Starting From Scratch?
A New Approach to Subnational Public Finance

David Bell[*]
University of Stirling

Willem Sas[†]
University of Stirling & KU Leuven

Abstract

In many countries, the arrangements in place for lower-level governments to finance the public goods and services they provide, are highly complex. The intricate combinations of grant mechanisms and tax autonomy are often regarded as unfair, opaque or ineffective, and tend to lack legitimacy as a result. This paper therefore explores a set of transparent and intuitive guidelines to design a new fiscal framework for regional public finance. It builds these from principles rather than an ad hoc process dictated by political expediency. It also accounts for the possibility that one or more regions may want to leave the federation or union, given sufficient popular support. To offset this possibility, and within certain bounds, our framework allows subnational jurisdictions to unilaterally decide how much tax autonomy and fiscal responsibility to adopt. Our paper therefore offers a fresh perspective on subnational public finance.

---

[*]Economics Division, University of Stirling. E-mail: d.n.f.bell@stir.ac.uk

[†]Department of Economics, KU Leuven, Belgium & Economics Division, University of Stirling, UK. E-mail: willem.sas@stir.ac.uk

1 Introduction

In most federations or countries with other forms of multi-level governance, lower-level (subnational) governments only partially finance their expenditures from own taxes or user fees. The resulting 'vertical fiscal gap' between subnational expenditures and revenues is bridged by central government grants, or by subnational borrowing.[1] Importantly, and while convincing arguments in favour of such arrangements exist, they can have significant drawbacks as well.[2] These mechanisms are often perceived as unfair, opaque or as lacking legitimacy. Furthermore, existing attempts to promote local accountability through the transfer of tax-raising powers are frequently regarded as insufficient, or ineffective.

In the UK, for example, the main element of the financing scheme has been the Barnett formula, which was introduced in 1979 as a stopgap measure. It has since been used to determine funding allocations to Scotland, Wales and Northern Ireland. Following the independence referendum of 2014, the Scottish Parliament acquired significantly more tax and welfare powers than the other Nations of the UK, so that different versions of the Barnett formula now apply to allocate grants to the devolved institutions.[3] To different degrees, other countries operate similar levels of complexity in their fiscal frameworks, and are often perceived as equally ineffective or lacking legitimacy.[4] Hence, and although such arrangements may solve some short-term political problems, they cannot form a stable long term solution to the question of how to distribute fiscal powers and organise equalisation payments. In this paper, we therefore explore a set of equitable, transparent and intuitive guidelines for establishing a stable framework for subnational finances.

Focusing on 24 OECD countries in Fig. 1 below, it is clear why a defunct framework for subnational finance may be detrimental to general welfare. First, the revenue streams needed to finance devolved spending are large: on average lower-level governments account for around 30% of total public spending. Only around half of these expenditures are covered by subnational own revenues, so that all subnational governments in these OECD countries are to some degree dependent on transfers from central government. The form of fiscal framework in each country is therefore fundamental to determining both taxation and the provision of public services at subnational level. Flaws in these frameworks, such as an ill-conceived choice regarding the degree and nature of tax autonomy or grant design, can have negative

---

[1]We use the term subnational to reference the regional/state tier of government in this paper. Our proposals would also apply to the municipal level, however, even within a technically unitary country.

[2]See e.g. Boadway and Shah (2009) for a detailed overview of the literature on fiscal federalism.

[3]Within England itself, devolution of fiscal powers has been less extensive and is limited to some property taxes and user charges. London has the widest range of powers: for other city-regions limited changes have been linked to customised "city-deals".

[4]See Boadway and Shah (2007) for an extensive overview of existing fiscal frameworks, and a thorough analysis of their shortcomings.

economic and political implications. In their most extreme form, fiscal frameworks that are widely perceived as unfair can be a threat to the continued existence of the federation, or union.

Figure 1: Regional expenditures and (tax) revenues in % of total public spending
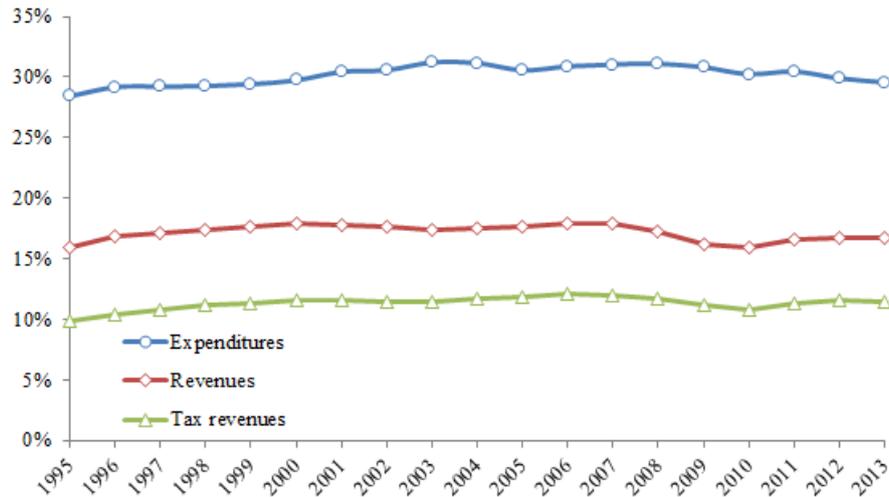
Source: own calculations, based on the OECD fiscal decentralisation database. We constructed a balanced panel data set out of the uninterrupted time series of 24 OECD countries, including: Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Luxembourg, Netherlands, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom. (http://www.oecd.org/tax/federalism/oecdfiscaldecentralisationdatabase.htm)

