OECD Regional Development Papers

Fiscal equalisation and regional development policies:

Is there a case for enhanced synergies?

OECD

OECD Regional Development Papers

Fiscal equalisation and regional development policies: Is there a case for enhanced synergies?

By Antti Moisio and Miquel Vidal-Bover

Fiscal equalisation and regional development policies have often been perceived as separate policy fields. As a result, little is known about their potential interactions and implications for economic growth and welfare. This working paper reviews the two policies, explores the potential for enhanced synergies between the two, and proposes a theoretical framework linking them. The latter, which has not been empirically tested yet, posits that if regional development policies are correctly designed and implemented, their success should result in a drop of income disparities. Coupled with good governance practices and a framework that clearly allocates responsibilities among levels of government, more equal jurisdictions would find it easier to provide similar levels of services with comparable tax rates across the country. Therefore, whilst correctly designed and implemented fiscal equalisation policies remain a tool to patch gaps that may occur due to the shifting variety of revenue potential and spending needs of subnational entities, the need and the size of fiscal equalisation transfers could be significantly reduced if regional development policies in place are effective. This working paper concludes with a discussion on the benefits and challenges of enhancing synergies between the two policies, opening the door for future in-depth research.

JEL codes: H20, H30, O10, R10, R51, R58
Keywords: regional development policy, fiscal equalisation, territorial inequality, subnational governance

ABOUT THE OECD

The OECD is a multi-disciplinary inter-governmental organisation with member countries which engages in its work an increasing number of non-members from all regions of the world. The Organisation's core mission today is to help governments work together towards a stronger, cleaner, fairer global economy. Through its network of specialised committees and working groups, the OECD provides a setting where governments compare policy experiences, seek answers to common problems, identify good practice, and co-ordinate domestic and international policies. More information available: www.oecd.org.

ABOUT OECD REGIONAL DEVELOPMENT PAPERS

Papers from the Centre for Entrepreneurship, SMEs, Regions and Cities of the OECD cover a full range of topics including regional statistics and analysis, urban governance and economics, rural governance and economics, and multi-level governance. Depending on the programme of work, the papers can cover specific topics such as regional innovation and networks, sustainable development, the determinants of regional growth or fiscal consolidation at the subnational level. OECD Regional Development Papers are published on http://www.oecd.org/cfe/regional-policy.

This paper is authorised for publication by Lamia Kamal-Chaoui, Director, Centre for Entrepreneurship, SMEs, Regions and Cities, OECD.

Cover image: iStock/Getty images Plus / AlphaStd

Acknowledgements

This document was presented during the 4th Expert Group Meeting on Multi-level Governance and Public Investment for Regional Development of the Regional Development Policy Committee (RDPC) on 5 May 2022. The authors Antti Moisio, Senior Economist, and Miquel Vidal-Bover, Policy Analyst, would like to thank the RDPC delegates for their feedback. They would also like to express their gratitude to Nadim Ahmad, Deputy-Director, Dorothée Allain-Dupré, Head of Division, and Isabelle Chatry, Head of Unit, from the Centre for Entrepreneurship, SMEs, Regions and Cities (CFE) for their inputs and comments. The paper also befitted from valuable comments from Sean Dougherty, Head of Secretariat, and Andoni Montes-Nebreda, Policy Analyst, from the OECD Network on Fiscal Relations across Levels of Government for their comments.

The authors are also grateful to the delegates of the RDPC and the OECD Fiscal Network on Fiscal Relations across Levels of Government, who participated in a joint workshop on 22 March 2022. The proceedings of said workshop, entitled “Going beyond fiscal equalisation: institutional and fiscal tools to fight territorial inequalities”, substantially informed the reflections in this paper. Experts participating in this workshop included Professors Philip McCann (University of Sheffield Management School), Enid Slack (University of Toronto), Lars-Erik Borge (Norwegian University of Science and Technology), Andrew Reschovsky (University of Wisconsin-Madison), Diego Martinez-Lopez (Universidad Pablo de Olavide), Willem Sas (Stirling University) and Paul Smoke (New York University).

Table of contents

FIGURES

TABLES

BOXES

Introduction

OECD countries and regions are facing a series of socio-economic megatrends such as ageing, depopulation, job automation, and the green transition, which have been aggravated and, in some cases, accelerated, by the COVID-19 pandemic. This has heightened awareness of territorial inequities in public service provision in healthcare but also education (OECD, 2021[1]). More recently, Russia's aggression against Ukraine has also reignited inflationary pressures, which are exacerbating more recent pressures on consumer purchasing power. The uneven impact of these shocks and megatrends across regions risks fuelling discontent among regions and eroding social cohesion. As the forthcoming 2023 Regional Outlook of the OECD discusses, this reinforces the importance of actions that foster greater territorial solidarity and more equitable and sustainable development of all regions in a country (OECD, 2021[1]; OECD, 2021[2]; OECD, 2022[3]; OECD, forthcoming[4])

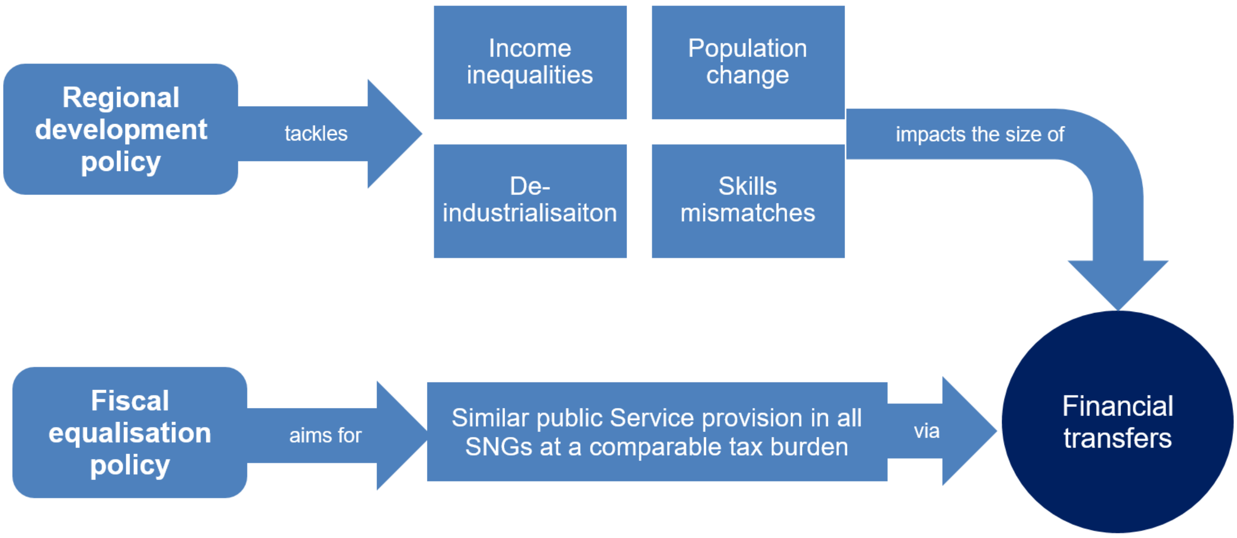
This working paper reviews two policies: fiscal equalisation and regional development policies. In principle, both policies have different objectives. While the former seeks to reduce fiscal disparities by providing a comparable level of public services at similar tax rates across regions, regional development policies typically aim to reduce income inequalities between places and between people and foster economic development. This paper therefore explores how the synergies between these two policies can be enhanced and co-ordinated in a way that avoids or minimises trade-offs. This is essential for all levels of government because, while these two policies are typically a prerogative of the central/federal government, subnational entities play an important role in pursuing a wide range of redistributive policies in collaboration with both national and supra-national players.

Yet, while fiscal equalisation transfers and regional development policy tools are important public policy tools, surprisingly little is known about their interactions and implications on aggregate economic activity, the distribution of population and income across space, regional migration flows, productivity, and welfare. Recent studies by the OECD (2021[6]; 2022[7]) find no clear correlation between the scale of regional income disparities and different levels of fiscal equalisation: countries with high regional income inequalities may pursue a weak or less generous fiscal equalisation policy, but they are just as likely to have a strong or more copious fiscal equalisation policy. The lack of correlation may simply point to a question of policy choices. Indeed, the design and implementation of fiscal equalisation mechanisms vary across countries, depending on the level of decentralisation, fiscal resources available, and the degree of political will. Of course, that is not to say that regional income inequalities would not be higher in the absence of fiscal equalisation mechanisms, but it is clear that they do not eliminate them.

Nevertheless, not least because of the absence of counterfactuals, the above observations do not imply that well-designed fiscal equalisation policies are not useful. As stated earlier, their main objective is offsetting differences in revenue raising capacity or public service costs and allowing subnational governments to provide similar public services with a similar tax regime. Fiscal equalisation policies thus do not normally pursue, as one of their main goals, reductions in income inequalities, and so the absence of any significant simple correlation between fiscal equalisation policies and regional income disparities should not be interpreted as a failure on the part of fiscal equalisation policies.

