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Adapting intergovernmental fiscal transfers for the future: Emerging trends and innovative approaches

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Abstract

Adapting intergovernmental fiscal transfers for the future: Emerging trends and innovative approaches

Intergovernmental fiscal transfers (IFTs) play a crucial role in addressing vertical and horizontal imbalances, promoting equitable service delivery, and aligning local spending with national priorities across OECD countries. However, their design involves navigating complex trade-offs between equity, efficiency, transparency, and autonomy. This paper reviews the theoretical framework of IFTs, aiming to dissect their objectives, incentives, and outcomes, and to clarify their classification. A significant contribution of this study involves new data that tracks IFTs across the OECD, revealing that transfers from central to subnational governments increased across all countries studied during the COVID-19 pandemic. While there have been no radical changes in IFTs in recent years, emerging trends such as performance-based grants, Ecological Fiscal Transfers, links with regional policy, and new budgeting techniques suggest potential avenues for reform. By understanding the present dynamics and trends, this study aspires to pave the way for more informed, strategic, and beneficial fiscal transfer policies in the years to come, ensuring that these transfers continue to serve their intended purposes effectively while adapting to changing economic and social conditions across OECD countries.

Keywords: intergovernmental fiscal transfers, fiscal federalism, subnational governments, fiscal imbalances, conditional transfers

JEL classification: H77, H81, R58

Adapting intergovernmental fiscal transfers for the future: Emerging trends and innovative approaches

By Sean Dougherty, Andoni Montes Nebreda and Tatiana Mota[1]

Key messages

- Intergovernmental fiscal transfers (IFTs) play a crucial role in addressing vertical and horizontal imbalances, promoting equitable service delivery and aligning local spending with national priorities. However, their design involves navigating complex trade-offs between equity, efficiency, transparency and autonomy.
- Recent economic shocks, such as the COVID-19 pandemic, have significantly impacted IFTs. Newly developed data shows that transfers from central to subnational governments increased across all OECD countries studied, with the most substantial relative growth observed in the area of Economic Affairs, followed by Social Protection.
- While there have been no radical changes in IFTs in recent years, emerging trends such as performance-based grants, Ecological Fiscal Transfers, links with regional policy and new budgeting techniques suggest potential avenues for reform.
- Aligning IFTs with broader policy objectives, such as social well-being, gender equality and ecological sustainability, could help achieve international and national agendas by reinforcing subnational capacities and incentives.

1. Introduction

1. In fiscal federalism, achieving equitable and efficient resource distribution across jurisdictions is crucial for enabling all government levels to enhance service delivery. The decentralisation process entrusts subnational governments (SNGs) with diverse responsibilities that require significant spending, while they exhibit varying degrees of fiscal autonomy and revenue composition.[2] The design of fiscal decentralisation is crucial, as it directly impacts the ability of SNGs to fund and deliver public goods and services.

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[2] New data that enables the distinction between spending requirements and revenue-raising responsibilities across SNGs are crucial for improving our understanding of the fiscal decentralisation process, the efficiency

2. However, it is widely acknowledged that subnational capacities often face considerable challenges, necessitating robust support mechanisms. In this context, Intergovernmental Fiscal Transfers (IFTs) serve as essential tools, ensuring fiscal resource distribution among different government levels. Indeed, in most countries, they form a substantial part of subnational finances, bridging fiscal gaps, correcting externalities, equalising revenue capacities and funding programs aligned with national priorities. Particularly in federations, where regional authorities often have substantial legislative powers, grants need to both respect this autonomy and align with national standards.

3. The structure and conditions of these grants play a vital role in directing regions towards prioritised sectors while allowing them sufficient fiscal independence. This balance is critical for the effective functioning of fiscally decentralised systems, ensuring that regional governments can support and adhere to broader national policies. In addition, transfers are instrumental in promoting regional equity and cohesion, supporting regions with lower economic activity or specific challenges, such as rural areas or those with ageing populations. The significance of IFTs is further amplified in OECD countries, characterised by higher levels of fiscal decentralisation (OECD, 2021), diverse economic landscapes, varying levels of development and distinct regional challenges.

4. Furthermore, the design of IFTs carries significant incentives and consequences. When adequately structured, these grants can enhance efficiency, accountability and quality of service delivery at the subnational level. Conversely, poorly designed IFTs may lead to detrimental outcomes such as fostering dependency, misallocating resources, or intensifying fiscal disparities among regions. The formulation of IFTs, therefore, requires a sophisticated understanding of the principles of fiscal federalism, the intricacies of political dynamics and the diverse economic conditions prevalent across regions. This approach is essential to create a balanced fiscal environment that enables both national and SNGs to operate effectively and fulfil their responsibilities to their communities. The strategic design of IFTs is not just a matter of financial distribution but a crucial element in ensuring that fiscal decentralisation translates into tangible benefits for all levels of government and, ultimately, the citizens they serve.

5. Research on IFTs provides a nuanced understanding of fiscal disparities, informs transfer mechanism design and assesses the effectiveness and efficiency of fiscal transfers (Shah, 2006; Boadway and Shah, 2007; Lago et al., 2024a). These studies shed light on the SNGs' unique fiscal capacities and expenditure needs, which are crucial in an era where accountability and transparency are paramount, ensuring that IFTs continually adapt to the evolving dynamics of fiscal relationships. As local governments gain more autonomy and as socio-economic landscapes change, the design and implementation of IFTs must remain relevant, responsive and robust. Following this line, this paper embarks on a comprehensive exploration of IFTs, a key tool in decentralised frameworks. The paper aims to dissect the multifaceted nature of these transfers, aligning their objectives, types, incentives and consequences and clarifying emerging trends in their design.

6. Our discussion and analysis are structured as follows: Section 2 draws the current landscape of IFTs, building on the newly developed data, which is based on the consolidation methodology applied to the COFOG (Classification of the Functions of Government) database (Dougherty & Montes-Nebreda, 2023a) in order to analyse government expenditures across 26 OECD countries over a 27-year period. This analysis contributes to shed light on the degree of financial autonomy, the existence of fiscal imbalances, and the influence of IFTs on the fiscal

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of resource allocation, and SNGs' capacity to meet their constituents' needs within the broader framework of fiscal federalism.

capacities of subnational governments. This practical approach is accompanied by a more theoretical view in Section 3, which reviews the literature on IFTs' objectives and their trade-offs, focused on equity and efficiency, explaining how their effectiveness and design vary based on country-specific factors. Section 4 introduces a comprehensive typology of grants, systematically categorising various transfer types, along with an exploration of the incentives and consequences inherent to each type. Finally, Section 5 summarises recently identified emerging trends in the field of IFTs and how they could potentially reform current grant frameworks so that they become more flexible and performance-based to address emerging challenges.

2. The current landscape of Intergovernmental Fiscal Transfers: from practice to theory

7. In the evolving landscape of fiscal decentralisation, SNGs are increasingly tasked with new responsibilities. This trend intensified over recent decades (OECD, 2021), and requires a focus on enhancing SNGs' own-source revenues through improved tax collection efficiency and broadened tax bases (e.g. local property taxes, or fees and charges for services). However, the success of these measures heavily depends on the degree of fiscal autonomy granted to SNGs, which varies significantly across jurisdictions (OECD, 2021). Additionally, accessing capital markets, issuing subnational bonds, and public-private partnerships (PPPs) are gaining traction among SNGs (De Biase & Dougherty, 2022). However, it is often central governments that possess more expertise and capacity in deploying these alternative financing options due to their larger scale.

8. In this context, the role of IFTs is significant. While the pursuit of fiscal self-resilience is important, IFTs remain a vital lifeline, especially for regions and municipalities with limited economic capacity. In federal and quasi-federal OECD member countries, SNGs' own revenue represents just about 25% of their total revenue (OECD, 2021). Nonetheless, central governments continue to play a dominant role in revenue collection, requiring SNGs to rely on grants to supplement their income. This need is accentuated by the fact that significant governmental expenditure responsibilities, such as education (24% of SNG spending on average), healthcare (18%) and social protection (14%), fall within the purview of SNGs (OECD, 2021). Consequently, a vertical imbalance arises due to a higher degree of decentralisation in spending compared to revenue generation, requiring compensation through grants (Blöchliger & Petzold, 2009; OECD, 2021).

9. The OECD has developed a new dataset, described in Box 1, to help shed light on IFTs. Figure 1 presents consolidated data for transfers paid and received by the General Government in each country, covering all transfers across government levels, including those related to Social Security and any policy area. In 2021, Belgium and Denmark stood out as the countries with the highest grants relative to GDP, with both exceeding 20% of GDP, followed by Austria, Spain and Italy. These five countries are characterised by their high degree of expenditure decentralisation. However, these countries' degrees of revenue decentralisation do not match, resulting in vertical imbalances that require covering gaps through IFTs. Conversely, Ireland and France, often considered examples of centralised governance, at the same time record the lowest proportion of grants relative to their economies within the OECD, both below 5% of GDP.

Box 1. New data on Intergovernmental Fiscal Transfers

To develop effective policy recommendations for reforming IFT frameworks, understanding their current dynamics is crucial. However, the unique characteristics of intergovernmental fiscal systems in each country complicate the creation of granular, comparable and comprehensive datasets. The optimal mix of design and incentives will differ based on each country's governance structure, fiscal priorities and developmental goals. Despite their usefulness, traditional methods for collecting data on fiscal transfers, such as surveys, are highly burdensome on respondents. As a result, the OECD Fiscal Decentralisation database ceased updating intergovernmental grant data in 2010. A decade later, the OECD Fiscal Network now employs the novel COFOG database consolidation method to revive this data resource. As outlined by Dougherty & Montes-Nebreda (2023a), this consolidation process across government levels and functional areas has enabled the calculation of precise spending figures for 26 OECD member countries over a 27-year span (1995-2021).

In governmental financial reporting, unconsolidated expenditures present the financial outputs of individual governmental levels without adjustment for the financial interactions among them. Each entity's budget is reported independently, showcasing the raw fiscal data that details how much each government level is spending in isolation.[3] In contrast, consolidated expenditures for a country include all spending by both national and subnational government entities, adjusted to exclude intergovernmental transfers such as shared revenues or grants. This approach prevents double-counting and provides a comprehensive view of the total public expenditure across all tiers of government, reflecting a holistic assessment of the nation's fiscal policy impact and resource allocation.[4] The contrast between the two sets of data — especially in terms of transfer size — can thus significantly inform both policy formulation and public understanding of governmental operations at various levels.