To resolve the common difficulties faced by existing fiscal frameworks, we propose an entirely new design in what follows. Our proposals are built from a set of principles – such as efficiency, accountability and equality of opportunity – rather than an ad hoc process dictated by political expediency. We also recognise that any fiscal arrangement will give rise to a "participation constraint", which we define as the cost of participating in the federation (or union), and which can vary across subnational jurisdictions. Hence, our arguments have a political economy element in that they take into account the possibility that the federation will be dissolved if subnational jurisdictions would choose to leave. Thus we allow for the possibility that real or perceived unfairness in the distribution of public resources across jurisdictions can undermine confidence in the federation. Moreover, and beyond these more economic or financial considerations, the willingness to dissolve the federation may also reflect perceived political benefits of autonomy in itself.

For this reason, our proposed framework allows subnational jurisdictions to determine how much tax autonomy and fiscal responsibility they wish to adopt, which, as a formalised blueprint for subnational public finance, is relatively novel.[5] Of course, to guarantee the

---

[5]There are earlier examples of such an asymmetric approach. For example in Canada, where opt-out

stability of overall national public finances, this kind of subnational discretion has to be limited in some way. There is a trade-off between subnational autonomy and the macroeconomic stability of the federation. By introducing nationally defined restrictions on subnational fiscal discretion, our proposal can at most to "soften" the participation constraint, rather than eliminating it altogether as this would undermine the stability of the federation. This to make the federation in question more viable, as well as resilient to credibility challenges, both internal as well as external.

Lastly, the principles-based approach outlined here is flexible and can be generalised. It therefore provides guidelines for federations in general. In what follows we will draw on the UK setting to exemplify a current case where the fiscal framework is asymmetric, lacks transparency and where the possibility that the Union will be dissolved is significant.

2 Principles

Economists generally agree on which functions of government to devolve to lower levels of government, and which competences to retain at the centre. As a general rule, powers that can be tailored to local needs or preferences are best organised at the regional or municipal level (Oates, 1999). Discretion over education, welfare, health care, infrastructure, transport, or skills policies is therefore often assigned to subnational governments. Conversely, whenever devolution leads to large losses in scale economies or coordination failures between local governments, policy levers are best kept in the hands of the highest level of government (Oates, 1972). As a result, areas such as defence, macro-economic stabilisation, most of social security, trade or foreign policy tend to remain the prerogative of central governments. (Boadway and Shah, 2009).

Unfortunately, there is no similar consensus regarding the collection of revenues that pay for devolved functions. Finding the optimal division of revenue-raising powers almost always boils down to striking the right balance between a variety of interrelated principles, which vary in importance according to local conditions. We describe the most important principles below.

2.1 Efficiency & Accountability

Excessive tax autonomy among subnational governments can lead to tax competition, reducing the welfare gains from locally financed expenditure (Wilson, 1986; Keen and Kotsogi-

---

arrangements allowed Québec to replace transfers by its own Personal Income Tax, which it then could shape to its own preferences which are more progressive and more pro-family. This corresponds to what we propose in what follows, with the difference that unilateral discretion is one of the explicitly formalised building blocks of our framework rather than an ad hoc measure.

annis, 2002; Wilson and Wildasin, 2004). Differential tax rates cause resource misallocation because the market becomes distorted. If, for example, Northern Ireland was given powers to reduce corporation tax so that it could compete with the Republic of Ireland, businesses from the rest of the UK might also move to Northern Ireland just to take advantage of the lower corporation tax rate. Revenue reductions resulting from such tax competition may reduce public service provision below welfare maximizing levels.

In the general case, central government can simply provide cash transfers to subnational governments instead of granting them tax autonomy. This avoids efficiency losses. The downside of this strategy is that voters will be less able to hold local politicians to account because the link between spending and revenue raising is absent (Boadway and Tremblay, 2012). Indeed, the transparency of the fiscal framework is undermined in this case, so that voters have diminished incentive to understand the connection between revenue raising and public spending, and are hence less likely to punish underperforming politicians at the polls (Lockwood, 2006). Similarly, poorly informed voters are more likely to acquiesce to excessive regional borrowing if subnational governments have the power to raise debt on financial markets. This may lead to defaults if subnational governments expect to be bailed out by higher levels of government, which in itself is more likely the more they are dependent on grant-based finance.[6]

2.2 Responsibility

There is clearly a trade-off between the efficiency losses of tax competition and the benefits of accountability in relation to tax powers.[7] But tax autonomy also brings about fiscal incentives, which rely on the positive feedback loop between 'good' policies and consequent financial rewards (Weingast, 1995; Jin et al., 2005; Weingast, 2009).