On the other hand, neither does this mean that fiscal equalisation and regional development policies are not linked. Regional development policy is a long-term, cross-sectoral, multi-level policy that aims to improve the contribution of all regions to national performance and reduce inequalities between places and between people (OECD, forthcoming[8]). In other words, one of the main aims of regional development policies is precisely to diminish inequalities across places and people by empowering and strengthening the capacities of all regions and subnational governments to make the best use of their full potential, taking into account their different development paths (OECD Regional Development Ministerial, 2019[8]). This working paper proposes a theoretical framework which posits that, if regional development policies are correctly designed and implemented, their success may result in a drop of income disparities. Coupled with good governance practices and a framework that clearly allocates responsibilities among levels of government (OECD, 2018[9]), more equal jurisdictions may find it easier to collect similar taxes and provide similar levels of services across the country. Correctly designed and implemented fiscal equalisation policies remain a tool to patch any gaps that may occur due to the shifting variety of revenue potential and spending needs of subnational entities (OECD, 2017[10]). However, the size of fiscal equalisation transfers, which tends to be much larger than those for regional development policies, could potentially be reduced in some countries (see Figure 1). As a politically sensitive matter, this could temper socio-political tensions that often arise in political discussions over fiscal equalisation systems. Be it as it may, this remains a theoretical framework that should be tested empirically in the future.

Figure 1. The relationship between fiscal equalisation and regional development policy: a stylised theoretical framework



Source: Authors' elaboration.

This working paper provides a preliminary discussion on the links and interactions between fiscal equalisation and regional development policies. First, the main elements and impacts of both policies are described and discussed. The last section of this working paper summarises some benefits and challenges that may emerge from stronger co-ordination between these policies, setting the scene of the current debate and opening the door for future in-depth research.

1 Fiscal equalisation and regional development policies

In decentralised countries, central/federal governments play a pivotal role in ensuring that equity is preserved across regions. Indeed, while well-designed decentralisation can lead to increases in economic growth, it also opens the door to widening inter-regional inequalities (OECD, 2019[11]). Research suggests that decentralisation processes can foster agglomeration effects (Bartolini, Stossberg and Blöchliger, 2016[12]; OECD, 2019[11]) and can lead to differences in financial capacity and administrative skills that prevents lagging regions from catching up, especially in asymmetrically decentralised countries (Ezcurra and Rodríguez-Pose, 2013[13]; Allain-Dupré, Chatry and Moisio, 2020[14]). With a view to tackle the challenges that come with decentralisation reforms as well as the risks of growing territorial disparities, two main instruments can be used: fiscal equalisation policy and regional development policy. This section reviews them both.

Transfer systems and the case for fiscal equalisation

Regions often differ in their needs and resources. On the one hand, public service expenditure needs vary depending on geographical factors (remoteness, isolation, low density of population, etc.) and/or their social composition (e.g., greater presence of children, elderly, or disabled people), pushing the cost per service upwards. For example, transport services in and out of sparsely-populated rural regions may have a higher per capita provision cost than in urban areas. On the other, revenue-raising capacities usually stem from differences in per capita GDP across jurisdictions: accordingly, without fiscal redistribution, less well-off regions are often unable to fund their public services properly as their direct tax revenues are not sufficiently large.

Transfer systems: an overview

Transfer systems form an important element of subnational government financing because they can help ensure that different subnational governments are able to provide at least the minimum acceptable level of services. In general, transfers are used to reduce fiscal disparities at two levels a) between central government and subnational government (*vertical fiscal gap*), and b) between subnational governments (*horizontal fiscal gap*). Vertical fiscal gaps can be diminished by paying lump sum transfers to subnational governments. Horizontal fiscal gaps are usually tackled with equalisation systems, which are based on indicators and formulas that take into account differences between subnational governments in tax bases (tax base equalisation) and in service needs and special circumstances (expenditure equalisation).

A well-working transfer system ensures that subnational governments can provide comparable level of public services with comparable tax rates (Dougherty and Forman, 2021[15]). Comparability is important mainly for two reasons: first, the central government can better monitor subnational governments using indicators on service availability and quality, and second, local residents can compare the local public services and tax rates of their own jurisdiction to situations in neighbouring jurisdictions.

To classify the different types of transfers, the OECD Fiscal Federalism Network developed a taxonomy of grants (Figure 2) (Blöchliger and King, 2006[16]). The main separation is between *earmarked (conditional) and non-earmarked (unconditional) grants*. Subnational governments must use earmarked grants or the conditional grants for a specific purpose whereas they can spend non-earmarked or unconditional grants freely. Both main types of transfers are further divided into *mandatory and discretionary transfers*. Mandatory transfers are defined in law, whereas discretionary transfers do not have such clear basis. Discretionary grants are generally not recommended in wider use, as they may make the transfer system more complex and less transparent, making it more likely to suffer from lobbying and corruption practices. The discretionary grants can be divided into grants for *capital expenditure* and grants for *current expenditure* (Blöchliger and King, 2006[16]; Bahl and Bird, 2018[17]).

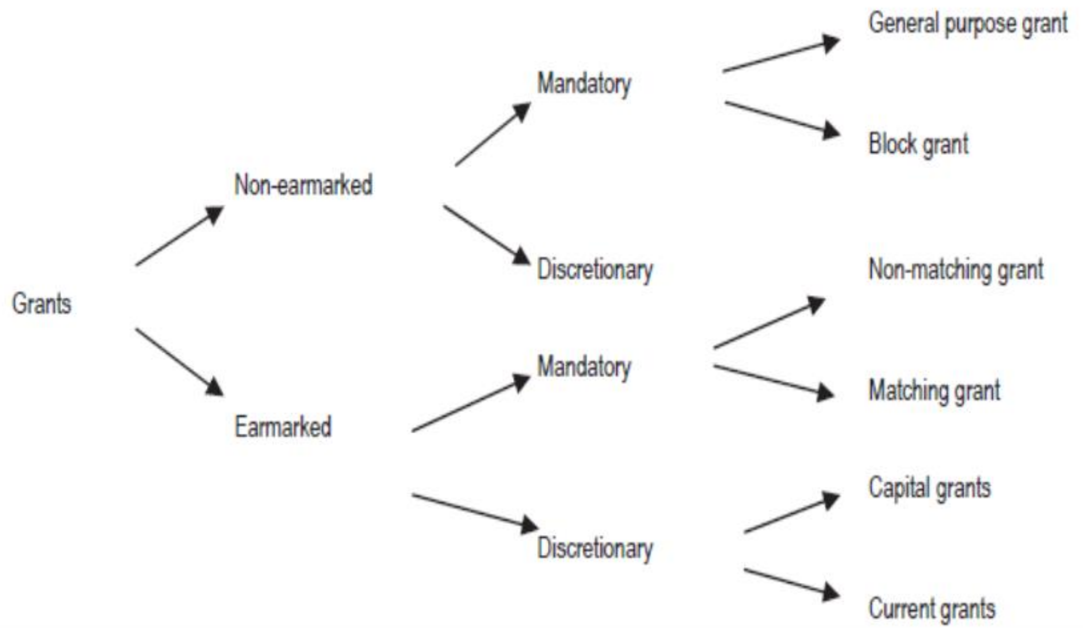
Earmarked grants may be further subdivided into *matching and non-matching grants*. Earmarked grants aim to incentivise municipalities to spend funds on specific projects. Such grants are typically used by central governments to internalise externalities, i.e., to ensure that the recipient municipality or region will also take into account the effects on other jurisdictions when making investment decisions (Boadway and Shah, 2007[18]). Matching grants (i.e. a certain percentage of subnational government expenditure in a specific service, say in education) can be useful especially when a new public service is launched. Using matching grants more widely and for a longer time is generally not advisable, because matching grants have been shown to have a tendency to boost spending growth, which can jeopardise the long-term sustainability of public finances (creating or aggravating issues related to higher public deficits, public debt, tax rates, etc.) (Dahlberg and Rattsø, 2010[21]; Moisio and Uusitalo, 2013[22]; Boadway and Shah, 2007[18]). Earmarked grants, especially matching grants, can be problematic for municipalities with low levels of own revenue, especially if the conditional grant is a matching grant, i.e., an own funding share of the recipient municipality is required. This is because for the municipalities with weak tax bases it can be hard to raise enough own revenue to cover the self-financing shares (OECD, 2019[11]).

The non-earmarked (unconditional) grants can be divided into *block grants* and *general purpose grants*. Block grants and general purpose grants are typically defined using formulae, and they are usually recommended for funding subnational governments because they come with no strings attached and allow subnational governments a wider margin of manoeuvre to allocate the resources according to local needs and circumstances (Oates, 1972[23]; Boadway and Shah, 2009[24]). Non-earmarked grants give more decision-making freedom for regions and municipalities to use the funds. There are three main types of such transfers: general per capita grants, revenue equalisation grants, and expenditure equalisation grants. A general per capita grant provides the same amount of revenue per capita to each municipality.

The problem with such general per capita grant is that it does not consider the (tax) revenue capacity or the expenditure needs of the municipality. Equalisation grants have been developed for that purpose. The revenue equalisation grants assist municipalities whose tax capacity is lower than some standard level, usually the average. Expenditure equalising grants aim to take into account the service needs (e.g., number of students, demographics, length of roads) and circumstantial factors (e.g., population, population density, remoteness) of expenditures to ensure that every municipality can provide at least a minimum acceptable level of service with a comparable tax rate. Vertical equalisation arrangements refer to transfers from the central to subnational governments, whereas horizontal equalisation arrangements constitute transfers from wealthier jurisdictions to poorer ones, a practice also known as the “Robin Hood principle”.