The expansion of the Fiscal Decentralisation database provided results for two consolidation methodologies. The "Funded by" (FB) approach identifies the government level responsible for funding expenditures in each policy area.[5] Conversely, the "Spent by" (SB) method determines which level of government effectively implements spending programs across various COFOG sectors. They are calculated as follows:

$$Transfers\ \boldsymbol{paid} = Unconsolidated\ expenditure - Consolidated\ expenditure\ (\text{"Spent by"})$$

$$Transfers\ \boldsymbol{received} = Unconsolidated\ expenditure - Consolidated\ expenditure\ (\text{"Funded by"})$$

The variation between these approaches is influenced by factors such as spending and tax autonomy, vertical imbalances and the degree to which intergovernmental transfers compensate for these imbalances. Thus, discrepancies in the results of these methods reflect the size of transfers and whether they are earmarked or general-purpose. The "Spent by" findings align with the methodology for compiling more aggregated consolidated expenditure data within the OECD Fiscal Decentralisation database (see Dougherty & Montes-Nebreda, 2023a). This paper relies on these newly developed data to analyse the current landscape and evolution of intergovernmental fiscal transfers in OECD countries.

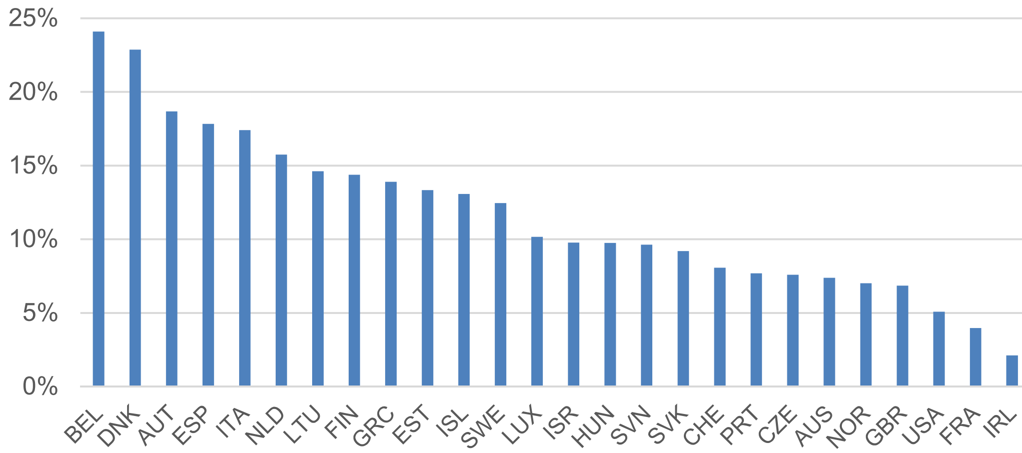
[3] This form of reporting is essential for transparency and local governance, allowing internal and external stakeholders to assess the financial health and accountability of specific government segments.

[4] The consolidated data serves to evaluate the overall economic effect of governmental actions, ensuring that analyses of fiscal stability and policy effectiveness are based on the aggregate financial activities of the entire country.

[5] Also called the 'initial source of public funds'.

Figure 1. Total transfers paid or received by the general government, 2021

% of GDP

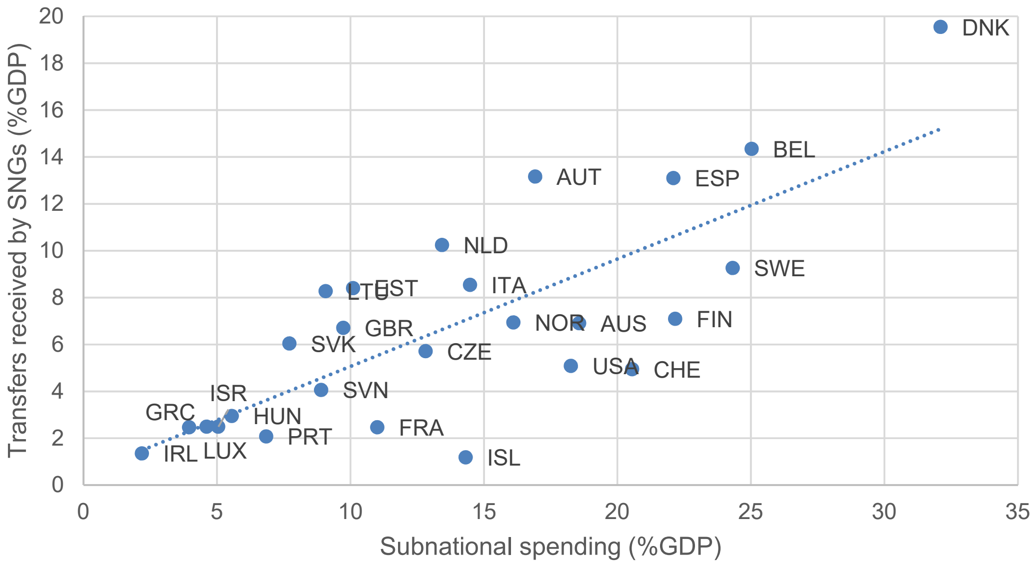


Source: elaboration based on the OECD Fiscal Decentralisation database.

10. Figure 2 reveals a clear correlation between the volume of transfers received by SNGs and their expenditure levels, with Denmark leading in terms of transfers received as a proportion of GDP, followed by Belgium, Austria and Spain. The shift in rankings between Belgium and Denmark from Figures 1 to 2 corresponds to Belgium's significant transfers to Social Security, whereas Denmark predominantly channels its transfers to local governments. Excluding Austria, these countries also rank highly in subnational spending, alongside Sweden and Finland. In contrast, OECD countries with more centralised spending responsibilities, such as Ireland, Greece and Luxembourg, exhibit a lower reliance on transfers, reflected in their smaller GDP percentage allocations to such transfers.

Figure 2. Correlation between subnational spending and transfers received by SNGs, 2021

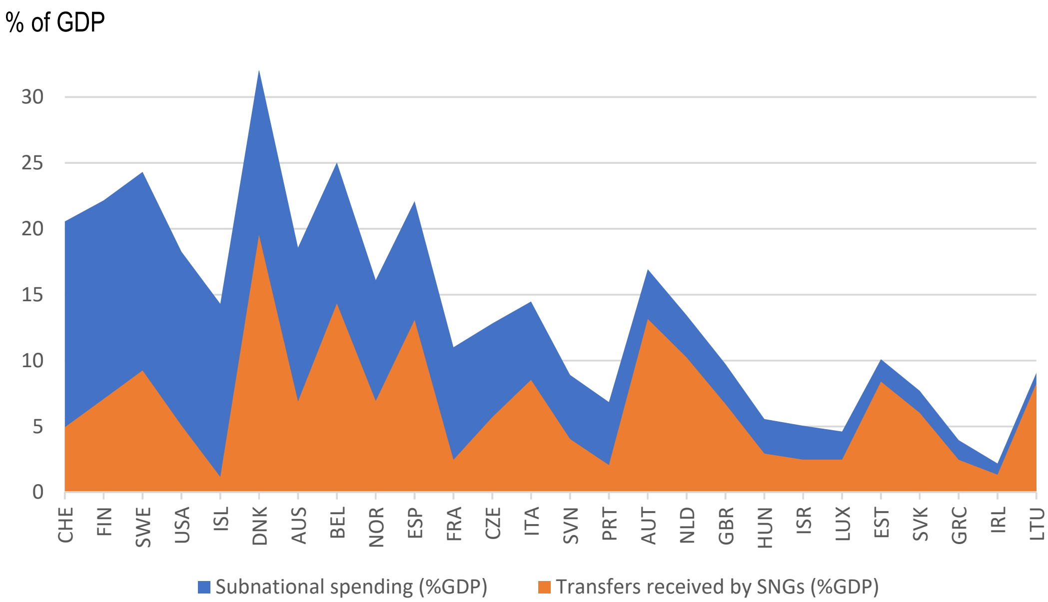
% of GDP



Source: elaboration based on the OECD Fiscal Decentralisation database.

11. Figure 3 illustrates the difference between the expenditures of SNGs and the transfers they received in 2021, which serves as a proxy of revenue autonomy – the larger the gap, the larger the revenue autonomy. Again, this discrepancy is most pronounced in countries with high degrees of expenditure decentralisation, such as Switzerland, Finland, Sweden and the United States, where the gap exceeds 15 percentage points. Conversely, in Estonia, Slovakia, Greece, Ireland and Lithuania, the difference is less than 2 percentage points. However, this smaller gap does not necessarily indicate a lower reliance on transfers in these countries; a more detailed, relative analysis is required to determine transfer dependence.

Figure 3. The gap between subnational spending and transfers received by SNGs, 2021

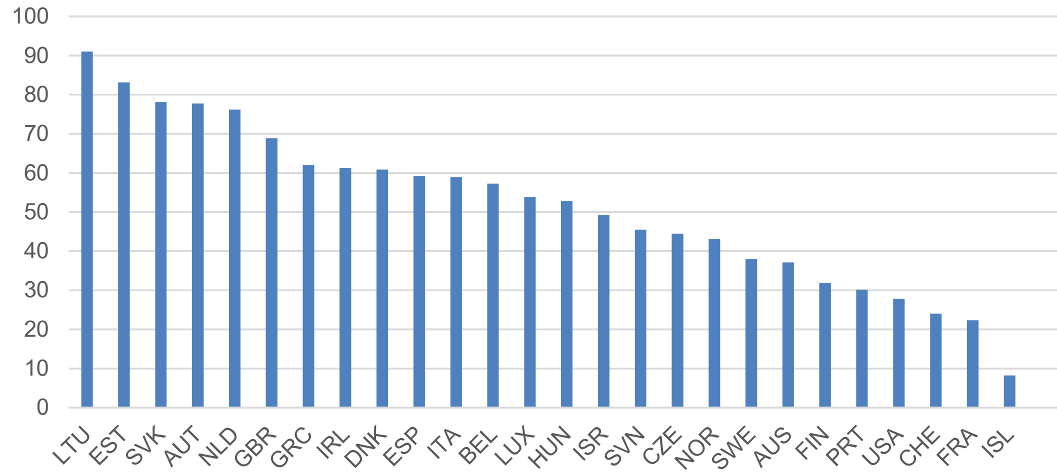


Source: elaboration based on the OECD Fiscal Decentralisation database.

12. Regardless of how decentralised spending is, transfer dependence can still be very high. Figure 4 illustrates that there is no definitive relationship between the degree of spending decentralisation and the dependence on transfers for funding SNGs' spending. High reliance on transfers, and thus, low tax autonomy, is observed not only in unitary countries like Lithuania, Estonia and Slovakia but also in federal and quasi-federal countries such as Austria, Spain and Belgium, as well as in highly decentralised countries like Denmark. In the same vein, SNGs with the least dependence on transfers are found in federal countries like Switzerland, the United States and Australia and also in unitary countries such as Israel, France, Portugal and Finland. At this point, it is relevant to point out that it is not evident which revenue streams should be considered transfers. The classification of revenue streams as transfers, including tax-sharing and revenue-sharing schemes, varies, complicating the analysis. For instance, Austria's SNGs heavily rely on a revenue-sharing mechanism, making it appear as one of the countries most dependent on transfers in Figure 4. To this aim, the OECD (2021) provides a comprehensive overview of measurement approaches to tax autonomy.

