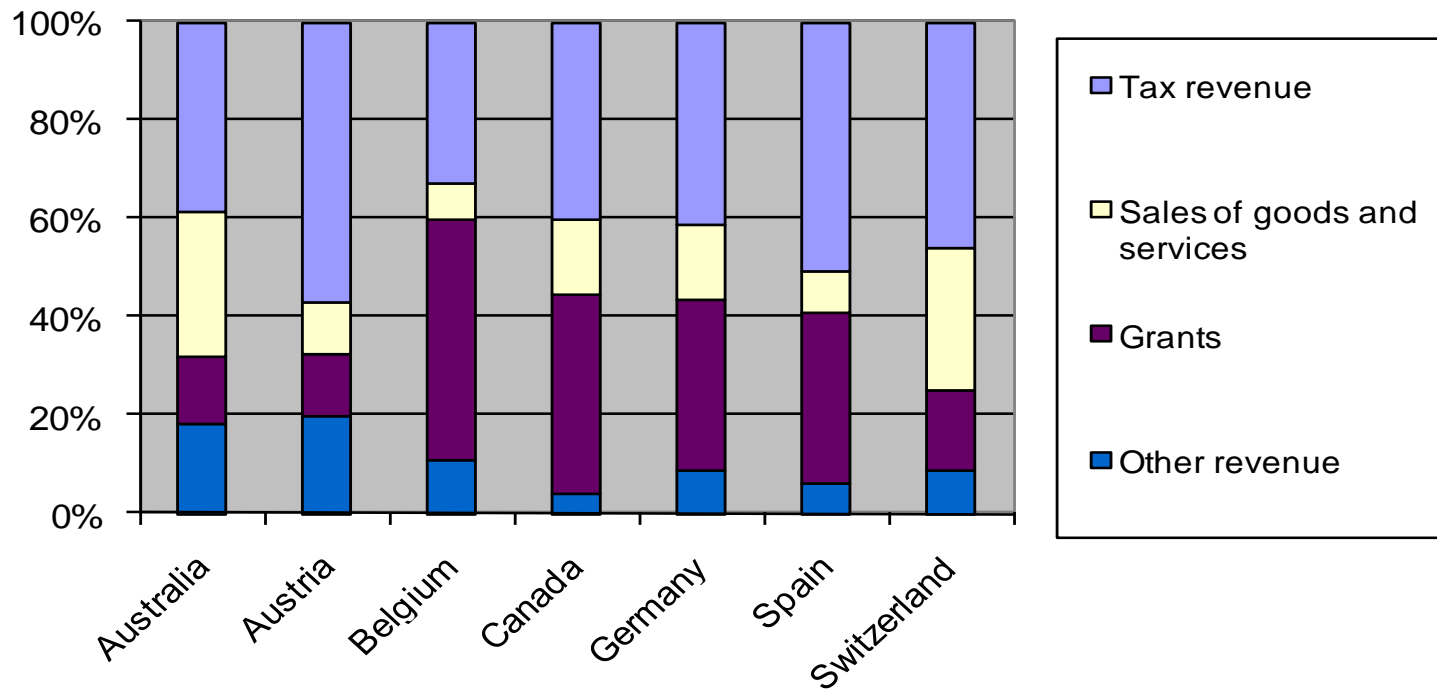
- Diversity in OECD practices on expenditure assignments
- Property-oriented services are provided at the local level in most countries
 - Public order and safety
 - Environment (water, sewers, garbage)
 - Economic affairs (transportation)

Local Spending Responsibilities

- More variation in people-oriented services
 - No local role in education in Australia but major role in the rest of the OECD
 - No role in health in Australia; major role in Switzerland; minor role in the rest of the OECD
 - High proportion of expenditures on social protection in Germany, Belgium, Switzerland