With the exception of Lithuania and Chile, which adopted a fully horizontal system, OECD countries have most often opted for vertical fiscal equalisation transfers alone (e.g., Australia, Canada, Japan) or for a combination of the horizontal and vertical approaches (e.g., Germany, Norway, Spain, Sweden and Switzerland) (OECD, 2021[6]).

Figure 2. The OECD taxonomy of grants



Source: (OECD, 2019[25])

Fiscal equalisation grants can help ensure equitable public service provision

With the aim of mitigating regional differences in fiscal capacity and expenditure needs, most OECD countries have developed fiscal equalisation systems, each of them with different specificities. In general, fiscal equalisation systems can be grouped based on who makes the transfer and what item is being equalised.

On the other hand, fiscal equalisation systems can be placed into three categories depending on which item in the subnational accounts they seek to equalise: revenue equalisation, expenditure equalisation, and gap-filling equalisation (OECD, 2021[6]). Revenue equalisation seeks to compensate for disparities in per capita revenues by measuring the real or potential per capita revenues of a subnational entity (see Box 1 for more detailed discussion). Countries with vertical fiscal equalisation arrangements such as Canada tend to use a representative tax system based on cross-regional average tax rates to calculate the size of the transfer for each subnational unit. Horizontal equalisation in Canada is carried out at the provincial level in Canada. Provincial transfers to municipalities in Canada are largely conditional in the sense that funds must be spent on specific services designated by the provincial government (Bird and Slack, 2021[26]).In turn, horizontal revenue equalisation arrangements are often characterised by skimming; a rule by which all subnational revenues above a certain threshold are appropriated by the centre and redistributed among subnational governments. This is the case for example of Germany.

Expenditure equalisation seeks to narrow inter-regional disparities in per capita costs. This is usually done by using average or standardised costs based on different budget categories rather than subnational actual expenditures. This adds a considerable layer of complexity to the equalisation formula and design, although this varies widely across countries: for instance, while India only considers two factors when accounting for the per capita cost variation between its states (namely, forest cover and surface area), Sweden includes a set of sectoral expenditure models that rely on a number of variables each.

Finally, gap-filling equalisation combine cost and revenue equalisation into one single transfer whose aim is to bridge the gap between assessed costs and assessed revenues. Japan and Korea are both examples of this modality.

Box 1. Fiscal equalisation can equalise differences in per capita tax bases and expenditures

Both the revenue and expenditure equalisation are usually formula based. In a simple form, the tax equalisation formula can be written as:

$$\textit{Tax capacity equalisation}_i = POP_i \times [\textit{tax rate}_j \times (\textit{tax base}_j - \textit{tax base}_i)]$$

where *Tax equalisation*$_i$ is the tax equalising grant for municipality i, POP_i is the number of inhabitants in municipality i, *tax rate*$_j$ is the country average municipal tax rate, *tax base*$_j$ is the average municipal per capita tax base, and *tax base*$_i$ is the per capita tax base of municipality i. In this example, the tax capacity is equalised to the country average.

An example of a simple expenditure equalisation formula for one public service can be written as:

$$\textit{Expenditure equalisation}^k_i = POP_i \times [SE^k_i - SE^k_j],$$

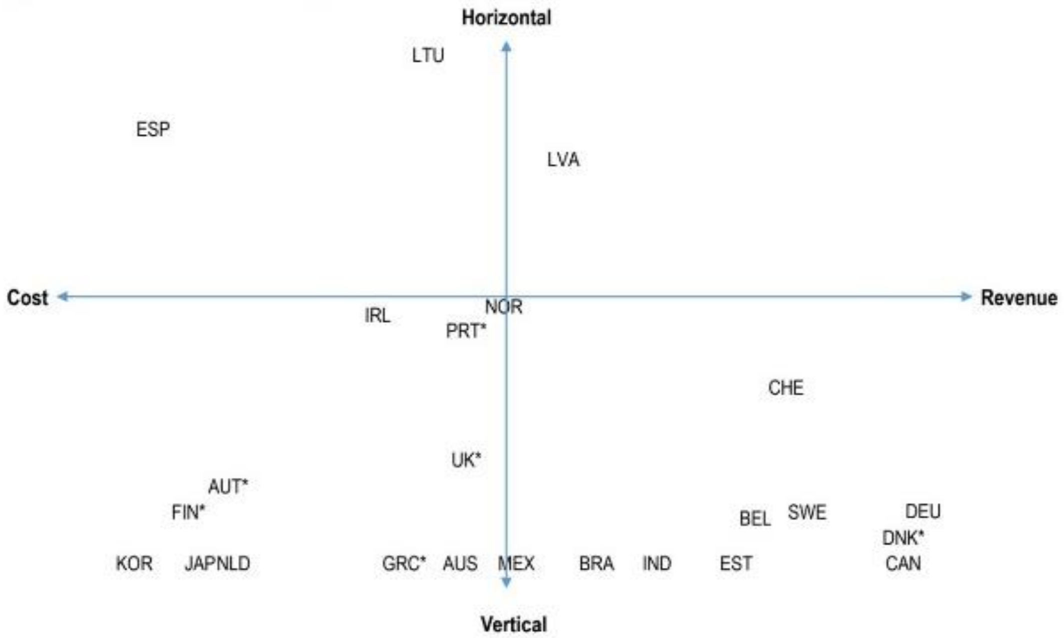
where *Expenditure equalisation*^k_i is the equalisation entitlement for expenditure type k for municipality i, SE^k_i is the standardised per capita expenditure of public service k for municipality i, and SE^k_j is the average national per capita standardised expenditure for public service k (Boadway & Shah, 2007). Expenditure equalisation systems are often very complicated entities, consisting of several indicators for service needs and circumstantial factors, and with many public services.

Source: (Boadway and Shah, 2007[18]).

Overall, in the OECD 54% of fiscal equalisation arrangements adopt a combination of revenue and cost equalisation while 23% rely exclusively on revenue equalisation and the remaining 23% fall into the category of gap-filling equalisation. OECD countries seem to avoid exclusively cost equalisation systems, probably due to their additional complexity (Dougherty and Forman, 2021[15]).

The wide range of choices when designing a fiscal equalisation policy has led to the emergence of very diverse fiscal equalisation schemes throughout the OECD. Figure 3 shows the pattern of equalisation arrangements, both within and across countries. The horizontal axis displays the cost-revenue dimension, with countries on the left having adopted a more “cost-oriented” equalisation scheme, and the vertical axis depicts the vertical-horizontal dimension, with countries placed higher using horizontal transfers rather than vertical ones.

Figure 3. Visualisation of approaches to fiscal equalisation



Note: Asterisks indicate placement from (OECD, 2013[27]).
Source: (OECD, 2021[6])

Figure 3 also hints at a preference for vertical fiscal equalisation programmes, which are in place in a majority of OECD countries. Instead, horizontal fiscal equalisation is applied in only a few countries, either combined with a vertical system (e.g. Latvia, Spain) or in isolation (e.g. Lithuania, Chile), and at different degrees across the cost-revenue spectrum.

Chile implements a horizontal equalisation scheme, called the Municipal Common Fund (FCM). FCM equalises both spending needs (35% of equalisation) and revenue potential (65%). Funds are distributed to beneficiaries according to a formula based on criteria such as the population, property exemptions, poverty and local revenue. The FCM's resources come from automatic contributions from municipalities via the transfer of a portion of their tax revenues (i.e. territorial tax, municipal business licenses, vehicle registration tax, and the tax on vehicle transfer and revenues from fines). Other transfers to municipalities in Chile include earmarked grants for health expenditure (delegated functions), and access to specific funds for social and investment programmes (OECD and UCLG, 2019[28]; OECD, 2017[10]).

In Estonia, the equalisation grant is based on the difference between the estimated average operating cost of the municipality and the estimated own revenue of the municipality. The estimated revenue consists of the municipal share of income tax revenue and land tax revenue. The estimated expenditure is based on a calculation using the information of expenditure needs. Currently, 90% of the (positive) difference is considered. The equalisation formula also takes into account the possible revenue from mining activities and the "island municipality" status.

Box 2. Lithuania's horizontal fiscal equalisation system

Lithuanian municipalities receive most of their revenue from personal income tax, whose rate and applicable tax share is defined by the central government. Lithuania's central government manages a fiscal equalisation system that transfers resources from wealthier jurisdictions to less well-off ones. Central government transfers represent roughly 90% of local government revenues and only 60% local government spending is non-earmarked, which points to low spending autonomy (OECD, 2020[29]).

The main criterion used to determine each municipality's contribution to the fiscal equalisation system is the projected PIT per capita; those above this standard must send a share of their revenue to other municipalities. In 2020, only eight out of 60 local governments were net contributors to the system. This inter-budgetary reallocation of funds co-ordinates a transfer of resources to municipalities that are suffering from ageing and depopulation trends. These municipalities are often rural and highly dependent on these transferred funds, a dynamic that could push a race to the bottom and little effort from municipalities to explore other ways of attracting revenue to improve their economic, financial, and social situation (Skauronė and Montvydaitė, 2019[30]). In this sense, a new amendment to the Law on the Methodology for Determining Municipal Budget Revenues allocated in 2020 an additional share of the PIT to municipalities with average or low economic growth potential which exhibited a growing payroll indicator. This serves as an encouragement for municipalities to promote business development, job creation and attract investments.