The crux of the argument is that if a policy measure boosts regional growth, this is likely to affect the tax base of e.g. personal income, business, or property taxes positively as well. A certain degree of devolved tax autonomy then allows subnational governments to tap into this expansion of local tax bases. And because rent-seeking incumbents will never have enough funds to further their goals or win over potential voters, it will be in their own 'fiscal interest' to invest in such growth-enhancing policies. A virtuous cycle is thus set in motion, where the

---

[6]Aside from a more detailed description of both theoretical arguments regarding regional borrowing, an empirical validation is given by Rodden (2002), Rodden et al. (2003), Blankart and Klaiber (2006), Bordignon and Turati (2009) and Baskaran (2012). See also Foremny (2014) for evidence on the positive effect of tax autonomy on regional fiscal deficits. Note that some degree of regional borrowing discretion should be guaranteed in any case when taxation is devolved, to smooth regional-specific shocks to the fiscal base. Especially when equalisation mechanisms are not in place to provide interregional insurance against asymmetric shocks.

[7]Other arguments, which rely more on the benefits from economies of scale, support the case for centralised taxation. Harmonising tax base and rate structures at the central level economises on administrative costs, as compliance and collection costs are reduced (Oates, 2005).

right policies lead to additional tax revenues which, in turn, lead to more of these policies.

Since local growth often promotes local welfare as well, politicians are held 'responsible' for their good policies through the tax revenues they generate. This is important in settings where democratic accountability is weak, and politicians are corrupt or inept. The degree to which subnational governments retain the financial rewards from their policies – what we will call the 'retention rate' – will be vital here. Importantly, grants can also be made 'responsibility-sensitive', linking their implicit retention rate to regional growth or other performance-based measures such as unemployment rates or schooling levels.

2.3 Horizontal Equity

Crucially, even if local politicians are incentivised to take local welfare into account, the nationwide welfare effects of such a 'responsibility-sensitive' fiscal framework may be less beneficial. When, for example, education or welfare policies are devolved and partially financed on the basis of (economic) performance as suggested above, underperforming regions will have less finance available to keep schools and welfare programs equivalent to those in more prosperous regions. The notion of 'horizontal equity' – generally understood as the equal treatment of otherwise equal citizens by the government, regardless of their location – is violated as a result. To compensate for such imbalances, an equalisation mechanism is usually established to realign interregional differences in fiscal capacities (Boadway and Shah, 2007).[8]

However, such equalisation payments reduce the 'retention rate' and therefore erode the fiscal independence and responsibility of local politicians. Also, equalisation transfers between subnational jurisdictions are often politically controversial, especially if interregional inequality (e.g. in income per capita) is persistent.[9] In what follows, we therefore aim to design funding instruments that uphold fairness in a less contentious way, without excessively eroding political responsibility. In doing so, we trace the issue of horizontal equity back to more normative grounds and specifically to the notion of 'equality of opportunity'. We propose to extend the normative argument that individuals should only be held accountable for those circumstances that are within their control, to the case of subnational governments. They should therefore experience the gains (or losses) of only those actions for which they can justifiably be held responsible (Cohen, 1989; Roemer, 1998). Conversely, circumstances and events beyond their control should be compensated by some form of public insurance so as to

---

[8]Much like a centrally organised tax-benefit system, equalisation mechanisms also provide insurance against region-specific, cyclical shocks which would otherwise have increased local costs or reduced revenues. Empirical evidence of interregional risk-sharing is e.g. given by Asdrubali et al. (1996) for the US, in Andersson (2008) for Sweden, and Arachi et al. (2010) for Italy.

[9]Sas (2017) lastly, shows that standard equalisation schemes also fail to mitigate tax competition in realistic settings where taxes are raised on an ad valorem basis.

maintain 'equality of opportunity'. Our argument is that if local electors cannot reasonably be held responsible for adverse (or beneficial) local outcomes, then it is justifiable for the central government to offer some compensation (or to extract rent). In contrast, no compensation should be paid for outcomes that are a clear consequence of local policy-making.

2.4 Continuity & Predictability

The longevity of inter-governmental fiscal arrangements is contingent on continued participation by central and subnational governments. New arrangements will be required if national or subnational governments fail to adhere to fiscal rules or if external shocks undermine compliance. Subnational governments may quit the polity if their electorate takes the view that autonomy is preferable to compliance with fiscal agreements. Obviously, such a decision would also have monetary implications, but we solely focus on the fiscal issues in this paper. Also, if subnational governments anticipate eventual breakdown, their incentive for entering a permanent fiscal agreement is substantially weakened. However, if central government can credibly commit to compliance, subnational governments will be more willing to join. In turn, this implies a need for central government to behave in a predictable fashion, as set out in the agreement, and for transparency around the information required for its implementation, given that subnational governments will continually assess compliance. Some federal countries address these issues through an institutional mechanism that is independent of central government, such as a fiscal council.

3 A new fiscal framework

Combining the principles touched upon above, an 'ideal' framework of regional public finance would implement a positive feedback loop between political performance and (tax) revenues. It would also remain transparent to voters and robust both to competitive pressures between subnational governments, as well as to credibility challenges from all actors.