Local Government Revenues

**Sources of Local Government Revenues,
Selected Federal OECD Countries, 2007**



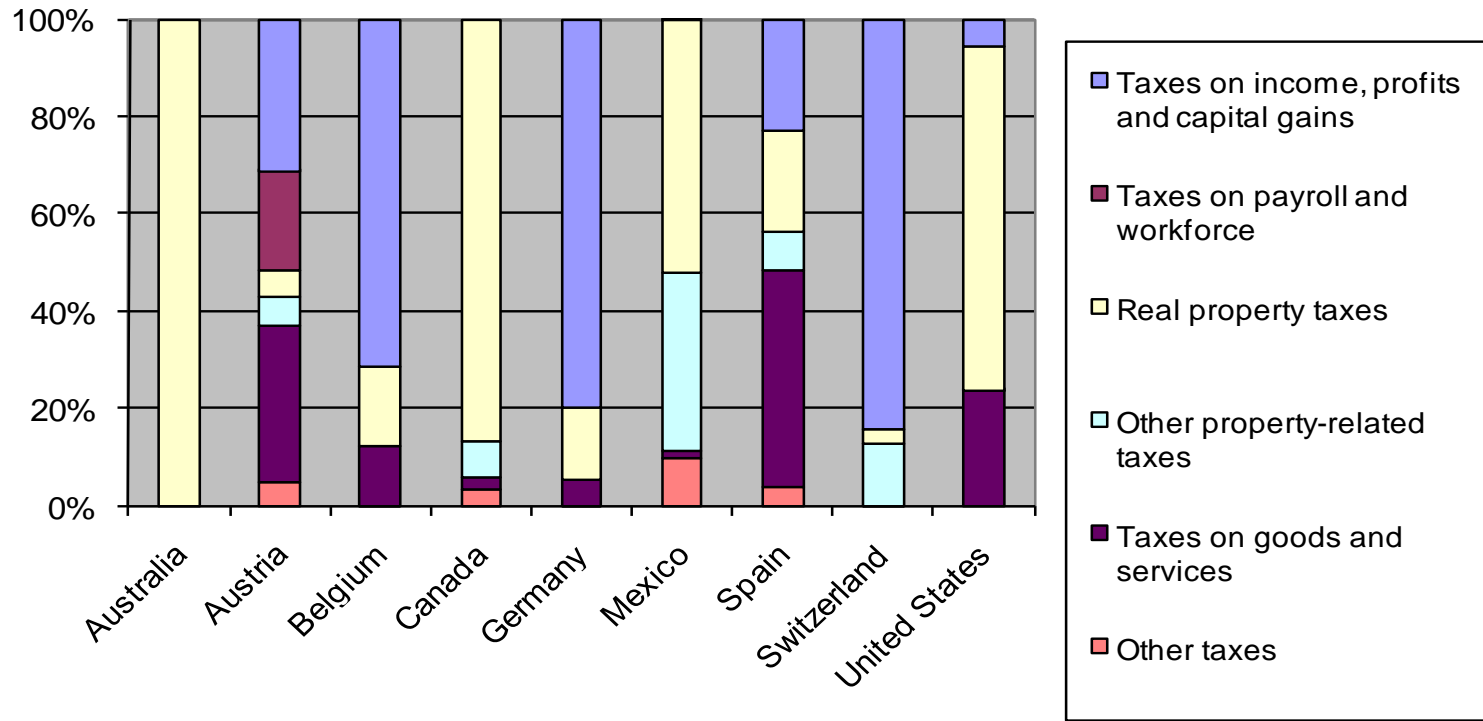
Source: OECD, *Revenue Statistics 1965-2008*, 2009, Tables 139-198 and OECD, *Revenue Statistics 1965-2006*, 2007, Tables 141, 157, 165.

Local Government Tax Revenues, Selected Federal OECD Countries

| | Local government tax revenues as % of GDP, 2007 |
|-------------|---|
| Australia | 0.9 |
| Austria | 4.0 |
| Belgium | 2.3 |
| Canada | 2.9 |
| Germany | 3.0 |
| Spain | 3.1 |
| Switzerland | 4.8 |

— Source: OECD *Revenue Statistics 1965-2008*, 2009, Tables 139-168 and OECD *Revenue Statistics 1965-2006*, 2007, Table 157

Distribution of Local Government Tax Revenues, Federal OECD Countries, 2007



Source: OECD, *Revenue Statistics 1965-2008*, 2009, Tables 139-168 and OECD, *Revenue Statistics 1965-2006*, 2007, Table 157

Local Government Revenues

- Diversity in the amount of revenues under local control
- Local governments rely on intergovernmental transfers for a significant percent of revenues (less so in Australia because state government delivers many local services)
- Variation in the number of local taxes