Figure 4. Subnational transfer dependence, 2021

% of total SNG spending

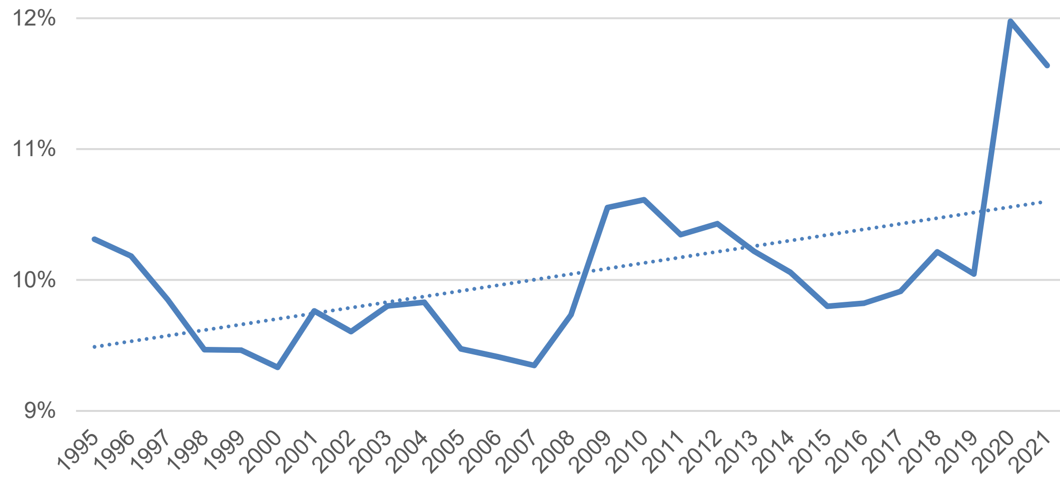


Source: elaboration based on the OECD Fiscal Decentralisation database.

13. Variability in the magnitude of IFTs is observed between countries and over time. Indeed, the proportion of grants paid has gradually increased over recent decades, rising from 10.3% of GDP in 1995 to 11.6% in 2021 based on an unweighted OECD average. Figure 5 illustrates the fluctuating trajectory of grants during this period, closely mirroring the economic cycle. In times of economic expansion, transfers generally declined, whereas significant crises – such as the Global Financial Crisis in 2008, the COVID-19 pandemic in 2020 and, to a lesser extent, the “dot com” crisis in 2001 – prompted central governments to step in and provide increased financial support to SNGs. The increase in transfers was notably sharp in 2020 when subnational tax revenues suffered a moderate decrease and spending needs rocketed (Dougherty & De Biase, 2021). Following these events, there was a trend towards normalisation in grant levels. Nonetheless, political resistance from SNGs and budgetary inertia have pushed for their consolidation, exerting a strong resistance to fiscal adjustment. Although the counter-cyclical pattern of grants is seen as a positive aspect of fiscal policy, it also suggests the vulnerability of SNGs’ own revenue systems in responding to economic downturns without federal assistance.

Figure 5. Evolution of total transfers paid or received by general government

% of GDP (unweighted OECD average)



Source: elaboration based on the OECD Fiscal Decentralisation database.

3. Objectives and outcomes: the equity-efficiency trade-off

14. Crafting effective IFT systems involves navigating key trade-offs to balance diverse fiscal policy goals and administrative realities. These trade-offs include transparency vs. complexity, where the clarity and understandability of allocation formulas must be balanced against the need for formulas that accurately capture the complexities of fiscal capacities and needs across jurisdictions. There is also the flexibility vs. outcome-oriented results trade-off, which contrasts the desire for SNGs to have autonomy in spending decisions with the central government's need to ensure funds achieve specific policy outcomes. Central control vs. local autonomy explores the tension between necessary oversight and the freedom of local entities to address their unique challenges. Predictability vs. adaptability highlights the need for stable funding expectations against the capacity of fiscal systems to respond to changing economic conditions. Additionally, incentives for fiscal effort vs. the risk of dependency consider how to motivate SNGs to maximise their revenue sources without becoming overly reliant on central transfers. Lastly, accountability vs. innovation addresses the challenge of ensuring responsible fiscal management while fostering creative solutions to local and national challenges. Each of these trade-offs requires careful consideration to design IFT systems that support effective and efficient governance across all levels of government (Searle & Ahmad, 2005; Ter-Minassian, 2021).

15. However, the most relevant trade-off in designing IFTs is the balance between equity and efficiency. This trade-off involves ensuring a fair distribution of resources while also achieving efficient outcomes by analysing distributional effects and understanding the induced behavioural responses to optimise both national and regional objectives (Lago et al., 2024b). IFTs are multifaceted instruments essential in federal or decentralised government systems. Their design and implementation are highly specific to each country, reflecting its institutional framework, which includes the size, number and geographical distribution of SNGs, their responsibilities, fiscal resources, and the dynamics of power-sharing between central and sub-national levels.

3.1. *Equity considerations in IFT schemes*

16. Equity considerations in IFT schemes are central to ensuring a just distribution of fiscal resources across various jurisdictions. The primary aim is to ascertain that all regions and municipalities, irrespective of their economic strength or socio-economic characteristics, can provide a comparable standard of public services to their citizens. To assess the equity impact of IFTs, policymakers typically compare pre-transfer and post-transfer per capita budgetary capacities across jurisdictions, often helped by the Gini coefficient. This involves analysing the extent to which IFTs mitigate horizontal fiscal imbalances (across jurisdictions), providing insights for evaluating transfers' role in diminishing fiscal disparities.

17. Fiscal equalisation occupies a preeminent role in pursuing equity objectives through IFTs. It aims to enable equitable access to public services across regions while maintaining similar levels of tax effort. This approach, as seen in countries like Australia and Denmark, shifts the focus from income equalisation to equitable service access, balancing national standards with the autonomy of subnational entities. This reorientation from income to service access equity aligns with the broader objectives of ensuring consistent public service delivery across diverse regions (Searle & Ahmad, 2005).

18. Furthermore, the notion of equity in IFTs extends beyond merely equalising fiscal capacities. It encompasses the broader aim of reducing regional disparities. In this regard, IFTs can be instrumental in redistributing resources from more affluent to less prosperous regions, thus facilitating the economic and social development of historically underdeveloped or geographically isolated areas (Boadway & Shah, 2007). Indeed, the utilisation of grants as an income equalisation strategy is evident in some OECD countries, such as Germany and Spain, with European Structural Funds being a paramount example at the supranational level.

19. The use of general-purpose grants for fiscal equalisation, aimed at balancing personal incomes across regions, provokes considerable academic discussion (Padovano, 2007). This debate is particularly relevant in the discourse concerning place-based versus people-based policies (Neumark & Simpson, 2015), where the roles of fiscal equalisation and regional policy in addressing not only regional but also personal income disparities are examined. Questions also arise regarding the interaction between these two policies. In terms of regional disparities, recent findings from Spain indicate that regional policy is more cost-effective than fiscal equalisation in narrowing regional income gaps, as the impact of the latter is more indirect (Lopez-Laborda et al., 2024). Additionally, Searle & Ahmad (2005) point out that direct government interventions, supported potentially by special-purpose grants, can more precisely target specific needs than broader attempts at income equalisation. This prompts further scrutiny into whether a policy should target specific income distribution metrics, such as the interpersonal Gini coefficient, rather than focusing solely on interregional inequality measures.

20. *Enhancing IFT equity through better coordination and data management*: The absence of detailed, readily available data on transfers from central to local governments represents a barrier to addressing equity issues in fiscal transfer systems.[10] This data gap is often exacerbated by insufficient coordination across different central government entities involved in transfer management.

[10] This issue is particularly pronounced in nations lacking a specialised body, such as a national ministry or finance commission, dedicated to overseeing the finances of local governments.

21. In this context, creating a comprehensive system for tracking and analysing all types of fiscal transfers is essential.[11] Implementing such a monitoring framework would enable a thorough assessment of how these transfers collectively affect regional equity. Strengthening coordination and monitoring empowers policymakers to align fiscal transfers more closely with equity goals. Promoting collaborative service delivery is particularly important for smaller entities with constrained budgets. Partnering with adjacent regions or engaging with different governmental tiers can offer a more resource-efficient approach to service provision than independent efforts (Ter-Minassian, 2021).

3.2. Efficiency considerations in IFT schemes

22. Efficiency in IFT schemes relates fundamentally to the judicious allocation of resources to achieve desired outcomes without unnecessary expenditure. An efficient IFT system not only redistributes resources but also ensures their optimal use to enhance societal welfare. Therefore, evaluating the efficiency of these systems requires considering how IFTs address externalities and spillovers, as well as how they mitigate tax competition and congestion costs.

23. *Externalities and spillover effects*: A primary function of IFTs in promoting efficiency is their ability to manage externalities and spillovers. Externalities occur when the actions of one jurisdiction have beneficial or detrimental effects on neighbouring areas. For example, a region's investment in pollution control can positively impact adjacent areas through cleaner air or improved public health. IFTs can compensate or levy charges on jurisdictions for these cross-border impacts, ensuring regions internalise the broader societal costs or benefits of their actions. This approach ensures that local goods with negative externalities are provided in lesser amounts, while goods with positive externalities are provided in optimal amounts (Oates, 1997).

24. IFTs, particularly matching grants, are often recommended to motivate SNGs to consider the broader public interest by internalising externalities or spillover effects.[12] Earmarked grants for projects that address externalities – such as environmental conservation, infrastructure developments that span multiple jurisdictions, or public health initiatives – along with formula-based grants designed to reflect the impact of spillovers, can effectively channel resources towards these ends. Another approach involves promoting co-operative agreements between neighbouring SNGs, supported by IFTs, to jointly address issues that have cross-border effects[13] (Agrawal et al., 2023a).

25. However, accurately estimating the magnitude of spillover effects and the appropriate size of grants needed to address them is a task filled with uncertainty.[14] While grants can stimulate subnational spending, their success in specifically targeting and reducing externalities is debatable. There is notable scepticism regarding the capacity of higher-level governments to craft grant schemes that successfully encourage SNGs to incorporate spillover considerations into their policy-making processes (Lago et al., 2024a).

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[11] Ideally, this system should encompass a broad spectrum of transfers, including unconditional grants for equalisation, conditional grants, revenue-sharing transfers not aimed at equalisation and the own-source revenues of SNGs.

[12] Matching grants theoretically incentivise SNGs to increase spending in these areas by reducing the effective cost of providing services with positive spillovers.

[13] Such collaborative measures ensure an efficient allocation of resources towards common challenges, capitalising on the collective effort of SNGs to address externalities.

[14] This difficulty contributes to the mixed empirical evidence on the effectiveness of grants in mitigating inter-jurisdictional externalities (Lago et al., 2024).