3.1 Tax autonomy

A first option would be to devolve those tax instruments which are to some measure linked to economic activity, and are raised on a relatively inelastic – yet salient – tax base. Decentralised arrangements for income tax and property taxes would be obvious candidates for the UK, in the sense that these automatically funnel the proceeds of growth-enhancing policies back into local revenues, are highly visible, and are raised on less mobile tax bases. Thus, if subnational governments successfully promote local growth, they will reap the rewards through higher taxes, which can then be used to increase re-election chances. The increased visibility of

policy interventions will also improve electoral outcomes, if the policies being pursued are sound. As a result, because economic activity can often be linked to higher levels of welfare, local politicians are held accountable and responsible for their actions, to the benefit of their electorate.

Note that tax sharing, where revenues from a specific tax base are shared between national and subnational governments, apparently provide an alternative mechanism for increasing regional tax autonomy. However, tax sharing can be implemented in many ways and these vary considerably in the extent to which they genuinely extend subnational fiscal autonomy (Blöchliger & King, 2006). For example, the UK government has agreed to share half of VAT revenue raised in Scotland with the Scottish Government from 2019. This will significantly increase tax revenues retained in Scotland, but will have little effect in extending the fiscal powers of the Scottish Government, given that it will control neither the VAT tax base, nor the rates at which is applied. Moreover, as it is difficult to link measures of local social and economic performance to local VAT revenues, variations in these revenues will not incentivise local politicians to perform better. The 'responsibility feedback loop' as described above, will fail.

3.2   The need for a new grant mechanism

As discussed above, devolving tax powers to lower levels of government will almost always reduce horizontal equity between regions. The more a subnational government has to rely on its own fiscal base, the more interregional differences in fiscal capacity – which are due to a variety of factors, often beyond the control of politicians – come to the surface. This then trickles down into the quality of local public services, leading to different treatments of otherwise equal citizens across localities. Equalisation mechanisms to correct for such imbalances are generally imperfect, in the sense that they usually redistribute between regions based on interregional differences in regional income or fiscal capacity, rather than explicitly linking money flows to regional needs. This form of interregional redistribution often foments political backlash, but also reduces the retention rate, and therefore weakens the responsibility feedback loop.

The responsibility effect of tax autonomy tends to be rather blunt as well. The purpose of the responsibility feedback loop is to reward local politicians for policies that increase local welfare. But what are such policies and how do they interact with the evolution of tax revenues? Tax autonomy boosts the economic growth objective for subnational governments: it expands the fiscal base and therefore provides local policy makers with additional tax revenues. But if economic growth is based on the attraction of foreign investment in polluting industries or on developers who run down natural resources, welfare may not be increased

in line with tax revenues. Timing matters too, since investments in, for example, education, skills and infrastructure are likely to have medium to long term effects on local growth and prosperity, but may be less attractive to current politicians because they do not offer an immediate political return via the fiscal base. Although economic growth may seem an obvious objective of responsible policy-making, it may be necessary to consider more refined and desirable criteria to direct local fiscal incentives towards longer term objectives that enhance welfare.

To remedy both shortcomings of full tax autonomy — in that it erodes horizontal equity and offers a blunt measure to boost local welfare — without losing too much of its advantages, we propose a new grant mechanism. It allows for a more subtle, flexible and intuitive interpretation of horizontal equity, and also takes into account various responsibility criteria to nudge local politicians in the right direction. It would, however, always operate alongside a substantial degree of devolved tax autonomy to preserve the transparency benefits of the latter, but offsetting its deficiencies. Subnational governments should therefore also be given some discretion over borrowing decisions to smooth region-specific revenue shocks. In the UK, these might extend beyond the provisions available through the current fiscal framework agreements in place for Scotland and Wales.[10]

3.3 Designing a new grant mechanism

In designing a new grant mechanism, we separate outcomes for which local politicians can and should be held responsible from those which are beyond their control. Hence, we propose that subnational fiscal frameworks should comprise both 'responsibility' and 'compensation' elements. This concept draws on the axiomatic formulation of both principles developed by Flearbaey (2008), and is founded on an 'equality of opportunity' ethical framework. Such fiscal frameworks should therefore explicitly and transparently combine a compensation and a responsibility element in a relatively simple and understandable formula. The compensation element will reflect equity considerations by reducing the disadvantages that citizens face due to the circumstances of the area in which they happen to live. The responsibility mechanism rewards authorities that drive favourable outcomes in policy areas over which they have discretion. The last element of our proposal is that, within specified limits, subnational governments should have the right to determine the relative importance of the responsibility and compensation elements in their revenues. These limits should relate to the need for subnational fiscal autonomy not to undermine the economic stability of the federation.

---

[10]Scotland for example, is allowed to borrow to make up for a forecast shortfall in revenues – when Scottish GDP growth is below 1% and at least 1 percentage point less than UK GDP growth. Since the correlation between devolved revenues and Scottish GDP is far from perfect, this is often argued to be constraining. See also Bell et al. (2016) for more details on the capital and resource borrowing limits in numbers.