Note: Net contributors were Vilnius City, Kaunas City, Klaipėda City, Neringa, Kaunas district, Klaipėda district, Vilnius district and Trakai district municipalities.

It appears that designing and implementing a fiscal equalisation mechanism comes with its challenges, and may, at worst, fuel perverse incentives. Firstly, devising an equalisation formula implies choosing among different methodologies with various nuances. Selecting a "comparable" tax standard implies deciding on whether to use the highest tax base, the average one or yet another alternative. Similarly, measuring fiscal capacity requires determining which taxes are included in or left out of said measurement: property tax, land transfer duties, user fees, etc. Other formulae group similar subnational entities together or apply several weighting factors such as population density or road network extension. In general, experience has shown that complexity in the methodology does not necessarily result in greater fiscal equity. Complex equalisation systems may have unintended negative consequences through implicitly perverse incentives. These include the use of need factors for government employment and incidence of crime, which may contribute to higher public employment and a reluctance to initiate policies to curb crime, etc. (OECD, 2019[11]). In some cases, some equalisation systems may also have counter-productive effects, fundamentally increasing dependency and encouraging "tax laziness", subsidised subnational governments are not incentivised to develop their tax bases) (OECD, 2017[10]).

Secondly, inefficiencies due to misallocation of labour and business may also arise when intergovernmental transfer systems and fiscal equalisation systems, by creating a level-playing field, curb inter-regional mobility (Albouy, 2012[31]). This effect would disincentivise companies and individuals from moving to another region where they could increase their productivity and develop their full potential. While intergovernmental transfers and fiscal equalisation may reduce the potential gains that individuals could reap from moving (e.g. lower tax rates, better public services and other benefits), companies can be locked in because of generous support programmes and may also find it harder to access a workforce that has the required skills as a result of lower migration. Consequently, fiscal equalisation policies, in rectifying fiscal inequities, run the risk of weighing down on regional/national economic growth. Finally, fiscal equalisation mechanisms are usually subject to heated political debates, with opposing interests between wealthier and poorer regions as well as between regions and the central government making it hard but essential to reach a national consensus on the standard of equalisation to be used, at least for a reasonable period of time.

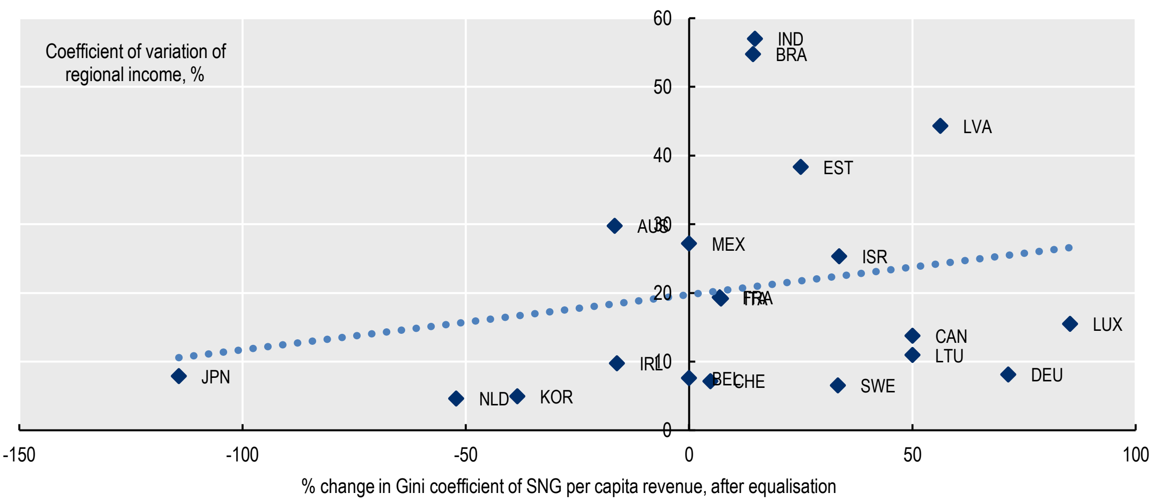
Is fiscal equalisation associated with lower fiscal and income disparities?

OECD empirical studies have shown, through different approaches, that fiscal equalisation tends to be associated with lower fiscal disparities. In a sample of 15 OECD countries, fiscal equalisation amounts to roughly 2.3% of GDP, 4.8% of total government expenditure and almost half of all intergovernmental grants on average (Blöchliger et al., 2007[32]). On average, fiscal equalisation is associated with lower revenue disparities between subnational governments (measured by the Gini coefficient or variation coefficient) by almost two thirds in these countries, and in some countries such as Australia or Germany, the disparities are practically eradicated.

The impact of equalisation on inter-jurisdictional revenue disparities greatly depends on the type of equalisation. Recent OECD research has estimated the change in the Gini coefficient of per-capita revenues of subnational governments before and after equalising transfers are applied, and has found that gap-filling equalisation systems are associated with a rise of 36% in the Gini coefficient in subnational government per capita revenue disparities (OECD, 2021[6]). This is not the case for combined revenue-cost and especially revenue equalisation systems, which lead to unambiguous declines in subnational government revenue inequality. The equalisation modality thus has an impact on disparities in inter-regional per-capita revenues.

Yet, the relationship between fiscal equalisation and regional income disparities remains far from clear (Figure 4).

Figure 4. Regional disparities vs extent of fiscal equalisation



Note: This chart illustrates the trend line resulting from a univariate regression of the percentage change in inter-jurisdictional Gini coefficient of revenue per capita after equalisation to the coefficient of variation of regional income per capita. The linear coefficient is not significant (P-value = 0.35) The dispersion of individual countries around the trend line (blue dots) indicates the presence of both high and low regional income disparities at varying levels of fiscal equalisation. Cross-sectional data obtained for roughly 2016-18 depending on country.
Source: (OECD, 2021[6])

Figure 4 indicates that there is no significant correlation between the size of fiscal equalisation and levels of regional income equality. There are several potential explanations for this. In particular, countries differ considerably in the design and intensity of their transfer systems. In order to better understand the relationship, other factors that may be affecting the relationship should be controlled for. It should also be noted that assessing equalisation systems cannot solely rely on their influence on local revenue disparities. Consideration must also be given to the varying degrees of fiscal equalisation present in different countries, ranging from none, partial, to extensive models. Further research is necessary to enhance our understanding of the relationship between fiscal equalisation and regional income differences.

These findings indicate that, while fiscal equalisation can effectively create a level-playing field in the fiscal arena across subnational jurisdictions, as it is designed to do, it is not necessarily a panacea for redressing regional income inequalities. Regional development policies, which to a large extent embody this goal, are, in principle, better suited to pursue this objective.

In Sweden, the fiscal equalisation system (see also Box 3) combines both vertical and horizontal arrangements based on five allocations, which comprise income equalisation and cost equalisation. Its detailed formula to allocate grants to subnational governments follows three main guiding pillars: justice in service provision, socio-economic composition, and territorial considerations. This formula is highly complex, taking into consideration a set of sectoral expenditure models equipped with over a hundred variables each. With some room for discretionary and earmarked grants, most grants are general. Importantly, the formula also includes so-called structural grants, whose primary goal is to aid municipalities suffering from depopulation trends or problems related to their labour market composition (e.g., ageing, industry close-downs, skills imbalances). Remote regions such as the Norrland County are thus net beneficiaries from this fiscal equalisation strategy.

Box 3. Sweden’s formula-based equalisation

The income equalising formula

Sweden’s income equalisation grant equalises tax potential (not real tax revenues) between municipalities and between counties. Tax potential is defined using the actual tax base per capita times the average tax rate. The local governments with a per capita tax revenue below 115% of the average tax receive a grant, and local governments with a tax above 115% of the average tax pay a fee according to a special formula. The formula can be written as follows for the receiving municipality/county:

$$Grant_i = tax\ rate_j \times (1.15 \times tax\ base_j - tax\ base_i) \times C_k$$

where $Grant_i$ is the tax equalising grant for municipality/county i, tax $rate_j$ is the country average municipal/county tax rate, tax $base_j$ is the average municipal/county tax base, and tax $base_i$ is the tax base of municipality/county i. The result is multiplied with compensation rate C_k, which is 0.95 for municipalities and 0.9 for counties.

The main purpose behind the income equalisation grants is to equalise differences in the local tax base. In 2015, there were large differences in municipal tax bases: from a minimum of SEK 191 500 per capita to a maximum of SEK 504 400 per capita. The majority of the municipal tax bases, however, were grouped near the mean tax base (239 934 SEK per capita).

The municipalities/counties where the tax base is above 115% of the country average, have to pay a contribution to the equalisation system. If the tax base is between 115% and 125% of the country average, the compensation is 0.60 times the exceeding amount of tax base. For the part of the tax base that exceeds 125% of country average, the municipality pays 0.85 times the exceeding amount.