26. *Tax competition*: While promoting efficiency by limiting the size of the public sector (Sorens, 2014), tax competition poses risks when SNGs engage in excessive tax reductions to attract tax bases, leading to a "race to the bottom" outcome. This dynamic can cause a general decline in tax revenues, adversely affecting welfare levels and public sector financial sustainability. Equalisation grants, when allocated according to potential fiscal capacity, can alleviate these competitive pressures by not compensating SNG losses due to lowered taxes and limiting their revenue gains from attracted tax bases (Blöchliger et al., 2007; Agrawal et al, 2024).[15] However, this levelling process can reduce the motivation for local governments to seek tax system improvements or innovations, potentially leading to a lack of fiscal diversity and ignoring local needs (OECD/KIPF, 2016). Studies in Canada show a decrease in tax competition following equalisation transfers,[16] whereas research in Australia and Germany reveals a more modest effect.[17] These discrepancies suggest that the success of transfers in limiting tax competition depends on the unique institutional frameworks and the specifics of the equalisation formula (Lago et al., 2024a).

27. To counteract tax competition, common approaches include the central government setting minimum tax rates for SNG-levied taxes and curbing their ability to issue tax exemptions and special incentives. Tax harmonisation and collaborative efforts are also seen as potential remedies. The efficacy of these approaches depends on economic parameters, such as the elasticity of the tax base with respect to the jurisdictional trade rate and the adoption of distributional effects that allow for political support (Ter-Minassian, 2021; Agrawal et al, 2024).

28. *Congestion costs*: IFTs are also significant in preventing congestion costs, particularly in urban areas, by providing infrastructure funding for transportation, incentivising population mobility, developing land use regulations and supporting local economic development. They enable a fiscal redistribution that promotes a more balanced distribution of population and economic activities, reducing congestion pressures in overcrowded cities (Alesina & Spolaore, 2005; Hortas-Rico & Rios, 2020). Congestion costs manifest as increased traffic, higher living costs and environmental stress, impacting the quality of life and economic productivity. Conversely, rural areas, which often struggle with challenges like resource underutilisation and economic stagnation, stand to gain from the financial support provided by grants. This redistribution not only helps balance population densities but also supports the economic development of less dense regions, easing urban infrastructure burdens and promoting regional economic growth.

29. *Encouraging subnational tax effort*: The relationship between IFTs and SNGs' tax efforts is intricate, with research findings varying based on the IFT design. Some studies suggest that IFTs discourage SNGs from exploiting their own-source revenues – indicating a crowding-out effect.[18] This occurs particularly when increases in a region's own-source revenue lead to a proportional decrease in unconditional transfers from the central government, or when systems

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[15] This phenomenon, primarily studied within OECD countries such as Canada, Germany, Switzerland and the USA, varies based on fiscal and institutional frameworks (Blöchliger & Pinero-Campos, 2011).

[16] Studies focusing on Canada's equalisation system have shown a decrease in tax competition among provinces, attributed to the system's focus on fiscal capacity disparities (Hayashi & Boadway, 2001; Smart, 2007; Ferede, 2017).

[17] Available from Dahlby & Warren (2003); Buettner & Krause (2021).

[18] The crowding-out effect stems from the dynamics of political economy, where officials at the subnational level prefer to rely on transfers from central governments rather than increase local taxes, as the latter is more politically challenging. Central governments, in turn, are inclined to support this dependency on transfers, as it enhances their influence and control over subnational entities.

apply a very high fiscal equalisation degree, provide unlimited transfers, or guarantee SNGs a minimum fiscal capacity irrespective of their revenue efforts (Bergvall et al., 2006; Blöchliger et al., 2007).

30. Other studies indicate that IFTs can encourage greater tax effort, demonstrating a crowding-in effect.[19] This occurs particularly when the design of the transfer formula considers the potential revenue or fiscal capacity instead of the actual revenues collected. This approach encourages SNGs to enhance revenue generation without the fear of reduced transfers (Lago et al., 2024a). Consequently, this variation is largely influenced by the structural framework of the grant systems and the unique institutional characteristics of different countries.

31. In this context, periodic reassessments of SNGs' fiscal autonomy are imperative, allowing for the fine-tuning of incentives in IFT frameworks to adapt to evolving requirements. For instance, increased fiscal autonomy could reduce reliance on vertical transfers, allowing for a more refined response to local preferences. This shift requires SNGs to align their own-source revenues with their expenditure responsibilities. Ideally, equalisation transfers should primarily address inherent income disparities among SNGs and the potential tax revenues they can generate. Their objective is not to compensate for underutilised local tax bases but to rectify structural imbalances (OECD, 2021).

32. *Improving subnational fiscal discipline*: The overreliance on intergovernmental grants can undermine SNGs' financial prudence, leading to overspending, reduced tax efforts, large budget deficits and debt accumulation.[20] This situation is often associated with the "common pool" problem, where fiscal indiscipline emerges because the financing is perceived to come from taxes raised outside the jurisdiction, leading to a tendency towards overspending and fiscal irresponsibility.[21] Furthermore, the prospect of central government bailouts during crises can incentivise risky fiscal behaviours among SNGs, with central governments often increasing grants to avoid cuts in essential public services like healthcare or education.[22]

33. To mitigate these tendencies and strengthen subnational fiscal discipline, policymakers can incorporate performance-based elements into grant mechanisms. This approach involves making a portion of the funding contingent on meeting predefined fiscal performance targets, such as achieving efficiency in public spending, improving revenue collection, or adhering to budgetary constraints. Additionally, implementing a system that evaluates fiscal capacity and effort can ensure that grants are allocated based not only on existing needs but also on the demonstrated efforts of SNGs to enhance their fiscal health.[23]

[19] The crowding-in effect refers to a scenario where government interventions stimulate or encourage additional SNGs' revenue efforts. In the context of IFTs, the crowding-in effect suggests that such transfers may incentivise SNGs to enhance their own-source revenue collection or invest in public goods and services, thereby augmenting overall economic activity and fiscal health.

[20] This issue corresponds with the soft budget constraint hypothesis, suggesting that reliance on transfers and significant fiscal imbalances undermine budgetary discipline, leading to increased borrowing and debt accumulation.

[21] Aldasoro & Seiferling (2014) and De Mello (1999, 2000) have demonstrated the common pool problem's role in creating a deficit bias, expanding subnational expenditures, reducing tax efforts and increasing indebtedness across both OECD and non-OECD countries.

[22] For instance, gap-filling transfers may disincentivise SNGs from pursuing efficient tax policies or exercising expenditure restraint, as they rely on central government bailouts to cover fiscal shortfalls (Boadway, 2006).

[23] This could involve adjusting grant formulas to reward SNGs that successfully expand their tax bases or implement cost-saving measures.

34. Moreover, enhancing transparency and accountability in the allocation and utilisation of grants can promote fiscal discipline. By making information on grant allocations, spending outcomes and performance benchmarks publicly available, stakeholders, including citizens and oversight bodies, can hold governments accountable for their fiscal decisions. Encouraging local stakeholder participation in budgetary processes and decision-making can further align spending with local needs and priorities, reducing the likelihood of wasteful expenditure. Ultimately, by carefully balancing the need for financial support with incentives for fiscal autonomy and responsibility, policymakers can design IFT systems that address immediate fiscal imbalances while fostering long-term fiscal sustainability and discipline at the subnational level (OECD/KIPF, 2016; OECD, 2022).

35. *Mitigating rent-seeking behaviour and flypaper effect*: The allocation process for IFTs is susceptible to rent-seeking behaviour, where SNGs lobby for an increased share of funds regardless of their actual fiscal needs or capacity. This conduct is compounded by the flypaper effect, where grants lead to a disproportionate increase in local spending compared to equivalent increases in local revenue.[24] This suggests that transfers can create inefficiencies in resource allocation and exacerbate fiscal imbalances (Shah, 2006; Yilmaz & Zahir, 2020).

36. The flypaper effect is particularly common with unconditional grants. To mitigate this, central governments can opt for block or earmarked grants, set specific conditions on grant usage, or link grants to performance outcomes to ensure that funds are directed toward their intended uses.[25] Additional strategies include promoting SNG fiscal autonomy, improving transparency and accountability in fund allocation and usage, and engaging local stakeholders in the decision-making process about IFT management. Publicly sharing details on expenditures and the results of IFTs allows for oversight by citizens and regulatory bodies, ensuring that spending aligns with local demands and priorities.

37. *Addressing spending asymmetries in SNGs*: The literature underscores asymmetries in the effects of changes in the level of transfers on SNG spending patterns. While increases in IFTs typically lead to higher SNG spending, reductions in transfers do not proportionally decrease expenditures due to the inflexibility of public spending. This “fiscal replacement” effect indicates that SNGs might increase taxes to offset reductions in transfers, striving to preserve their level of expenditures.[26] Such dynamics contribute to the expansion of governments at the subnational level, as SNGs leverage external funds to expand their services, occasionally exceeding efficiency and sustainability limits. Hence, the marginal propensity to spend from increased grants surpasses the propensity to cut expenditures when grants diminish, with conditional block grants demonstrating lesser asymmetrical effects than unconditional grants[27] (Lago et al., 2024a).

[24] The fly-paper effect occurs when lump-sum intergovernmental transfers lead to a greater increase in public spending by SNGs than an equivalent rise in personal income would. This means that SNGs are more likely to allocate these transferred funds towards public expenditure rather than providing tax relief.

[25] Such measures motivate SNGs to prioritise results and efficiency over mere expenditure increases.

[26] This effect was introduced by Gramlich (1987).

[27] This asymmetrical impact is further influenced by institutional and political factors. Municipalities with lower debt, those governed by left-wing administrations, or those with less rigorous tax collection efforts are more prone to the “fiscal replacement” effect, increasing taxes to compensate for reduced grants (Lago et al., 2024a)

4. Aligning transfer types and incentives

38. In this section, we provide a detailed classification of IFTs. While the real-world application of these classifications is not always clear-cut, we aim to categorise these transfers as comprehensively as possible, recognising their varied structures and alignment with specific policy objectives. Subsequently, we will examine the common incentives associated with each type of transfer, as observed in the financial management practices of various countries, exploring the outcomes and implications of these fiscal choices, and shedding light on how different IFTs influence the broader landscape of public finance and governance.

4.1. Classification of intergovernmental fiscal transfers: The role of grant earmarking

39. IFTs are classified based on their conditions and objectives, which significantly influence their effectiveness. In Figure 6, we adapt an earlier OECD model to illustrate common IFT classifications in OECD countries (Bergvall et al., 2006; Spahn, 2012; Lotz, 2013). This model elaborates on a typology of IFTs based on the conditionality attached to them, ranging from unconditional general-purpose grants to open and closed-ended earmarked grants that aim to enforce certain performance criteria or policy priorities.[28]

40. Some additional criteria relevant for categorising IFTs could not be depicted in Figure 6 due to their complexity and the fact that they manifest across various types of transfers, complicating their representation in a single diagram.[29] These criteria include the methods used for allocating funds and the level of government responsible for initiating the transfer. Allocation methods vary to meet the fiscal needs and strategic objectives of different regions. For example, formula-based transfers consider factors like population size and fiscal capacity, while needs-based transfers target regions with greater needs.[30] Performance-based transfers encourage specific outcomes by increasing the allocation of resources based on the achievement of *ex-post* conditionalities.[31] Revenue-sharing distributes funds from specific sources, ensuring both central and SNGs benefit. Finally, gap-filling transfers aim to bridge the fiscal gap between a region's revenue generation and its expenditure needs. Regarding the direction of the flow, vertical transfers typically move from higher to lower government levels, such as from national to sub-national entities. Meanwhile, horizontal transfers occur between jurisdictions at the same level, often aimed at reducing economic disparities or addressing horizontal spillovers[32] (Blöchliger & Petzold, 2009).