3.3.1 The formula

In practice, our approach implies that grants from central to subnational governments will have two components. The first will be linked to observable performance-related factors relating to local welfare such as mean per capita income, measures of inequality, labour market outcomes or capital formation (tangible and intangible, social and natural). This comprises the *responsibility* element. The second component of the grant will be determined by needs-based factors comprising demographic, geographic and other indicators. This comprises the *compensation* element. We discuss both the criteria for establishing the compensation and responsibility elements in more detail in Section 3.3.2.

Both mechanisms are then rolled into the same formula expressed by Eq. (1) below, which spells out how an annual lump sum G^t assigned for regional spending would be allocated across subnational governments i in a given year t.

$$G_i^t = \overbrace{(\beta_i^t \times G^t)}^{Compensation} \times [1 + \underbrace{(\mathbb{1}_E \times \omega_i \times (\alpha_i^t - \bar{\alpha}^t))}_{Responsibility}]. \tag{1}$$

To illustrate, suppose the grant mechanism only finances education. The lump sum G^t in Eq. (1) would then cover the total amount deemed sufficient to cover spending on education nationwide. This could be actual spending at the time of introduction of the new grant scheme. Following its introduction, the lump sum evolves based on pre-defined indices such as inflation π^t and/or economic growth $\bar{\alpha}^t$ as specified below, so that

$$G^t = G^{t-1} \times (1 + \bar{\alpha}^t) \times (1 + \pi^t). \tag{2}$$

However, this adjustment only keeps the lump sum G^t from eroding in real or nominal terms, but does not subdivide it across the subnational governments. This is where the compensation mechanism on the right hand side of Eq. (1) has an effect, since needs-based indicators are used for this allocation. Sticking to our example, the lump sum could thus be split across regions based on a simple measure of need such as the population N_i^t of school age. This would set the regional share β_i^t, used in Eq. (1) to allocate the lump sum G^t, equal to

$$\beta_i^t = \frac{N_i^t}{N^t}. \tag{3}$$

Next, and to reward regional politicians for welfare-enhancing policies via their incoming revenues, the responsibility mechanism introduces performance-based indicators α_i to the grant scheme, as also marked on the right hand side of Eq. (1). These indicators determine the *growth* of the sub-divided lump sum, and thus provide regions with a bonus if they perform better than the average value $\bar{\alpha}^t$, given by

$$\bar{\alpha}^t = \frac{\sum_{i=1}^n \alpha_i^t}{n}, \tag{4}$$

so that we can define the indicator function in Eq. (1) as follows

$$\mathbb{1}_E(\alpha_i^t, \bar{\alpha}^t) = \left\{ \begin{array}{ll} 1, & \text{if } \alpha_i^t > \bar{\alpha}^t \\ 0, & \text{otherwise} \end{array} \right. ,\qquad(5)$$

which then sets out the conditions for receiving the bonus. Keeping to our example of education, this could imply that regions where the growth rate α_i^t of growth in pupil numbers is higher than the national average $\bar{\alpha}^t$ in a given year t, receive a bigger grant in that year. Crucially, the formula allows each subnational jurisdiction to decide on the potential size of the responsibility bonus, albeit within certain nationally agreed-upon bounds. As specified in Eq. (1), the size of the bonus will be defined by the weight $\omega_i \in [\underline{x}, \overline{x}]$ chosen by each region i, with x setting the upper and lower bounds on regional discretion. The unilaterally set weights could also be allowed to vary through time, following shifts in regional preferences for responsibility and autonomy.

Our grant scheme has both pragmatic and conceptual attractions since it simultaneously combines responsibility and compensation elements. It is more intuitive and politically operational than standard equalisation grants which tend to be solely equity-oriented and far less underpinned by responsibility arguments. By linking needs directly to funding moreover, the grant scheme offers an element of horizontal equity which is highly visible. This, and its ability to incorporate a 'responsibility' element, improves its chances of finding broad support across a federation where views differ between subnational governments on the desirable level of tax accountability and interregional fairness. In addition, our formula is fixed and transparent, yet automatically adapts to changes in needs and performance through time, setting it apart from discretionary regional finance schemes that are open to political meddling (also known as pork-barrel politics) and the resulting inefficiencies.[11]

The grant scheme is also highly flexible, in the sense that it can be separately applied to specific policy areas — as in our education example above — or to the sum total of regional spending to be financed by grants.[12] Since we can also attribute weights to the responsibility component of the grant formula, the scheme not only allows for flexibility in the choice of needs-based and performance-based criteria, but also regarding their relative importance. It would thus be possible to allow the relative weight of responsibility to vary across lower-level jurisdictions, as the latter can decide separately and unilaterally on the likelihood or appropriateness of being rewarded.

---

[11]Since the compensation component of the grant scheme is largely shock-proof for the same reason, the grants will implicitly maintain a lower bound of interregional insurance.

[12]In this latter case the lump sum G_t would simply capture overall devolved spending, and the aggregate needs-based and performance-based indicators could be a weighted average of various specific and relevant indicators. If applied to one policy area furthermore, the grant scheme also allows for the grant to be hypothecated or 'earmarked', i.e. subject to the precondition that the funds have to be spent in the specific area in question.