Local Government Tax Revenues

- More than 80% of tax revenues from personal and corporate income taxes in Belgium, Germany, Switzerland
- More than 80% of tax revenues from property taxes in Australia, Canada, US
- Sales taxes are levied mainly by cities in the US
- Mix of taxes in Austria and Spain (40% of local tax revenues from sales tax in Spain and almost 30% in Austria)

Local Government Taxes

- No country raises more than 10% of total taxes from property tax
- Income-tax reliant countries (e.g. Belgium, Germany, Switzerland) tend to spend more on social protection
- In almost all OECD countries, decisions on what revenue instruments local governments can use are decided by higher level of government or national constitution

Local Government Taxes

- Access to taxes depends on:
 - types of expenditures that must be funded;
 - local government's capacity to administer a tax;
 - willingness of a senior government to assign taxes to local government; and
 - constitutional and legislative requirements

User Fees

- User fees in every country but particularly significant percent of revenues in Australia and Switzerland
- Charged for use of airports, transit, parking, water, sewers, solid waste collection and disposal, recreational facilities

Intergovernmental Transfers: Types

- ❑ General purpose (block) transfers
 - Vertical fiscal imbalance (fiscal gap)
 - Horizontal fiscal imbalance (equalization)

- ❑ Specific purpose transfers
 - Matching to address spillovers (but matching rates are generally higher than justified by spillovers in most countries)
 - Non-matching to achieve minimum standards

Intergovernmental Transfers

- Federal grants generally have to go through provincial/state governments (e.g. Canada, Germany)
- General purpose grants dominate in most OECD countries (e.g. 70% of grants in Germany)
- Specific purpose transfers prevalent in Canada and US (e.g. 85% of grants in Canada)
- Equalization transfers not common in the US; comprehensive system of equalization transfers in Germany

Problems with Transfers

- Soften the budget constraint (undermine fiscal discipline)
- Discourage municipalities from “getting the prices right”
- Distort local decisions
- Reduce accountability
- Fungibility
- Not stable and predictable

Local Borrowing

- Most countries – significant help from higher level governments in facilitating access to credit markets for local governments
- Requires well-functioning financial markets and creditworthy local governments
- US: tax-exempt bonds

Local Borrowing

- Agencies allow risk pooling, economies of scale, and knowledge of local governments to provide access to commercial credit on more favourable terms
- US: municipal bond banks (pool borrowing)
- Canada: provincial finance corporations
- Western Europe: autonomous agencies run on commercial principles assist local borrowing

Implications for India from Federal OECD Countries

- Diversity in institutional arrangements
- No consistent or uniform approach to local government taxation
- Few countries rely on only one local tax; some rely on two taxes, and still others have three taxes
- Generally, broader spending responsibilities come with greater diversity of taxes

Implications for India from Federal OECD Countries

- Need for clarity of expenditure assignments
- Finance follows function
- As much as possible, each government should finance expenditures out of own revenues:
 - Local autonomy
 - Responsibility and accountability
 - Stability and predictability of revenues

Implications for India from Federal OECD Countries

- Residents should bear the cost of providing services:
 - User fees to fund services where beneficiaries can be identified
 - Local taxes to fund services that provide collective benefits to the local community
- Accountability to local residents is critical to success of local governments

Implications for India from Federal OECD Countries

- Matching revenue tools to expenditure responsibilities:
 - Private goods – user fees
 - Public goods – taxes on residents
 - Spillovers –intergovernmental transfers
 - Large capital investments - borrowing

The Need for a Mix of Taxes

- A mix of taxes is appropriate:
 - One tax may create distortions offset by a mix of taxes
 - Improves flexibility in adapting to local conditions and circumstances
 - Increases revenue elasticity

Criteria for a Good Local Tax

- Immobile tax base
- Adequate, stable and predictable tax yield
- Difficult to export
- Visible and accountable
- Fair
- Minimize harmful inter-municipal competition
- Easy to administer and collect

Not all criteria can be met at the same time

Which Taxes?

- Property tax – tax on immobile factors; related to benefits from local services
- Income tax – based on benefits for services not capitalized into property values; buoyant
- Payroll tax – easy to administer but barrier to employment
- General and selective sales taxes – tax commuters and visitors; buoyant
- Local business taxes – export tax burden; costly to administer