In 2015, 38 out of Sweden’s 290 municipalities had a tax base higher than 115% of the average tax base in the country, and that hence had to pay a fee into the system. Of these 38 municipalities, 20 are located in the Stockholm County area.

Cost equalising formulas

Cost equalising grants are based on standard costs which are calculated using several formulas. The Swedish cost equalising system is very detailed as it includes a separate model for each mandatory subnational service (there are 10 sub-models). The formulas are based on research results highlighting factors that affect subnational costs. The models include indicators describing different aspects of subnational costs, such as demographic structure, ethnicity, socio-economic situation and geography. The indicators used in the formulas are selected so that subnational governments themselves cannot affect the equalisation. Only differences between estimated costs and the average standard cost are taken into account. Contrary to income equalisation, which is mostly centrally funded, Swedish cost equalisation is strictly between municipalities/counties, though there is a different system of each of these subnational government levels.

Source: (OECD, 2017[33])

Regional development policy aims to support economic activities in all regions

Regional development policy is a long-term, cross-sectoral, multi-level policy that aims to improve the contribution of all regions to national performance and reduce inequalities between places and between people (OECD, forthcoming[8]). It aims to do so by supporting economic activities in regions in a way that ensures effective use of public resources (OECD, 2019[34]). Thus, while fiscal equalisation seeks to aid weaker subnational governments financially, place-based regional development policy aims to tackle the root of a region's weakness, mobilise its endogenous assets and resources, and strengthen its economic tissue in the long term so that development paths are created and economic inequalities are reduced as much as possible (Oliveira Martins, Tompson and Garcilazo, 2010[35]; McCann, 2023[36]).

To increase territorial equality, regional development policy at the national level does not consist of a fixed set of policies; rather, it consists of strategies to support the coherent implementation of various policies across sectors (transport, employment, education, economic development, energy, welfare, etc.) with the involvement of multiple stakeholders such as local and regional governments, the private sector, and citizens themselves. Oftentimes, the policy debate includes other stakeholders such as international organisations or non-governmental organisations and encompasses relevant issues such as innovation and entrepreneurship, climate change, skills, and demographic change. Regional development policy can therefore be understood as a "policy of policies", tapping into various policy arenas to support regional development with the aim of addressing the regional dimension of core issues that OECD countries are currently facing (OECD, 2019[34]).

The case for place-based policies

Over the past few decades, regional development policies have been classified into two main categories, depending on whether the focus is put on efficiency or equity.

So-called people-based policies posit, drawing from mainstream neoclassical growth theory, that regional development policy interventions in poorer and lagging areas of a country not only are unnecessary but also represent a loss in efficiency. Perfect competition and factor mobility should produce constant or diminishing returns to scale in wealthy regions because of agglomeration dynamics and high land and labour costs. Concentrating wealth production in a dense agglomeration of economic activity should diffuse wealth to and among other regions, leading to real income convergence and opportunities (Glaeser, 2008[37]).

Nevertheless, in the last few decades only the former has materialised: wealth has become concentrated in dynamic large urban agglomerations, but virtually none of the accumulated benefits has been diffused to lagging regions, which often host stagnating or declining industries and suffer from geographical remoteness. These spatially-blind approaches to regional development policy have failed to deliver on their promise of wealth diffusion to the rest of regions. Although inequalities across countries have declined, inequalities between regions within countries have not, and persist over time, especially at the level of small regions (OECD, 2022[41]). Today, 70% of the population in the OECD live in countries that have experienced increases in regional income inequality, polarisation, and bottom region divergence in the past two decades. This is often due to the top metropolitan regions pulling ahead, widening the gap with lagging regions. The 2008 Great Financial Crisis appears as a turning point that split OECD countries in terms of their regional income inequality trajectories (OECD, 2023 forthcoming) OECD estimates show that productivity in the least productive region of a country is 46% lower on average than productivity in the most productive region (OECD, 2019[34]). What were meant to be space-neutral policies have not been able to address spatial disparities, which have seen increasing splits between large urban areas and other regions of a country in many economies. According to the people-based approach, uneven regional development may go hand-in-hand with overall economic growth.

Contrary to people-based policies, place-based approaches to regional development policies maintain that uneven regional development is too high a price to achieve overall economic growth and productivity. Widening territorial inequalities correlate well with growing public discontent and faltering trust in institutions (Rodríguez-Pose, 2018[40]), which can threaten social cohesion. Not fixing these problems can result in significant economic, social, and political costs (OECD, forthcoming[4]).

To defuse these tensions, place-based regional policies posit that less-developed regions of a country have the potential to reduce gaps with wealthier regions. Place-based policies crucially recognise that just as regions differ in their economic performance, they also differ in the factors that lie behind this performance. Not taking into consideration the geographical context (understood in terms of social, cultural, and institutional characteristics) will undermine the aims of any policy that seeks to promote the economic development of a region. Regional development policies are an important complement to sectoral policies, as they provide an integrated development strategy tailored to the specificities of each place (OECD, forthcoming[8]). Consequently, the objective of place-based policies is thus to analyse each region's strengths and weaknesses to then use existing regional strengths productively for endogenous economic development while addressing specific weaknesses that may form bottlenecks to economic development. By ensuring that opportunities are provided also to declining places, feelings of being left behind or abandoned can be tackled.

How do place-based policies work?

Place-based policies do provide direct support to lagging regions, but not at any cost. Place-based regional policies do not perpetuate the use of subsidies to lagging regions as a lifeline for their ailing industries. Whilst equity is the ultimate goal of these policies, it is not to be achieved by funnelling resources from productive to unproductive regions. This is in contrast with the past regional development policy, which mainly focused on large-scale infrastructure development and measures to attract subsidies and inward investment as its two fundamental pillars. But despite significant public funding to lagging regions, these policies based mostly on said pillars largely failed to help individual lagging regions catch up (OECD, 2022[41]; Spahn, 2007[42]).

The objective of place-based policies is, instead, to help regions utilise their own strengths and potential by increasing employment, productivity, and competitiveness. This counteracts potential races-to-the-bottom among regions; rather than undercutting each other, oftentimes at the expense of tax revenues or labour standards, place-based policies allow for each region to compete in a productive way while lifting the economic performance of the country. As such, place-based regional policies should not be understood as policies that seek to implement the same levels of amenities and infrastructure in all territories of a country. This would likely prove inefficient. Instead, regional policies should be perceived as a long-term equity generator, setting the framework conditions for equity, co-operation, and growth for the long run (Council of Europe, 2021[43]).

Table 1. Characteristics of modern place-based regional development policy

	Regional policy characteristics
Problem recognition	Low productivity (levels and growth); underused regional potential; lack of regional competitiveness; inter-regional and inter-personal inequality.
Objectives	Increasing productivity growth; delivering high-quality of life and well-being to people across economic, social and environmental dimensions.
General policy framework	Tapping underutilised regional potential through regional programming; building on existing strengths; developing regional innovation systems.
Spatial orientation	All regions within a country are targeted with policies adapted to each region.
Actors	All levels of government; relevant non-governmental stakeholders (public, private, academia, non-governmental organisations).
Unit for policy intervention	Interventions should consider both administrative and functional geographies where appropriate. Functional geographies cover the areas in which people live, work and interact (e.g. rural-urban linkages, functional urban areas, cross-border regions, etc.).
Time dimension	Should provide a stable long-term policy environment while responding adequately to newly emerging challenges and opportunities.
Policy fields	Context-specific; considering all relevant policy areas and regional characteristics (economic, geographic, demographic, social, cultural, etc.).
Focus	Endogenous development based on local assets and knowledge.
Instruments	Broad range of instruments, including targeted investment in human capital (e.g. higher education, vocational training, early childhood education, etc); infrastructure investments; support for business development (e.g. business incubators, credit provision, etc.); research and innovation support; co-ordination between non-governmental actors (businesses, universities, etc.).
Operational approach	Encourages policy co-ordination across sectors, levels of government and jurisdictions; and promotes participation and dialogue with private stakeholders and citizens.

Source: (OECD, 2019[11]) revised and updated from (OECD, 2010[44])

Table 1 briefly displays the main characteristics of modern place-based regional policies. As can be seen, place-based regional development policies go well beyond offering direct support only to lagging regions. In fact, irrespective of the stage of development at which a region may find itself, regional development policy may involve adapting to specific territorial assets, designing attractiveness and investment strategies, optimising complementarities, devising efficient multi-level governance systems, and promoting stakeholder engagement. Place-based policies are also an effective tool to anticipate and address region-specific impacts of global megatrends such as automation, demographic changes, or climate change. For example, the OECD calculates that the number of jobs at high risk of automation varies between 4% and 39% across OECD regions (OECD, 2019[34]). New estimates also show that the share of workers in the OECD whose jobs involve a significant number of "green tasks" (i.e. tasks that directly help improve environmental sustainability or reducing greenhouse gas emission) ranges from 7% to more than 35% across OECD regions (OECD, 2023[45]). Similarly, different geographical factors imply that not all regions will be affected by the adverse effects of climate change such as floods. Therefore, place-based frameworks represent an ideal tool to allow sufficient room for adaptation to each region's needs and foster sustainable development processes, away from one-size-fits-all solutions that ignore geographical specificities. In this sense, place-based strategies usually include decentralisation strategies to make multi-level governance systems more flexible and, sometimes, asymmetric to reflect regional disparities.