The transparency of this approach with respect to interregional fairness, responsibility and local needs can facilitate the democratic debate that would precede the establishment of a new fiscal framework. As a result, and more so than other existing mechanisms, our grant scheme can respond to the demands of any real-world objective setting elicited through the electoral process.

3.3.2 How to measure compensation and responsibility?

Choosing which criteria are relevant to introduce as needs- or performance-based indicators will partially follow from the democratic process, which logically depends on the kinds of policy domains that are devolved in the first place. The 'compensation' mechanism would rely on indicators and measures of need, on which agreement is often problematic.[13] Once the criteria are elicited, an institutional process would still be needed to identify appropriate indicators, their weighting, and how they might be adjusted over time. There are international exemplars of such institutions, including the Australian Grants Commission. To ensure trust, this institution would have to be transparent and independent from government at all levels.

Focusing on the UK in what follows, and based on the functions of government currently devolved to the UK nations, we would propose the following list of easily accessible indicators to underpin the compensation mechanism:

- Number of older people (+80)

- Number of dependent children (-18)

- Number of people claiming income-related benefits

- Number of people with a long-term limiting illness

- Number of people from a minority ethnic group

- Number of people living outside communities of 10,000 people or more

- Number of people living on remote islands

All of these are based on population numbers, and are therefore highly transparent, and for this reason applicable to other developed countries seeking to establish stable fiscal frameworks. They will always be expressed as regional population shares in the relevant nationwide population, before being inserted into the grant formula spelled out in detail in Eq. (1).

---

[13]The Independent Commission on Funding and Finance for Wales for example, selected a group of indicators and then attempted to determine equalisation payments for Wales based on identifying comparable levels of need and associated levels of financial support in England.

Moving on to the responsibility mechanism, the retention of revenues will be based on achievement of particular objectives. Such mechanisms already exist for the Scottish and Welsh fiscal frameworks, but are Byzantine in their complexity. For example, the Scottish Government gains (or loses) the revenue associated with increasing (decreasing) its income tax per head at a faster rate than in the rest of the UK.[14] It can use this additional revenue for its electoral advantage as it sees fit.

For reasons set out in Section 3.2, responsibility incentives need not be limited to the retention of additional tax revenues. They could also include targets for the outcomes of spending programs such as increases in new firm formation or participation rates, improvements in life expectancy, reductions in inequality or increases in skills formation. This would be controversial in a UK context since each government jealously guards its ability to set priorities. However, there are perhaps some broad objectives such as increased life expectancy or improved productivity which might be agreed without interfering with governmental strategy as to how these should be achieved. Nevertheless, unless the process for determining those outcomes that would be subject to these incentives – and how good performance would be rewarded – was agreed by all governments, progress on this form of responsibility payment might be difficult. On the other hand, the fact that our mechanism allows each government to determine the relative importance of the responsibility bonus as explained in Section 3.3.1, can be expected to reduce frictions here, as we discuss further below.

3.4   Towards a softer participation constraint

A 'fair' combination of responsibility and compensation may seem normatively sound and intuitive, but will not necessarily be perceived as such. Preferences regarding horizontal equity may differ across regional jurisdictions for many reasons, and more importantly, are susceptible to change. Preference instability of this kind is then liable to influence the process of devolution itself. If for example a compensation-inspired grant system is politically unpopular in a given region, the fact that it is normatively fair from a nationwide perspective will matter less. In this case, and as resistance to interregional fairness mounts, calls for more responsibility in the form of (tax) autonomy or even full independence can increasingly be expected. To different degrees this has happened in Spain, Italy, Belgium, the UK, Canada, Germany and other countries.

By allowing each subnational government to modulate the relative weight of responsibility directly and unilaterally, our proposed framework resolves some of these issues from the outset. Moreover, and from a dynamic point of view, the resulting flexibility of the participation

---

[14]This is due to the adjustments made to the Barnett formula, introduced to compensate for the decentralisation of income tax after 2016. See Bell et al. (2016) for a detailed account on these reforms, as well as their expected (budgetary) effects.

constraint is guaranteed across time, as each regional government can unilaterally decide to refashion its desired trade-off at pre-defined points – ideally after nationally agreed periods of time. The price of this flexibility will largely be paid by central government, since any shifts in subnational support paid through the grant scheme will ultimately be financed by the national budget, and/or public borrowing. Understanding of the game theoretical implications of a softer participation constraint is therefore crucial if the framework is to be kept stable. On the one hand regions performing above average at a consistent rate will be driven to set their responsibility weights at the maximum level as a best response in equilibrium, whilst below-average regions would do the opposite. However, as economic fortunes and policies will vary over time, below-average regions would still be tempted to outperform the average in the medium term, after which they would re-adjust their weights. The incentive to do better is therefore present for underperforming regional governments, even when a certain lower bound of compensation is always guaranteed as is the case in our scheme. Nonetheless, the responsibility bonus will need to bounded by certain thresholds, framed by a nationally agreed consensus.

Additionally, we also foresee the need to introduce a transition mechanism to facilitate political compliance, which would compensate for the differences between the old and new systems. Over a sufficiently wide – and to be agreed upon – time frame, the net budgetary effects of introducing the new grant system for each subnational government would be neutralised. Such a correction could then be phased out gradually as the envisaged transition period draws to an end.