[28] This classification scheme is instrumental in understanding the underlying objectives of different grant types, whether they aim to maintain fiscal balance, equalise resources among regions, or incentivise specific policy outcomes. While this approach aligns with Spahn's (2012) findings, it also differs in the categorisation of certain transfers.

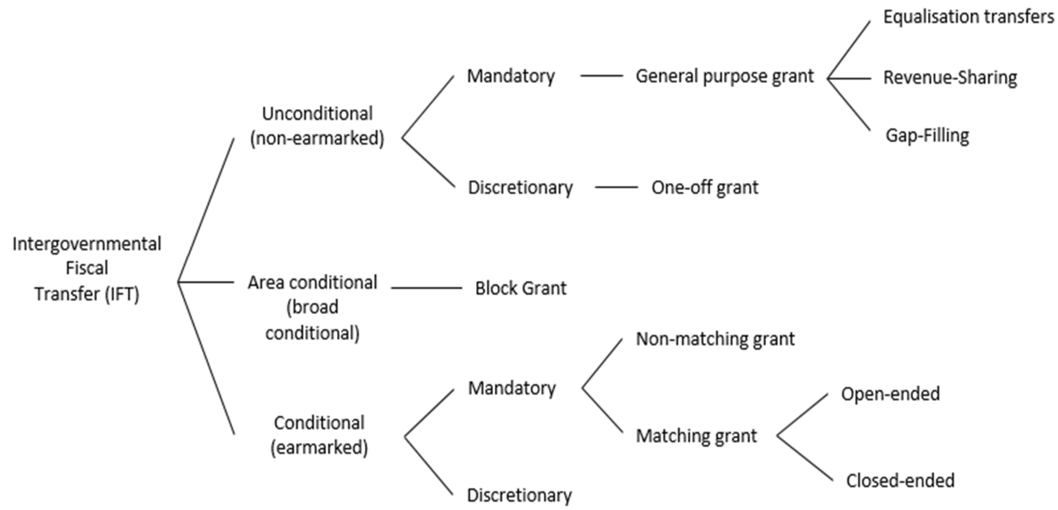
[29] Details of IFT's types and incentives are displayed in the following section 4.2.

[30] This approach is particularly beneficial for regions facing unique challenges or higher costs in providing services, ensuring that these areas receive adequate financial support.

[31] This type of transfer encourages efficiency and effectiveness in service delivery by linking financial support to measurable results (Dougherty & Forman, 2021). Performance-based transfers are distinguished from regular earmarked transfers by the fact that the conditionality is applied *ex-post*, rather than being specified *ex-ante* as an obligation for the transfer to occur. In regular earmarked transfers, the conditions are defined up front and must be met before the funds are disbursed.

[32] For example, to re-establish Olson's principle of fiscal equivalence, which is compromised when residents (taxpayers) in one jurisdiction benefit from local public services provided by a neighbouring jurisdiction.

Figure 6. Intergovernmental fiscal transfer scheme classification



Source: adapted from the OECD typology.

41. The European Charter of Local Self-Government[33] emphasises the preference for non-earmarked grants to allow local authorities the freedom to allocate funds based on their priorities. This approach, widely adopted in Europe, has led many countries to shift from earmarked to general-purpose grants, thereby enhancing local autonomy and expenditure efficiency.[34] While this shift provides greater autonomy and flexibility in fund allocation, it also raised challenges in accountability and the precise targeting of funds towards policy goals.[35] The impact of this shift varies across countries, reflecting differences in political, economic and administrative structures, and raising concerns about potential increases in regional inequalities[36] (Kim et al., 2010).

42. Insights from specialist workshops conducted in 2007 and 2009[37] underscored the decision-making process involved in selecting general or earmarked grant types, connecting theoretical discussions with practical implementation realities. There is a strong argument for limiting earmarked grants to address the vertical fiscal imbalance that can arise between central

[33] The Charter, particularly Article 9, provides a foundational perspective on the allocation of tax bases and revenues between central and SNGs and on the nature of grants. The Charter stipulates that "as far as possible, grants to local authorities shall not be earmarked for the financing of specific projects" (https://www.coe.int/en/web/impact-convention-human-rights/european-charter-of-local-self-government/).

[34] During the 1980s and 1990s, countries in the Nordic region, as well as Japan and Korea, shifted from earmarked to general-purpose grants, driven by the conviction that such grants offer superior benefits. This shift was particularly impactful in the context of the Nordic countries, known for their strong tradition of local governance and public service delivery (Kim et al., 2010).

[35] The lack of earmarking made it difficult to monitor the effectiveness of spending in specific sectors such as education or healthcare.

[36] Regions with stronger economic bases were better positioned to leverage these grants compared to their less prosperous counterparts, potentially exacerbating disparities in the quality of public services.

[37] The Korea Institute of Public Finance (KIPF) and the Danish Ministry of the Interior and Health jointly organised a workshop in 2007 and edited a book titled "Measuring Local Government Expenditure Needs– The Copenhagen Workshop 2007". Later, in 2009, KIPF and the Danish Ministry of the Interior and Social Affairs held another workshop on the issue of choosing between general and earmarked grants and presented the book "General Grants versus Earmarked Grants Theory and Practice".

and SNGs. This argument is rooted in the "benefit principle", which advocates for a closer alignment of SNGs' spending decisions with their revenue sources, promoting a more direct linkage between expenditure and revenue (Olson, 1969). Despite this theoretical preference, the practical experiences of local governments often present a counterargument. Local authorities are commonly responsible for providing essential public services such as healthcare, education and social welfare, all of which demand significant financial resources. Earmarked grants are crucial in supporting these services, highlighting the importance of effective intergovernmental relations in ensuring the efficient and fair provision of essential services.[38]

43. For example, the European Commission, through its structural funding and reform support programs, aims to strengthen local capabilities and encourage structural reforms within its member states.[39] Similarly, in the United States, there is a significant reliance on conditional or earmarked grants within federal transfers, especially in sectors such as interstate transportation. Italy's 2001 constitutional reform established the "essential level of services" standard for key public services, such as health and education, supported by a system of earmarked grants to ensure their provision. These examples underscore the complex and context-dependent reality of fiscal federalism, where the theoretical ideals must align with practical governance necessities (OECD, 2018; Kim, 2021; Lago et al., 2024b).

44. Furthermore, earmarked grants can be particularly effective in environmental policy, where unconditional grants might lead to an undersupply of ecological initiatives.[40] Ecological Fiscal Transfers (EFTs), a form of earmarked grants, emerge as a viable tool to align subnational efforts with international green agendas while addressing the capacity and willingness challenges faced by smaller SNGs (Dougherty & Montes-Nebreda, 2023b).

45. The decision between earmarking funds and allowing spending discretion involves balancing national objectives with local governance needs. Excessive conditionalities can limit budgetary flexibility[41] and require separate planning processes for each funding source, often leading to fragmented planning and "participation fatigue." Conversely, too much freedom may result in misaligned budget allocations or insufficient funding for essential services[42] (Shotton & Gankhuyag, 2021).

46. The literature suggests tailoring IFT designs to the specific contexts of individual countries, considering administrative capacity, governance structures, and socio-economic

[38] For example, England's transition from general to earmarked grants for school funding in 2006 illustrates that the decision on the type of grant to use should be tailored to the specific requirements and objectives of each sector, rather than adhering to a blanket preference for one type over the other (Kim, 2021).

[39] The effectiveness of these grants is an ongoing debate, but the Commission's role in direct fiscal transfers remains a key factor in the design of grant systems.

[40] This is particularly crucial as unguided subnational provisions might fall short of achieving nationally agreed-upon green targets. The need for behavioural change and compliance with environmental targets, especially for smaller SNGs, compounds this challenge.

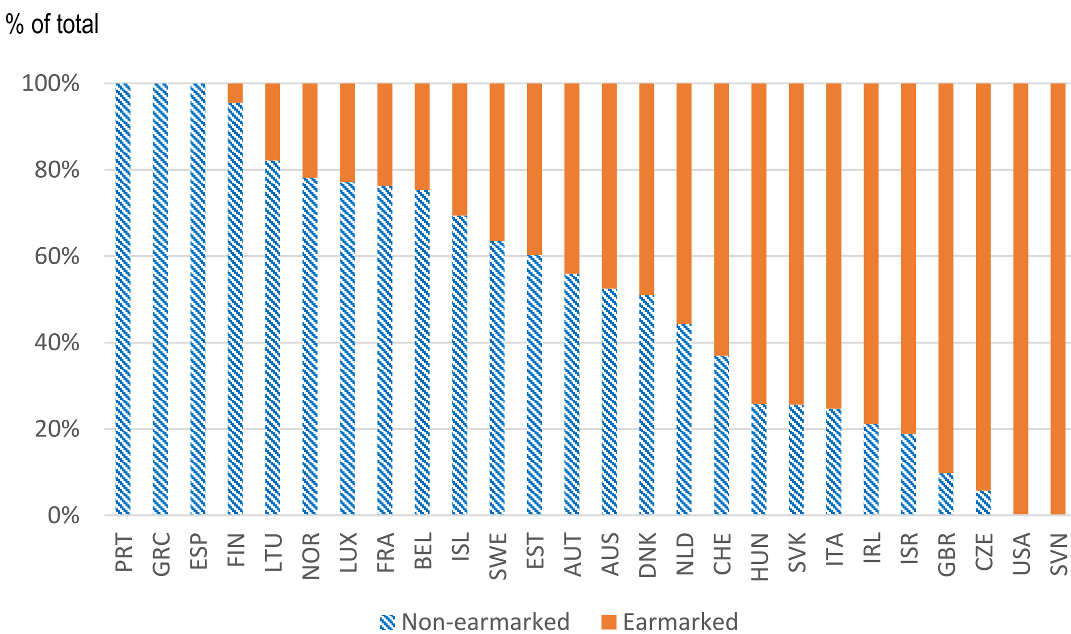
[41] For instance, in India, prior to the 14th Finance Commission reforms, a system dominated by conditional grants limited local decision-making. Similarly, in Bhutan, Laos and Viet Nam, public investments are constrained to pre-set plans, reducing local adaptability. In Indonesia, the earmarked DAK grants have led to inefficient allocations of funds, while in Mongolia, the emphasis on capital expenditure through Local Development Fund grants promoted unsustainable infrastructure projects (Shotton & Gankhuyag, 2021).