As essential as they are to achieve a regionally balanced development, place-based regional policies cannot replace structural policies. Instead, place-based policies provide the degree of regional specificity to economic policy that is needed to unlock untapped regional potential. Structural policies that adopt a place-based lens are thus able to spur economic growth, not only in the region directly affected, but also in the surrounding regions and in overall national aggregates.

Box 4. The challenges of place-based regional policies in Champagne-Ardenne (France)

Context

The region of Champagne-Ardenne—part of the region Grand Est since the regional reform effective since 1st January 2016—has been suffering from sustained deindustrialisation and economic stagnation. The decline in manufacturing activities coupled with an exceedingly slow transition to service jobs has triggered an increase in unemployment and a drop in population that have dragged the region into a development trap. This predominantly rural region relies heavily on agriculture and agri-food industries. Champagne-Ardenne qualifies as an old industrial, formerly well-off region that has stagnated for the past few decades.

Economic challenges call for place-based regional development policies

The low dynamism of Champagne-Ardenne is tightly linked to its high levels of specialisation, which make the region vulnerable to conjunctural shocks. An appropriate place-based regional development policy should exploit the strengths of the region and avoid past strategies based on transport infrastructure investment, which have been shown to contribute to a polarisation effect towards Paris, fuelled by the incentives created by the centralised French system. Therefore, local policy-makers are now prioritising the following actions:

- **Increase investment in higher education**. In order to redress existing skills mismatches, current regional policies aim to further invest in higher education institutions with a view to increase the student population by 50% over the next decade. This is crucial to mobilise endogenous resources to revitalise the entrepreneurial ecosystem.
- **Diversify economic sectors**. Promoting rural tourism in the region and leveraging world-wide reputation in wine-making could generate new sources of revenue and prevent from relying intensely on one sector that is subject to conjunctural shocks.
- **Develop closer ties between departments**. The merger of Champagne-Ardenne with Lorraine and Alsace in 2016 promoted better co-operation arrangements between departments and increased the potential for regional investments in local economic development projects, leading to gains in efficiency by avoiding duplication. On the other hand, the merger also caused a loss of public sector jobs (and their multiplier effects) due to the dismantling of regional administration offices in the region.
- **Continue and expand the initiatives of economic development agencies**. "Invest in Reims" and the newly-created "Grand e-nov" regional innovation agency have both been hailed as successes in attracting companies and supporting local businesses with innovative ambitions.
- **Co-operate with other levels of government**. Recently, the French central government has signed contracts between local authorities and itself. The so-called "Pacte Ardennes" makes the region a pilot territory for several national policies directed at spurring local economic development.
- **Revisit fiscal equalisation mechanisms**. Local policy-makers believe fiscal equalisation mechanisms should be reviewed in order to better reflect depopulation trends in this stagnating regions and their shrinking tax bases. Despite having been enshrined in the Constitution in 2004 (Art. 72.2, para. 5), the French equalisation system suffers from a deficit of transparency. This largely stems from the recurrent modifications that have led to the existence of 14 funds and allocations, eight of them being vertical and the remaining six, horizontal (Taugourdeau and Kies, 2019[46]).

Source: (Iammarino et al., 2020[47])

2 Enhancing synergies between fiscal equalisation and regional development policies: benefits and challenges

While incentives for developing own-source revenues at the subnational government level contribute to regional growth policies, many subnational governments nevertheless need substantial additional financing to provide the services they are assigned (OECD, 2019[11]). To avoid the proliferation of so-called unfunded mandates —that is, mismatches between the responsibilities allocated to and the resources available to regional and local authorities (Rodríguez-Pose, Tijmstra and Bwire, 2009[48]; OECD, 2019[11]; Rodríguez-Pose and Vidal-Bover, 2022[49]), fiscal equalisation mechanisms aim to correct fiscal imbalances and thus provide approximately comparable levels of public services under comparable tax regimes (Blöchliger et al., 2007[32]). An appropriate fiscal equalisation system is one that guarantees that "finance follows function", that is, that regional governments are equipped with the necessary resources to fulfil the responsibilities in their portfolio (Bahl, 1999[50]). This is in line with Article 9.5 of the European Charter of Local Self-Government, which calls for guaranteeing the protection of financially weaker subnational authorities with an effective fiscal equalisation system, among others.

If designed with this in mind, equalisation systems can also correct for structural differences (such as the percentage of welfare beneficiaries, population age structure, employment opportunities) between regions and redress inefficiencies that would distort firm and household decisions (Boadway and Shah, 2009[51]; Kim and Dougherty, 2018[52]). Unfortunately, this is not a straight-forward task. Creating the necessary incentives for policymakers as well as accurately measuring structural differences between regions may prove challenging.

This section aims to explore the benefits of strengthened co-ordination between fiscal equalisation and regional development as well as the challenges that may be faced when trying to establish these synergies (see Table below). The section brings together the discussion provided in the previous chapters and an additional analysis on the co-ordination aspect.

Potential benefits from enhancing synergies between policies

Fiscal equalisation can deter inter-regional movement of labour and business based on fiscal disparities only

As discussed above, fiscal equalisation can help to create a level playing field for citizens and businesses in regions (OECD, 2019[11])[1]. This can facilitate the inter-regional movement of labour and business primarily in response to economic reasons other than net fiscal benefits offered in different regions. For instance, large fiscal disparities could induce migration into regions that have higher revenues and better services. A loss of productivity could materialise if a worker decided to migrate due to such benefits even if they would work at a higher productivity level elsewhere (Hofman and Cordeiro Guerra, 2007[53]). A level playing field supported by fiscal equalisation could allow for more targeted regional development policy measures. In other words, better co-ordination of fiscal equalisation and regional development policy could help strike a balance between them, making overall regional development policy more effective.

Public services provided due to fiscal equalisation transfers can help promote economic development in poorer regions

Without fiscal equalisation, the potential of regional development policies could be seriously undermined. With no equalisation of revenue capacity and spending needs, subnational government services could be lower in fiscally poor regions and/or local tax rates higher. For the former, this would translate into disparities in service delivery, which would jeopardise poverty alleviation efforts, as public services that are usually provided at the subnational government level such as primary health and education are critical in empowering the poor (Hofman and Cordeiro Guerra, 2007[53]). Major disparities in subnational government service provision could therefore eventually perpetuate or delay income convergence across regions. With no fiscal equalisation it is also possible that migration to main urban areas could cause congestion in cities, resulting in a loss of welfare despite any potential productivity gains and overall economic growth (Henkel et al., 2021[54]).

Appropriate regional development policies could lessen the need and size of fiscal equalisation transfers

On the other hand, some authors posit that countries with very generous equalisation systems, such as Germany, may benefit from scaling down fiscal equalisation and increasing place-based policies (Henkel et al., 2021[54]). In principle, this would be especially beneficial for certain countries if fiscal equalisation crowds out private business and makes the periphery dependent on grants. Therefore, better co-ordination between fiscal equalisation and regional development could enable policy measures that increase the efficiency of public decision-making, for example by giving local governments a stronger incentive to develop their own tax bases.

Fiscal equalisation and regional development can both strengthen national unity

Furthermore, fiscal equalisation and regional development share the goal of national unity (OECD, 2019[11]). It is widely agreed that fiscal equalisation transfers can strengthen a sense of national citizenship among residents of diverse localities. For instance, large regional disparities in public service delivery may cause social unrest in regions that are left behind, and could undermine social cohesion. From this angle, it is clear that fiscal equalisation could contribute to regional development targets.

---

[1] Fiscal equalisation is discussed as one of the 10 OECD guidelines in *Making decentralisation work: A Handbook for Policymakers* (OECD, 2019[11]).

Policy co-ordination across ministries and among levels of government can raise total efficiency

In general, a strengthened co-ordination between fiscal equalisation and regional development policies could make regional development policies more effective and could help finding a better balance between fiscal equalisation and place-based policies. Even when the objectives and target groups are different, the outcomes of fiscal equalisation and regional development are closely related. Effective regional development policies that succeed in reducing regional income disparities may also work to reduce the need for large-scale fiscal equalisation schemes.

In addition, central governments are responsible for both fiscal equalisation and regional development policy, and both policies are financed from same budget. It is therefore natural to think that these policies and the funds allocated to those policies should be co-ordinated. Despite their different main objectives, in practice fiscal equalisation and regional development policies are inextricably intertwined. What is more, widening fiscal equalisation transfers may essentially respond to deficient or inexistent place-based regional development policies. Hence, it is clear that inter-ministerial co-operation is vital to align interventions and ensure that the different objectives of these policies are both equally achieved.

Potential challenges of co-ordinating and striking a balance between fiscal equalisation and regional development policies

It may be unclear how to incorporate fiscal equalisation into regional development goals (and vice versa)

The main purpose of fiscal equalisation is to ensure that subnational governments have the financial means to deliver the responsibilities assigned to them (OECD, 2019[11]). Similarly, it may not be obvious how regional development policy goals could be taken into account in a specific fiscal policy tool like fiscal equalisation.