3.5 Bridging tax autonomy and grant finance

In most countries the degree of devolved taxation usually follows from consensus-driven deliberation on a national scale. However, as was the case when determining the responsibility bonus in our grant mechanism set out in Section 3.3, unilateral discretion could also be granted in relation to regional tax autonomy. This implies a transfer of risk which the devolved governments will embrace with varying degrees of enthusiasm. They could opt for a high degree of compensation via the grant mechanism and relatively little fiscal responsibility, or they could opt for full tax autonomy, which implies a complete transfer of fiscal risk. If local borrowing limits are fully relaxed in the process, this would differ from complete independence only insofar as control of monetary policy would still be the responsibility of the central government, and there would be a requirement to pay for those services financed by the central government that are necessary to support a sovereign state.[15] To guarantee a

---

[15]As is currently the case for Navarra and the Basque country under the Spanish fiscal framework arrangements.

minimum amount of compensation via the grant mechanism, and also to safeguard the public finances underpinning the union, nationally agreed-upon limits to regional fiscal autonomy would be required to stabilise the fiscal framework at the federal level.[16] The extent to which unilateral discretion is bound by such nationally agreed thresholds will also serve as a check on interregional spill-overs.

To illustrate the workings of this choice, suppose the grant scheme proposed in Section 3.3 will always function alongside a certain amount of regionally devolved tax autonomy. Denoting regional revenues from devolved taxation by T_i, we can write overall regional revenues R_i of region i as

$$R_i^t = T_i^t + G_i^t, \tag{6}$$

which is nothing more than the sum of grant funding G_i^t and tax revenues T_i^t. Now, to define the amount T_i^t reserved for devolved taxation and the amount G_i^t to be financed via the grant mechanism in Eq. (6), we first define a measure X^t comprising nationwide overall desired spending on devolved powers. If we follow a compensation-based approach to compute how much of this nationwide budget X^t should be allocated to each region i, regional revenues spelled out in Eq. (6) become

$$R_i^t = T_i^t + G_i^t \equiv \overbrace{\beta_i^t \times X^t}^{Compensation}, \tag{7}$$

with β_i^t a – possibly weighted – average of all selected compensation criteria, as described in Section 3.3.2. Now that we know the total size of the pie per region, the question is how much of it will be raised via devolved taxation.

In this light, the extent to which subnational governments are allowed to decide on tax autonomy is denoted by γ_i in Eq. (8), and is bound by nationally agreed upon thresholds $[\underline{y}, \overline{y}]$, with $0 < \underline{y} < \gamma_i < \overline{y} < 1$. This unilaterally chosen percentage γ_i is then applied to the regionally allocated nationwide budget R_i^t, so that the revenues from tax autonomy in the starting year t of the new system in region i would be calibrated to equal

$$T_i^t = \gamma_i \times \overbrace{(\beta_i^t \times X^t)}^{Compensation} \equiv \tau_i^t B_i^t, \tag{8}$$

which subsequently evolves through time following the growth rate of the various tax bases devolved – or shared – for the purpose of tax autonomy, here captured by B_i^t, as well as the evolution of regionally chosen tax levels τ_i^t. If a counterfactual evolution of the nationwide budget X_t is maintained moreover, for example using the indexation method used in Eq. (3),

---

[16]Similarly, the feedback loop from fiscal to monetary policy through bond yields and interest rates would likely require agreement on deficits and debt between the different levels of government.

the unilateral choice defined by γ_i in Eq. (8) can be remade after a pre-defined but given amount of years, as was the case regarding the responsibility bonus in Eq. (1).[17] Next, and logically, the grant scheme would cover the residual of the regionally allocated budget as follows

$$G_i^t = (1 - \gamma_i) \times \overbrace{(\beta_i^t \times X^t)}^{Compensation} \times [1 + \underbrace{(\mathbb{1}_E \times \omega_i \times (\alpha_i^t - \bar{\alpha}^t))}_{Responsibility}], \tag{9}$$

where the conceptualisation of the grant mechanism is exactly the same as before, in Eq. (1).

Bridging tax autonomy and grant finance as we propose has two main advantages. First, we use needs-based indicators – such as regional population shares given by Eq. (3) in appendix – to define how much of the national budget X^t to allocate to each region. This links tax autonomy to the compensation-inspired approach set out earlier, independent of the unilateral choice of how much tax autonomy to actually take on as a region. Second, by allowing regions to unilaterally determine how much of this allocated budget they want to raise themselves by means of devolved tax authority, and how much will be financed through grants, the participation constraint – as discussed in the previous section – will be "softened" even more. Of course, the main implication of such flexibility will be asymmetric degrees of tax authority between the national and regional levels of government, yet often with regard to the same tax bases.[18] Some regions may opt for a higher degree of autonomy over e.g. a shared labour income tax base, and others for a relatively lower degree.