[42] In India, for instance, the relaxation of conditions on grants has led to a noticeable variation in spending on secondary education across states, prompting debates over the effectiveness of such flexibility. While these differences in spending may reflect the diverse needs of each state, they highlight the challenges of balancing fiscal autonomy with the need to maintain consistent service levels across the country.

conditions. In environments characterised by strong local governance, more flexible transfers may be effective, while in settings with institutional challenges, conditional transfers could ensure accountability and effective fund use (Lago et al., 2024b).

47. When examining the functional distribution of IFTs received by subnational governments, significant variations emerge across countries, as shown in Figure 7. For a majority, specifically in 15 of the 26 OECD countries included in the database, more than 50% of transfers are non-earmarked. This type of grant, such as fiscal equalisation, is included within the COFOG signature *General Public Services* (010). Greece, Spain and Portugal exclusively report non-earmarked grants, whereas Finland, Lithuania, Norway (Box 2) and Belgium have notably high proportions, exceeding 70% of total transfers. In contrast, Slovenia and the United States (see Box 3) show minimal use of non-earmarked transfers, with similarly low levels observed in the Czech Republic and Iceland.[43]

Figure 7. Net transfers received by subnational governments, by type, 2021



Note: for some countries, transfers may be reported as earmarked when paid to bodies only responsible for a specific policy area(s); Transfers related to social welfare in Finland have been classified as non-earmarked to maintain consistency with SNA as reported by Statistics Finland.
Source: elaboration based on the OECD Fiscal Decentralisation database.

[43] EU transfers, such as the EU Structural and Cohesion funds, constitute a significant form of fiscal transfer at the supranational level. However, this study specifically addresses transfers within federal and unitary nations, not those involving the EU. The EU transfer system is complex, operating within a unique legal framework that crosses economic, administrative, and national boundaries. For more detailed insights into EU transfers and absorption of funds, refer to Capella-Ramos et al. (2020) and Box 1.5 of OECD (2021).

Box 1. Country case: Norway

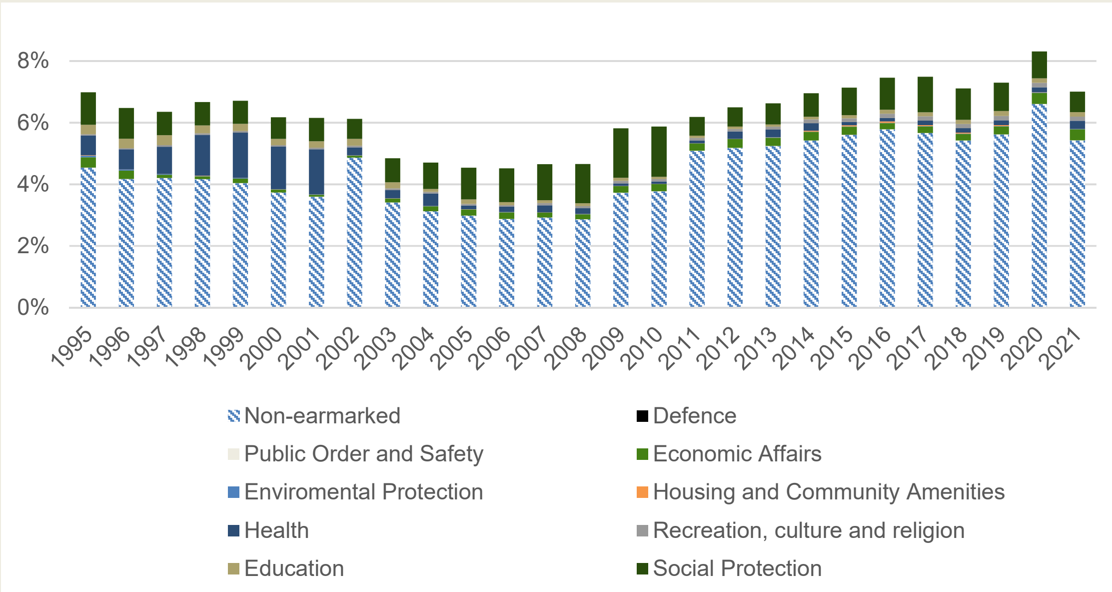
Norway's system of IFTs is not particularly large, yet there has been a notable increase in these transfers since 2008, predominantly in the form of non-earmarked grants. The "General Purpose Grant Scheme" is the primary source of these transfers, accounting for about 70% of the total revenue for local entities, including municipalities and counties. This scheme functions as a local equalisation mechanism that considers both the spending needs and fiscal capacities of local governments and includes a component for regional policy.

In 2022, Norway implemented a healthcare reform that transferred the ownership of all public hospitals from the counties to the central government (Hagen & Kaarbøe, 2006). This shift led to a substantial decrease in healthcare transfers, from 1.5% of GDP in 2001 to just 0.3% in 2002. Another significant aspect of Norway's IFT is the evolution of social protection transfers. Managed by the Norwegian Labour and Welfare Administration (NAV), which coordinates employment policies, unemployment benefits, retirement pensions, and minimum income programs, these transfers reflect a joint effort between central and local governments. Municipalities are responsible for social services, including minimum income schemes, training programs and emergency temporary housing. Consequently, the scale of social protection transfers has closely followed unemployment trends, peaking at about 27% of total transfers during the economic crisis of 2008-2010. During this period, non-earmarked grants also increased, probably as a reaction to the crisis. In 2020, transfer levels spiked due to increased General Grants intended to cover pandemic-related expenses and offset declines in local revenue, but they returned to pre-pandemic levels by 2021.

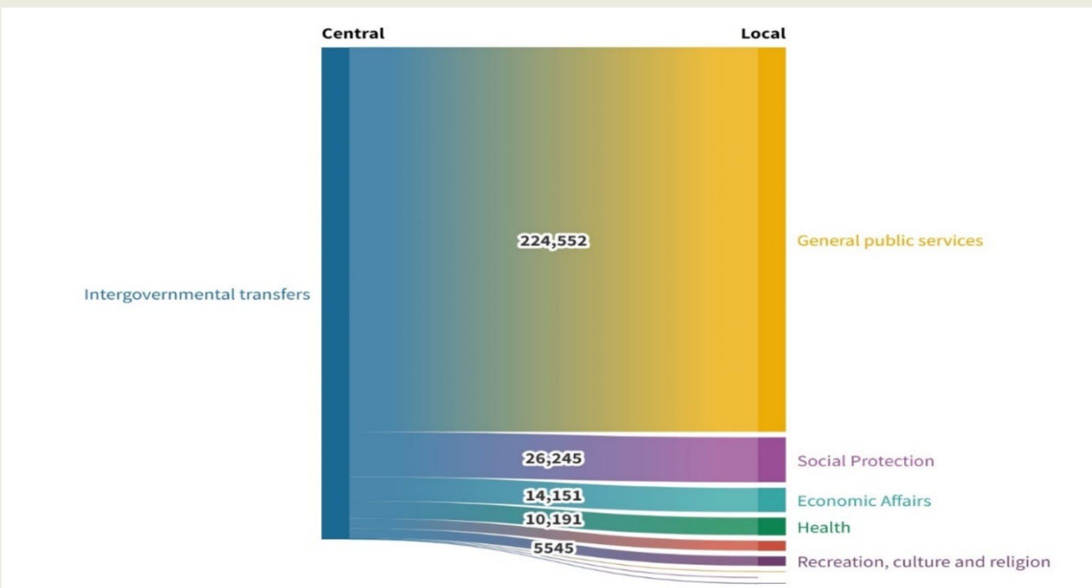
Currently and consistently throughout the entire period analysed, non-earmarked equalisation grants formed the most substantial transfers to local entities. While smaller in comparison, targeted transfers for social protection, economic affairs, healthcare and education are also noteworthy. These specific transfers are important as they support the primary expenses of counties and municipalities, which largely rely on general grants for providing services.

Figure 8. Intergovernmental transfers paid by the central to local governments in Norway

Panel A. Transfers over time by COFOG area (% of GDP)



Panel B. Transfers paid by COFOG area (NOK millions)

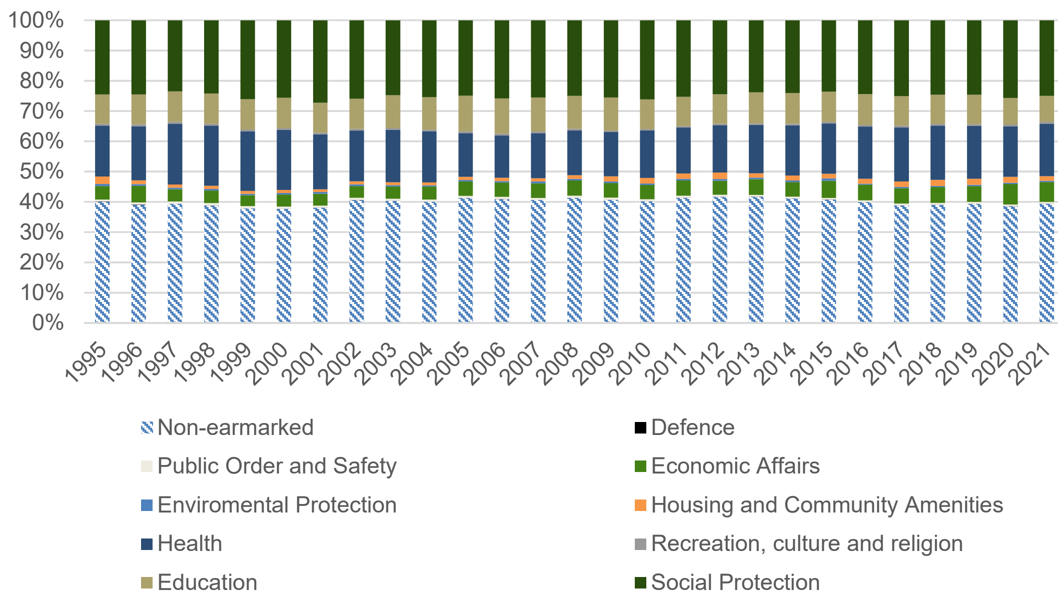


Source: elaboration based on the OECD Fiscal Decentralisation database.

48. Figure 9 presents a time-series analysis of the OECD's unweighted average distribution of grants, indicating a stable distribution pattern since 1995. General Public Services – which are non-earmarked grants – consistently account for approximately 40% of total transfers, making it the predominant category. Social Protection follows as the second largest category, constituting about 25% of transfers. Health ranks third in significance, although it shows the greatest variability, with its share fluctuating between 20% in 1997 and 14% in 2006. Surprisingly, despite demographic ageing and the impact of the pandemic, the proportion of grants allocated to healthcare has not increased. This unexpected stability can be attributed to several factors, including the re-centralisation of healthcare in certain countries (offsetting growth in spending), larger increases in grants for other functions, and the use of non-earmarked transfers to healthcare services. Education (080) is identified as the fourth largest area for transfers but has seen a decline in its share from nearly 10% in 1995 to about 8.5% in 2021, alongside Housing and Community Amenities (060). In contrast, Economic Affairs (020) has experienced the most significant growth in relative terms, especially during the pandemic. This increase, notable by a rise of 1.5 percentage points in a single year, may be related to public support for escalating costs in energy and transportation.