Overly complicated fiscal equalisation formulae may lead to unintended consequences

It is also frequently recommended that intergovernmental grants should focus on a single objective. In line with the traditional policy design principles posited by economist Jan Tinbergen, each specific economic objective necessitates a distinct policy instrument, given the lack of a singular instrument capable of simultaneously realising multiple economic goals. Accordingly, one should be careful not to jeopardise the main goals of regional development for stimulating economic development and fiscal equalisation for mitigating fiscal disparities.

In other words, equalisation should be the main purpose of equalisation transfers. In the same vein, regional development funds should be used to boost regional development. Setting too many objectives in a single grant programme may run the risk of failing to achieve any of them.

Reforms to fiscal equalisation systems could provoke political conflict

Extensive or abrupt changes in the policy mix between fiscal equalisation and regional development policy may be politically controversial. It is also possible that regional elected officials prefer fiscal transfers over other place-based policies. In particular, top-down reforms of co-ordination may encounter stiff resistance from subnational governments. Any reforms on these policies should ensure that regions retain ownership of both subnational public service delivery and regional convergence.

Differences in the size of transfers may disincentivise policy co-ordination

Stronger synergies may also be hampered by the fact that the funds allocated to fiscal equalisation are often much larger than those for regional development. For example, in Germany, the amount of fiscal transfers is more than twice as large as all EU structural funds taken together (Henkel et al., 2021[54]). Without any other additional incentives, it might be difficult to motivate co-ordination if the size of funds is very different.

Inter-ministerial co-operation cultures may influence policy co-ordination

Finally, different ministries in the government are usually responsible for these policies. While fiscal equalisation is usually managed by Ministry of Finance, regional development is the responsibility of other ministries such as Ministry of Interior or Ministry of Economy. Measures to strengthen synergies between these policies then depend much on the co-operation culture in the government.

Table 2. Summary of benefits and challenges of enhancing synergies between fiscal equalisation and regional development policies

Benefits	Challenges
Fiscal equalisation can create a level-playing field and facilitate inter-regional movement of labour and business on economic rather than fiscal benefits.	How to introduce regional development considerations in a fiscal equalisation formula remains unclear and would further complicate the fiscal equalisation formula.
Without fiscal equalisation, regional policies would be unable to tackle inequalities due to differences in public service provision levels.	Focusing on too many objectives could dilute the main purposes of both policies and achieve none.
Appropriate regional development policies could lessen the need and size of fiscal equalisation transfers.	Reforms to fiscal equalisation systems may stir political animosity.
Fiscal equalisation and regional development both ultimately pursue national unity.	Where fiscal equalisation receives more funding than regional development, there may not be sufficient motivation for co-ordination.
Enhanced synergies could contribute to better balance and efficiency of both policies.	Inter-ministerial cooperation may inefficiently convolute policy goals and efforts.

Source: Authors' elaboration.

Conclusions

For the past decade, territorial inequalities in most OECD countries and regions have been on the rise, largely driven by rising inequalities in labour productivity (OECD, forthcoming[4]). Despite sustained government efforts, regional disparities have not decreased significantly, and productivity differences between regions persist (OECD, 2019[34]). As a result, a growing discontent with the political and economic status quo has emerged in recent years. Furthermore, socio-economic megatrends such as ageing, depopulation, job automation, and the green transition, which have been aggravated and, in some cases, accelerated, by the COVID-19 pandemic. This has heightened awareness of territorial inequities in public service provision in healthcare but also education (OECD, 2021[1]). The uneven impact of these shocks and megatrends across regions risks fuelling discontent among regions and eroding social cohesion. This emphasises the importance of actions that foster greater territorial solidarity and more equitable and sustainable development of all regions in a country.

This working paper has reviewed two policy mechanisms that are traditionally used in decentralised contexts in order to ensure an equitable public service provision and similar standard of living for all inhabitants of a country, regardless of their location. On the one hand, fiscal equalisation aims to offset differences in revenue raising capacity and/or public service costs with the purpose of allowing subnational governments to provide similar public services with comparable tax rates. Fiscal equalisation thus strives to achieve fiscal equity among jurisdictions and ultimately to ensure equitable public service provision. On the other hand, regional development policies seek to tackle the root of a region’s weakness and strengthen its economic tissue in the long term so that development paths are created and economic inequalities are reduced as much as possible. In practice, place-based regional development policies analyse each region’s strengths and weaknesses to then use existing regional strengths productively for endogenous economic development while addressing specific weaknesses that may form bottlenecks to economic development.

Whilst fiscal equalisation transfers and regional development policy tools form an important part of public policy, surprisingly little is known about their interactions and implications on aggregate economic activity, distribution of population and income across space, regional migration flows, productivity, and welfare. This working paper has outlined some of benefits and the challenges that come with maximising synergies between fiscal equalisation and regional development policies. Challenges emerging from enhanced synergies between the two often involve overly complicated formulae that mix the objectives of different ministries, but that risk ending up achieving none. By contrast, the benefits of maximising synergies between the two indicate that while the objectives of these policies might be different, their outcomes are related: succeeding to implement a regional development policy that narrows territorial income inequalities could, in combination with good governance practices and a framework that clearly allocates responsibilities among levels of government, facilitate the collection of similar taxes across territories. This could lessen the need and the size of fiscal equalisation transfers, which are often politically sensitive matters. Therefore, synergies between policies (and ministries) should be enhanced to achieve both fiscal and economic equality. This remains a theoretical framework and would need to be empirically tested.

The different stances regarding enhancing synergies between these two policy instruments call for further research on at least five fronts.

First, papers such as this one and empirical studies in general have so far struggled to reach a robust conclusion on whether fiscal equalisation reduces income inequalities. Undertaking a longitudinal analysis would provide a way to further test the interrelationships between the two policies. Second, future studies should test the proposed theoretical framework in this document by analysing the potential effect of regional development policy interventions on the need or size of fiscal equalisation transfers across OECD countries. This would allow for a much better understanding of the synergies that may operate between the two. Of course, as a third point for action, more data on the size and use of equalisation and regional development policies in different countries is needed—crucial for the studies proposed to be carried out. Fourth, new analyses could look into the processes of co-operation between the actors responsible for these policies, often in different ministries at the central/federal level of government.

Finally, a broader reflection on the use of GDP per capita as the normative measure used is in order. This represents a significant caveat in current studies on fiscal equalisation and place-based development policies. While fiscal equalisation provides scope for local governments to spend more, potentially increasing local GDP, this cannot be taken for granted. For instance, a local government may procure certain services from a firm located in a neighbouring region. In that case, the neighbouring region's GDP would be boosted, but not that of the former. While GDP growth is essential and fiscal equalisation plays a part in promoting it, material well-being per capita is more important than GDP per capita or GDP growth if the ultimate aim of fiscal equalisation is to correct disparities in public service provision with comparable tax rates. In regions with a disproportionate number of elderly people, for example, GDP per capita would probably remain low even after fiscal equalisation as services would likely be provided by neighbouring regions with the necessary human resources and firms to deliver those services, but material well-being would be vastly improved because of fiscal equalisation. Therefore, including a measure of material well-being at the regional level may lead to a clearer and more robust relationship among variables, which studies using GDP measures have found challenging to establish.

What remains clear from this working paper is that further discussion with policy-makers is essential to fully seize opportunities for maximising synergies without adding administrative complexity, in the quest of delivering efficient policies that leave no one region behind.

References

Albouy, D. (2012), “Evaluating the efficiency and equity of federal fiscal equalization”, *Journal of Public Economics*, Vol. 96/9-10, pp. 824-839, https://doi.org/10.1016/J.JPUBECO.2012.05.015. [31]

Allain-Dupré, D., I. Chatry and A. Moisio (2020), *Asymmetric decentralisation: trends, challenges and policy implications*, OECD. [14]

Bahl, R. (1999), “Fiscal Decentralization as Development Policy”, *Public Budgeting & Finance*, Vol. 19/2, pp. 59-75, https://doi.org/10.1046/J.0275-1100.1999.01163.X. [50]

Bahl, R. and R. Bird (2018), *Fiscal Decentralization and Local Finance in Developing Countries*, Edward Elgar. [17]

Baker, M., A. Payne and M. Smart (1999), “An empirical study of matching grants: the `cap on CAP'”, *Journal of Public Economics*, Vol. 72/2, pp. 269-288, https://doi.org/10.1016/S0047-2727(98)00092-9. [19]

Bartolini, D., S. Stossberg and H. Blöchliger (2016), “Fiscal Decentralisation and Regional Disparities”, No. 1330, OECD. [12]

Bird, R. and E. Slack (2021), *Provincial-local equalization in Canada time for a change?*. [26]

Blöchliger, H. and D. King (2006), *LESS THAN YOU THOUGHT: THE FISCAL AUTONOMY OF SUB-CENTRAL GOVERNMENTS*. [16]

Blöchliger, H. et al. (2007), “Fiscal Equalisation in OECD Countries”, No. 4, OECD. [32]

Boadway, R. and A. Shah (2009), *Fiscal Federalism*, Cambridge University Press, Cambridge, https://doi.org/10.1017/CBO9780511626883. [51]

Boadway, R. and A. Shah (2009), *Fiscal Federalism: Principles and Practice of Multi-order Governance*, Cambridge University Press. [24]

Boadway, R. and A. Shah (2007), *INTERGOVERNMENTAL FISCAL TRANSFERS PRINCIPLES AND PRACTICE*. [18]