4 Concluding remarks

We suggest that the complexity, lack of transparency and independence of existing arrangements for distributing funds to subnational governments undermine both their sustainability and effectiveness. We propose that a new mechanism, which makes explicit the "compensation" and "responsibility" elements of their funding, should be established. This mechanism would permit subnational governments to determine the extent of responsibility and autonomy (and the level of risk) that they wished to take on, relative to a guaranteed amount of compensation for regional needs.

Applied to the UK setting, this would mean the Celtic nations could benefit or lose relative to the rest of the UK, depending on their decisions, and would potentially have to accept

---

[17]The same game theoretical caveats discussed in Section 3.4 are valid here. Depending on the evolution of the relevant devolved tax bases, we would therefore expect the bounds of unilateral discretion $\gamma_i \in [\underline{y}, \bar{y}]$ to offer less flexibility to the regions, given the potentially more pronounced strains on the federal/national purse following these unilateral decisions.

[18]Formulas of tax sharing between the central and lower levels of government could be based on the "split rate" approach, where e.g. two entirely different tax schedules would be applied on the same, shared labour income tax base. Alternatively a regional surcharge – or "piggy-back" – tax rate could be levied on central tax revenues, which are then lowered for the purpose.

unfavourable outcomes. Just as the rest of the UK would have to accept outcomes where they fared better. As a result, our framework would necessarily involve the establishment of processes to identify relative need across different parts of the UK, and to establish a transition mechanism to adjust toward the implied distribution of funding support. It would also be required to monitor spillover effects from idiosyncratic fiscal decisions. This would ideally require an institutional base: our proposal is to establish a Responsibility and Compensation Commission (RCC). It could be expected to be scrutinised by each Parliament.

References

Andersson, L., 2008. Fiscal flows and financial markets: To what extent do they provide risk sharing within sweden? Regional Studies 42, 1003–1011.

Arachi, G., Ferrario, C., Zanardi, A., 2010. Regional redistribution and risk sharing in italy: the role of different tiers of government. Regional Studies 44, 55–69.

Asdrubali, P., Sorensen, B.E., Yosha, O., 1996. Channels of interstate risk sharing: United states 1963-1990. The Quarterly Journal of Economics , 1081–1110.

Baskaran, T., 2012. Soft budget constraints and strategic interactions in subnational borrowing: Evidence from the german states, 1975–2005. Journal of Urban Economics 71, 114–127.

Bell, D.N., Eiser, D., Phillips, D., 2016. Scotland's fiscal framework: Assessing the agreement. Technical Report. IFS Working Papers.

Blankart, C.B., Klaiber, A., 2006. Subnational government organisation and public debt crises. Economic Affairs 26, 48–54.

Boadway, R., Shah, A., 2009. Fiscal federalism: principles and practice of multiorder governance. Cambridge University Press.

Boadway, R., Tremblay, J.F., 2012. Reassessment of the tiebout model. Journal of public economics 96, 1063–1078.

Boadway, R.W., Shah, A., 2007. Intergovernmental fiscal transfers: principles and practices. World Bank Publications.

Bordignon, M., Turati, G., 2009. Bailing out expectations and public health expenditure. Journal of Health Economics 28, 305–321.

Cohen, G.A., 1989. On the currency of egalitarian justice. Ethics 99, 906–944.

Foremny, D., 2014. Sub-national deficits in european countries: The impact of fiscal rules and tax autonomy. European Journal of Political Economy 34, 86–110.

Jin, H., Qian, Y., Weingast, B.R., 2005. Regional decentralization and fiscal incentives: Federalism, Chinese style. Journal of Public Economics 89, 1719–1742.

Keen, M.J., Kotsogiannis, C., 2002. Does federalism lead to excessively high taxes? The American Economic Review 92, 363–370.

Lockwood, B., 2006. The political economy of decentralization, in: Handbook of multi-level finance. Ahmad, Ehhisham and Brosio, Giorgio. chapter 2.

Oates, W., 1972. Fiscal federalism. Harcourt Brace Jovanovich (N.Y.).

Oates, W.E., 1999. An essay on fiscal federalism. Journal of Economic Literature 37, 1120–1149.

Oates, W.E., 2005. Toward a second-generation theory of fiscal federalism. International tax and public finance 12, 349–373.

Rodden, J., 2002. The dilemma of fiscal federalism: grants and fiscal performance around the world. American Journal of Political Science , 670–687.

Rodden, J., Eskeland, G.S., Litvack, J.I., 2003. Fiscal decentralization and the challenge of hard budget constraints. MIT press.

Roemer, J.E., 1998. Why the poor do not expropriate the rich: an old argument in new garb. Journal of Public Economics 70, 399–424.

Sas, W., 2017. Can fiscal equalisation mitigate tax competition? ad valorem and residence-based taxation in a federation. International Tax and Public Finance 24, 817–853.

Weingast, B.R., 1995. The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development. Journal of Law, Economics and Organization 11, 1–31.

Weingast, B.R., 2009. Second generation fiscal federalism: The implications of fiscal incentives. Journal of Urban Economics 65, 279–293.

Wilson, J.D., 1986. A theory of interregional tax competition. Journal of Urban Economics 19, 296–315.

Wilson, J.D., Wildasin, D.E., 2004. Capital tax competition: bane or boon. Journal of Public Economics 88, 1065–1091.