Figure 9. Evolution of transfers paid or received by general government by COGOG area

% of total, unweighted OECD average



Source: elaboration based on the OECD Fiscal Decentralisation database.

4.2. Selecting transfer types according to desired incentives

49. The variety of IFTs reflects the diverse fiscal needs across countries, each type tailored to meet the specific objectives. The strategic prioritisation of different IFT objectives is influenced by a country's economic context, institutional structure and socio-political environment, resulting in a broad spectrum of IFT applications globally. For instance, Argentina, Australia, Austria, Belgium, Brazil, Germany and Spain focus on shared revenues to address vertical fiscal imbalances. In contrast, Canada and the United States (Box 3) prefer block grants to fund essential services. In Asia, countries like Korea, India, Indonesia and Thailand predominantly use specific-purpose transfers to finance subnational projects (Ter-Minassian, 2021).

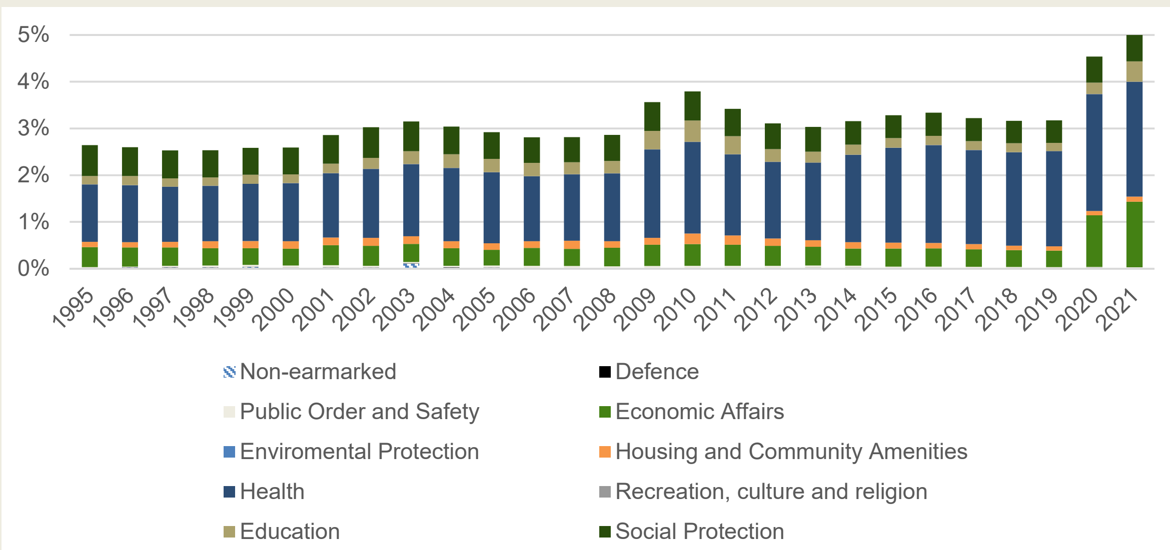
Box 3. Country case: United States

In the United States, the evolution of IFTs has exhibited a strong contracyclical pattern, moving inversely to the business cycle. While the total GDP percentage represented by these transfers has stayed consistent, they have increased during economic downturns, with subsequent inertia hindering a return to pre-crisis levels. The healthcare sector, particularly state-level Medicaid programs, is the most significant recipient of federal grants, accounting for about half of all federal transfers. This sector's funding has steadily increased, reflecting the expansion of social healthcare programs in the US.

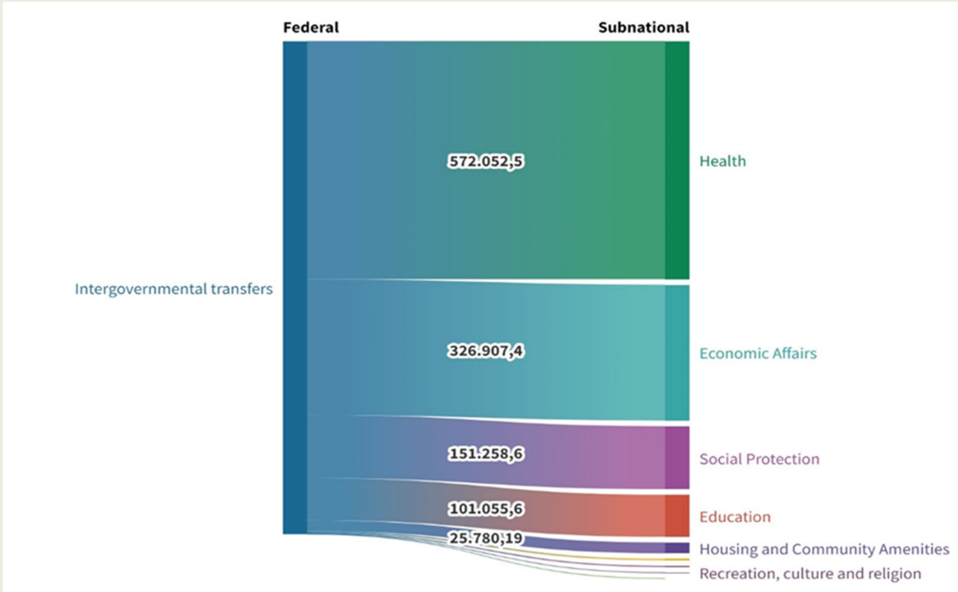
During the pandemic, transfers related to economic affairs experienced the most substantial growth, with initiatives such as the Coronavirus Relief Fund and State Fiscal Recovery Fund designed to stimulate economic recovery. Notably, the US stands out among OECD countries for its minimal use of non-earmarked transfers from the federal government.

Figure 10. Intergovernmental transfers paid by the Federal to subnational governments in the United States by COFOG area (% of GDP)

Panel A. Transfers over time by COFOG area (% of GDP)



Panel B. Transfers paid by COFOG area (USD millions)



Source: elaboration based on the OECD Fiscal Decentralisation database.

a. Unconditional transfers

50. ***General-purpose grants***, frequently mandated by law, provide broad financial support from central to SNGs without specific spending requirements. Their primary aim is to maintain local autonomy in decision-making and ensure fair resource distribution across various jurisdictions.[44] These grants empower SNGs to allocate resources based on unique local needs and priorities, thereby enhancing their fiscal autonomy. Although they generally do not influence economic pricing directly, they may not effectively encourage local governments to allocate spending towards national priorities (Boadway & Shah, 2007). Nevertheless, general-purpose grants can sometimes contribute to inefficiencies or resource misallocation, particularly in the absence of strong accountability mechanisms. A well-documented phenomenon associated with general-purpose grants is the "flypaper effect", where the injection of grant money causes local public spending to increase disproportionately compared to similar rises in local revenues[45] (Shah, 2006; Yilmaz & Zahir, 2020).

[44] These allocations are strategically designed to ensure that all regions or jurisdictions possess the fiscal capacity necessary to provide a comparable level of public services, regardless of their individual revenue-generating abilities.

[45] This effect is observed when, for example, a one-euro increase in grants results in a disproportionately higher increase in local spending compared to a similar increase in local tax revenue. This indicates that grant funds tend to 'stick' where they are allocated, thereby boosting local public expenditure more than if the same amount were obtained through local initiatives. This effect is often driven by the motivations of local bureaucrats who may seek to expand their budgets to enhance their chances of re-election or to consolidate power. Larger budgets can provide more authority and influence, prompting bureaucrats to focus on increasing local spending more when they receive additional grant funds than when they generate revenue locally.

51. Typically, the distribution of unconditional grants follows a formulaic approach and occurs regularly, acting as *equalisation transfers* or as part of a *revenue-sharing framework*. The formula-based and periodic nature of these disbursements provides predictability and stability in financial support, allowing SNGs to plan and budget more effectively for essential services.

52. ***Equalisation grants*** represent a fundamental component in the architecture of fiscal federalism, designed to reduce disparities in fiscal capacity and service needs across jurisdictions. They aim to ensure a more equitable resource distribution, allowing SNGs to offer comparable public services irrespective of their economic or demographic conditions. These grants can focus on fiscal capacity or service needs and may fully or partially equalise these aspects. While generally broad in scope, they can also target specific services or sectors. Some systems include mechanisms to mitigate economic fluctuations, thereby enhancing fiscal stability and adaptability. The complexity and transparency of the formulas and indicators used in these systems vary, reflecting each country's preferences for transparency, public acceptability, and data availability. This variation allows for fiscal adjustments tailored to the unique needs and disparities within a country (Dougherty & Forman, 2021; Ter-Minassian, 2021).

53. *Equalisation based on revenue capacities* aims to level the revenue-generating potential across regions, ensuring equitable public service provision nationwide, despite revenue-generating disparities among SNGs. In OECD countries, such schemes significantly reduce fiscal capacity disparities, accounting for about 2.3% of GDP (Blöchliger et al., 2007; Martinez-Vazquez & Searle, 2007; OECD, 2021).[46] Canada, for instance, uses the Representative Tax System (RTS) to equalise revenue capacities across provinces, with adjustments for higher service delivery costs in certain areas.[47] Canada also incorporates needs-based special purpose grants for sectors like healthcare and education.[48] More recent discussions on the RTS contemplate whether equalisation should solely focus on revenue capacity and how to integrate the federal government's significant "individual-based" programs into the equalisation framework, reflecting an evolving perspective on addressing both revenue capacities and specific service delivery needs[49] (Searle & Ahmad, 2005).

54. *Equalisation based on expenditure needs* addresses disparities in SNGs' spending requirements, particularly where local revenue generation is insufficient. South Africa serves as a prime example, where the equalisation strategy heavily focuses on assessing the expenditure needs of its provinces.[50] However, the provinces' constrained ability to generate revenue

[46] Ranging between 0.5% and 3.8% of GDP, or between 1.2% and 7.2% of government expenditures, across member countries (OECD, 2021).

[47] Canada's Federal Equalisation Program operates by evaluating each province's fiscal capacity and providing payments to those below the national average, enabling provinces to offer comparable public services at similar tax levels. However, recognising higher service delivery costs in the Northwestern Territories led to the introduction of a special grant, indicating a shift towards a more nuanced equalisation approach.

[48] The magnitude of these needs-based grants often surpasses traditional equalisation transfers, reflecting a shift in focus toward addressing specific service delivery requirements (Searle & Ahmad, 2005).

[49] The expansion of tax assignments and enhancement of provincial revenue powers in Canada, encompassing all major tax bases available to the central government, prompted a re-evaluation of vertical imbalances, as provinces theoretically could compensate for reduced federal revenues by increasing their own taxes.