Council of Europe (2021), *Territorial solidarity: the role regions can play*, Council of Europe, Strasbourg. [43]

Cuadrado-Roura, J., R. Martin and A. Rodríguez-Pose (2016), “The economic crisis in Europe: urban and regional consequences”, *Cambridge Journal of Regions, Economy and Society*, Vol. 9/1, pp. 3-11, https://doi.org/10.1093/cjres/rsv036. [39]

Dahlberg, M. and J. Rattsø (2010), *Statliga bidrag till kommunerna-i princip och praktik*, Swedish Ministry of Finance, https://eso.expertgrupp.se/wp-content/uploads/2013/07/Hela-2010_5-till-webben1.pdf. [21]

Dougherty, S. and K. Forman (2021), “Evaluating fiscal equalisation: Finding the right balance”, *OECD Working Papers on Fiscal Federalism*, No. 36, OECD. [15]

Dougherty, S. et al. (2022), “Going beyond fiscal equalisation: institutional and fiscal tools to fight territorial inequalities”, *OECD Fiscal Network Background Papers*, https://www.oecd.org/tax/federalism/going-beyond-fiscal-equalisation-note.pdf (accessed on 18 March 2023). [7]

Ezcurra, R. and A. Rodríguez-Pose (2013), “Political Decentralization, Economic Growth and Regional Disparities in the OECD”, *Regional Studies*, doi: 10.1080/00343404.2012.731046, pp. 388-401, https://doi.org/10.1080/00343404.2012.731046. [13]

Fratesi, U. and A. Rodríguez-Pose (2016), “The crisis and regional employment in Europe: what role for sheltered economies?”, *Cambridge Journal of Regions, Economy and Society*, Vol. 9/1, pp. 33-57, https://doi.org/10.1093/cjres/rsv032. [38]

Glaeser, E. (2008), *Cities, agglomeration, and spatial equilibrium*, OUP Oxford. [37]

Henkel, M. et al. (2021), “Fiscal Transfers in the Spatial Economy †”, *American Economic Journal: Economic Policy*, Vol. 2021/4, pp. 433-468, https://doi.org/10.1257/pol.20180294. [54]

Hofman, B. and S. Cordeiro Guerra (2007), “Ensuring inter-regional equity and poverty reduction”, in Martinez-Vasquez, J. and B. Searle (eds.), *Fiscal Equalisation: Challenges in the Design of Intergovernmental Transfers*, Springer. [53]

Iammarino, S. et al. (2020), *Falling into the middle-income trap? A Study on the risks for EU regions to be caught in a middle-income trap*, Final Report to the European Commission. [47]

Kim, J. and S. Dougherty (eds.) (2018), *Fiscal Decentralisation and Inclusive Growth*, OECD Fiscal Federalism Studies, OECD Publishing, Paris/Korea Institute of Public Finance, Seoul, https://doi.org/10.1787/9789264302488-en. [52]

McCann, P. (2023), “How Have Place-Based Policies Evolved to Date and What Are They For Now?”, OECD. [36]

Moisio, A. and R. Uusitalo (2013), “The impact of municipal mergers on local public expenditures in Finland”, *Public Finance and Management*, Vol. 13/3, pp. 148-166, https://www.researchgate.net/profile/Antti-Moisio/publication/272795680_The_Impact_of_Municipal_Mergers_on_Local_Public_Expenditures_in_Finland/links/59b10b8c458515a5b488fc58/The-Impact-of-Municipal-Mergers-on-Local-Public-Expenditures-in-Finland.pdf (accessed on 5 May 2023). [20]

Moisio, A. and R. Uusitalo (2013), “The Impact of Municipal Mergers on Local Public Expenditures in Finland”, *Public Finance and Management*, Vol. 13/3, https://www.researchgate.net/publication/272795680. [22]

Oates, W. (1972), *Fiscal Federalism*, New York, Harcourt Brace Jovanovich. [23]

OECD (2023), *Job Creation and Local Economic Development 2023: Bridging the Great Green Divide*, OECD Publishing, Paris, https://doi.org/10.1787/21db61c1-en. [45]

OECD (2022), *Making the most of public investment to address megatrends, regional inequalities and future shocks*, OECD Publishing, Paris. [3]

OECD (2022), *Regional Development Policy - OECD*, [41] https://www.oecd.org/regional/regionaldevelopment.htm (accessed on 20 April 2022).

OECD (2021), *Fiscal Federalism 2022: Making Decentralisation Work*, OECD Publishing, Paris, https://doi.org/10.1787/201c75b6-en. [6]

OECD (2021), *OECD Regional Outlook 2021: Addressing COVID-19 and Moving to Net Zero Greenhouse Gas Emissions*, OECD Publishing, Paris, https://doi.org/10.1787/17017efe-en. [2]

OECD (2021), *The territorial impact of COVID-19: Managing the crisis and recovery across levels of government*, OECD. [1]

OECD (2021), *The territorial impact of COVID-19: Managing the crisis and recovery across levels of government*, OECD, Paris, https://doi.org/10.1787/a2c6abaf-en (accessed on 27 April 2022). [5]

OECD (2020), *Raising Local Public Investment in Lithuania: Ensuring quality while maintaining financial sustainability*, OECD. [29]

OECD (2019), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/g2g9faa7-en. [11]

OECD (2019), *OECD Fiscal Decentralisation Database*, https://www.oecd.org/tax/federalism/fiscal-decentralisation-database.htm#A_1 (accessed on 30 August 2019). [25]

OECD (2019), *OECD Regional Outlook 2019: Leveraging Megatrends for Cities and Rural Areas*, OECD Publishing, Paris, https://doi.org/10.1787/9789264312838-en. [34]

OECD (2018), *Rethinking Regional Development Policy-making*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/9789264293014-en. [9]

OECD (2017), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, OECD Multi-level Governance Studies, OECD Publishing, Paris, https://doi.org/10.1787/9789264279049-en. [10]

OECD (2017), *OECD Territorial Reviews: Sweden 2017: Monitoring Progress in Multi-level Governance and Rural Policy*, OECD Territorial Reviews, OECD Publishing, Paris, https://doi.org/10.1787/9789264268883-en. [33]

OECD (2013), "Fiscal equalisation: A key to decentralised public finances", in *Fiscal Federalism 2014: Making Decentralisation Work*, OECD Publishing, Paris, https://doi.org/10.1787/9789264204577-7-en. [27]

OECD (2010), *Regional Development Policies in OECD Countries*, OECD Regional Development Studies, OECD Publishing, Paris, https://doi.org/10.1787/9789264087255-en. [44]

OECD (n.d.), *Job Creation and Local Economic Development*, OECD Publishing, Paris, https://doi.org/10.1787/26174979. [55]

OECD (forthcoming), "OECD Regional Outlook 2023". [4]

OECD and UCLG (2019), *World Observatory on Subnational Government Finance and Investment - OECD*, SNG-WOFI Database, http://www.oecd.org/regional/observatory-on-subnational-government-finance-and-investment.htm (accessed on 3 January 2021). [28]

OECD Regional Development Ministerial (2019), *Declaration on Policies for Building Better* [8]

Futures for Regions, Cities and Rural Areas, https://www.oecd.org/regional/ministerial/RDPC-Ministerial-Declaration-EN.pdf (accessed on 27 April 2022).

Oliveira Martins, J., W. Tompson and J. Garcilazo (2010), *Why policies may need to be place-based in order to be people-centred | CEPR*, https://cepr.org/voxeu/columns/why-policies-may-need-be-place-based-order-be-people-centred (accessed on 10 May 2023). [35]

Raupelienė, A. (ed.) (2019), *Identification of problems of fiscal autonomy in Lithuanian rural municipalities*, https://doi.org/10.15544/RD.2019.073. [30]

Rodríguez-Pose, A. (2018), "The revenge of the places that don't matter (and what to do about it)", *Cambridge Journal of Regions, Economy and Society*, Vol. 11/1, pp. 189-209, https://doi.org/10.1093/cjres/rsx024. [40]

Rodríguez-Pose, A., S. Tijmstra and A. Bwire (2009), "Fiscal Decentralisation, Efficiency, and Growth", *Environment and Planning A: Economy and Space*, doi: 10.1068/a4087, pp. 2041-2062, https://doi.org/10.1068/a4087. [48]

Rodríguez-Pose, A. and M. Vidal-Bover (2022), "Unfunded Mandates and the Economic Impact of Decentralisation. When Finance Does Not Follow Function", *Political Studies*, pp. 1-25, https://doi.org/10.1177/00323217221136666. [49]

Spahn, P. (2007), "Equity and Efficiency Aspects of Interagency Transfers in a Multigovernment Framework", in Boadway, R. and A. Shah (eds.), *INTERGOVERNMENTAL FISCAL TRANSFERS: PRINCIPLES AND PRACTICE*, World Bank, Washington, D.C. [42]

Taugourdeau, E. and J. Kies (2019), "The outlook for the finances of local authorities in France", *HAL Open Science*, https://halshs.archives-ouvertes.fr/halshs-02515779 (accessed on 27 April 2022). [46]

BETTER POLICIES FOR BETTER LIVES

For more information:

www.oecd.org/regional

@OECD_local

@OECD Centre for Entrepreneurship, SMEs, Regions & Cities