[50] This method, despite its focus on spending requirements, has its limitations. For instance, the use of the "economic output" variable in the South African model is sometimes seen as an indirect way of accounting for revenue capacity differences among provinces.

complicates the equalisation program, limiting the national government's capacity to promote efficient use of resources, for instance, through matching grants. The Financial and Fiscal Commission in South Africa has proposed a "cost-based" approach to overcome these challenges. This method would compel provinces to consider the real costs of reallocating resources, thereby encouraging more prudent budgetary decisions and motivating them to find cost-effective ways to achieve nationally set social service goals, with funding allocations reflecting local social conditions more accurately[51] (Shah, 2017).

55. This expenditure-focused approach, however, introduces its own set of challenges, including the risk of reinforcing unintended incentives. In practice, South Africa's reliance on current expenditure levels to determine equalisation transfers tends to perpetuate a mix of historical service delivery patterns, cost variances and inefficiencies across provinces. As a result, this strategy may inadvertently maintain existing provincial inefficiencies and established service delivery models, undermining the goals of fiscal equalisation efforts.[52] Furthermore, prioritising expenditure needs without adequately accounting for the potential of own-source revenue generation weakens fiscal discipline, potentially compromising the overall effectiveness of budget management (Searle & Ahmad, 2005).

56. The adoption of *equalisation grants based on both revenue capacities and expenditure needs* addresses the shortcomings inherent in focusing solely on either aspect. An example of this approach is Germany's State Financial Equalisation Scheme,[53] a sophisticated system designed to redistribute funds from wealthier states to those with lesser financial means, thereby ensuring nationwide fiscal balance. This system incorporates both horizontal transfers between states and supplementary vertical grants from the federal level.[54] Despite its intentions, the "Länderfinanzausgleich" has faced criticism for potentially creating disincentives for economic development and the complexity of its redistribution formula.[55] In response, the system has undergone several reforms aimed at refining the redistribution criteria and addressing concerns about fairness and efficiency. Similar models are found in Australia, Denmark and China, where the approach continues to evolve, shaped by the dynamic interplay between central governments and SNGs (Dougherty & Forman, 2021).

57. Fiscal equalisation reliance on detailed and often outdated data necessitates subjective decisions, consuming significant time and resources and fostering public scepticism about the fairness of tax revenue distribution. This scepticism is compounded by the schemes' tendency to exacerbate economic instability during downturns and to create disincentives for SNGs to pursue

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[51] Examples of social conditions used in cost measurement include the number of infants, elderly citizens, or students of school age.

[52] A similar challenge was observed in Italy, which initially focused solely on expenditure needs for its equalisation efforts. The subsequent introduction of revenue capacity considerations into the Italian equalisation framework marked a significant shift, enhancing the system's efficiency and effectiveness (Searle & Ahmad, 2005).

[53] In German: "Länderfinanzausgleich".

[54] Although the "Länderfinanzausgleich" is primarily focused on revenue capacities, it indirectly considers expenditure needs through the supplementary grants provided by the federal government to the states. These grants can be seen as a mechanism to address specific expenditure needs that are not fully covered by the horizontal financial adjustments among the states, such as higher costs for social services or infrastructure investment in less affluent states.

[55] Critics argue that the system might discourage states from enhancing their own economic performance if they know that increased revenue will lead to higher contributions to the equalisation mechanism or reduced receipts from it.

fiscal growth or diversify tax bases. The resulting strategic behaviours, such as the underreporting of fiscal capacities to secure larger grants, challenge the goals of fiscal federalism by discouraging autonomy and proactive fiscal management.[56] Yet, the challenge of accurately assessing these factors, often hindered by limited data, leads many countries to rely on simpler proxies or focus predominantly on revenue capacities.[57] This approach, while practical, may dilute the system's intended effectiveness and transparency, potentially affecting future tax reforms and shifts in expenditure responsibilities (Ter-Minassian, 2021).

58. ***Revenue sharing*** addresses vertical fiscal imbalances by supplementing SNG's revenue-generating capacities, allocating funds from higher government levels to lower ones. This strategy enhances SNGs' spending capabilities, mitigates socio-economic externalities and responds to local demands for a share of national tax revenues, providing a stable funding source for budgetary planning. It can take various forms, such as allocating specific tax revenues like the value-added tax (VAT), income tax, or distributing a fixed percentage of total national revenues. For instance, in Brazil, the State Participation Fund redistributes income and industrial taxes from the federal government to states. In Australia, the Commonwealth Grants Commission assesses fiscal capacities to recommend the distribution of Goods and Services Tax revenue among states and territories. In Germany, VAT revenue sharing based on population size supports the Länder.

59. Despite its advantages, revenue sharing can also introduce specific incentives and challenges. The stable inflow of national tax revenues can discourage SNGs from developing their own tax bases or improving tax collection efficiency, leading to a dependency on central funds and reducing local fiscal independence and innovation. Moreover, revenue sharing can introduce budget volatility for SNGs, particularly with pro-cyclical taxes[58] or revenues from fluctuating sectors like natural resources. Furthermore, if allocations do not adequately reflect the diverse fiscal needs and capacities of each region, revenue sharing may inadvertently perpetuate regional disparities (Martinez-Vazquez & Searle, 2007; OECD, 2021; Shotton & Gankhuyag, 2021).

60. ***Gap-filling transfers*** are specific financial allocations designed to bridge the gap between the revenues SNGs can generate and their spending needs. These transfers, typically unconditional, are essential in settings where SNGs have very limited revenue-raising capabilities. In regions such as South Asia and countries with a history of non-market economies,[59] gap-filling transfers have traditionally led to a dependency on central government funds, often at the expense of fiscal discipline and autonomy among SNGs. This dependency arises from the lack of stringent budgetary controls, reducing the incentive for SNGs to manage their finances prudently or explore avenues to enhance their revenue generation. Nonetheless, there is a noticeable shift towards acknowledging the drawbacks of an unregulated approach to

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[56] To address these unintended consequences, strategies should concentrate on promoting fiscal responsibility and boosting revenue collection efforts within SNGs. Implementing minimum standards for tax collection efforts and enhancing the clarity of the distribution process are critical steps. These measures aim to reconcile the motivations of SNGs with overarching goals of fiscal fairness and effectiveness.

[57] Some countries, like Australia, have entrusted this complex task to independent technical expert bodies, such as the Australian Grants Commission.

[58] Pro-cyclical taxes are taxes that tend to increase during economic expansions and decrease during economic contractions, thus amplifying the natural business cycle.

[59] Gap-filling transfers, commonly utilised in countries that were historically non-market economies, provide resources to SNGs. The usage of these funds is largely predetermined during the budgeting process, as subnational budgets are often integrated into the broader state budget.

gap-filling transfers. More countries are moving towards adopting rigorous and transparent fiscal management practices at the subnational level[60] (Spahn, 2012; Shotton & Gankhuyag, 2021).

b. Area conditional transfers

61. ***Block grants*** are designed to support broad categories of spending at the subnational level, such as education, infrastructure and social welfare programs. Although these funds are earmarked for broad categories of expenditure, SNGs retain considerable discretion over their use within these specified areas,[61] a flexibility that respects and promotes subnational autonomy.[62] In the United States (Box 3), block grants have traditionally funded a diverse range of initiatives, including infrastructure projects, healthcare and community development. Similarly, in Canada, block grants are significant, particularly in the context of social programs mandated by the federal government. However, the per capita allocation of these grants may not always suffice, requiring provinces to supplement funding with their own revenue[63] (Shah, 2006).

62. One notable advantage of block grants is their ability to mitigate the flypaper effect. By providing a fixed sum without matching requirements, block grants encourage more prudent and efficient spending decisions at the subnational level, potentially reducing the propensity to overspend. This characteristic has led to proposals in the United States to convert certain matching grants, like Medicaid, into block grants as a means to promote fiscal responsibility and reduce the flypaper effect (Sutter, 2016).

c. Conditional transfers

63. ***Conditional transfers***, commonly referred to as earmarked or specific-purpose grants, are designed to guide SNGs toward specific programs or initiatives. These transfers can be regular, providing a stable element in SNGs' financial planning, or discretionary, designed to meet unique needs or circumstances. They typically come with conditions that are either input-based, specifying the types of expenses they cover, or output-based, linking funding to specific service outcomes. Input-based conditions tend to be more restrictive, limiting SNGs to predetermined spending categories, whereas output-based conditions offer more flexibility, aligning with broader objectives while respecting local autonomy (Shah, 2006).

64. The allocation of earmarked grants can lead to equity concerns, particularly when they disproportionately benefit regions with pre-existing infrastructure, thereby exacerbating regional inequalities.[64] Furthermore, these grants can be viewed as central government encroachment on

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[60] This evolution highlights a growing consensus on the necessity for SNGs to adopt fiscal policies and strategies that are both responsible and sustainable.

[61] This characteristic distinguishes block grants from conditional or earmarked grants, where funds must be used for specific, predetermined purposes.

[62] However, this flexibility can also lead to challenges in ensuring that the funds are used effectively and efficiently. Without specific directives, there is a risk that funds may not be allocated to the areas of greatest need or may not be used in the most effective manner. This concern underscores the importance of robust local governance and accountability mechanisms to ensure that block grants achieve their intended outcomes.

[63] Although block grants are frequently distributed on a per capita basis, this method is not universal. The criteria for allocation can differ, depending on the specific goals of each grant.

[64] For example, in Vietnam, health sector grants allocated based on the number of hospital beds have disproportionately benefited already well-equipped areas.

areas traditionally managed by SNGs, sparking debates about re-centralisation (Shotton & Gankhuyag, 2021).

65. Monitoring the effective use of conditional grants is a significant challenge for central governments, often resulting in unaccounted additional financing for SNGs. This oversight issue has been particularly problematic in Latin America, where the extensive use of earmarked transfers has not consistently led to expected levels of local accountability. However, strategies like repeated interactions or contractual agreements can enhance the management and accountability of these grants, ensuring that they fulfil their intended purposes (Searle & Ahmad, 2005).

66. A unique aspect of some conditional transfers is their matching requirements, which require SNGs to contribute a portion of their own budgets to match the grant funds. These conditions, which can be open-ended with no maximum limit, or closed-ended, restricted to a certain amount, encourage local investment and engagement in the funded projects.

67. ***Conditional non-matching grants*** are strategic tools for higher-level governments to fund projects that may not be a priority for SNGs. These grants are particularly beneficial for initiatives with significant spillover benefits,[65] ensuring that such projects align with federal objectives, especially when specific goals are managed by dedicated departments rather than centralised bodies like the Ministry of Finance. This approach prevents fund diversion, ensuring that allocations are used as intended and safeguarding against resource misallocation, thus maintaining the integrity of national and local priorities by directing funds to their intended purposes (Shah, 2006).

68. ***Conditional matching grants***, commonly used in cost-sharing programs, require recipients to use the funds for specific purposes and contribute their own resources. These grants act as subsidies from the central government to SNGs for targeted sectors, leading to both income and substitution effects. The income effect enhances the demand for services in the subsidised sector due to the influx of additional resources. The substitution effect makes the subsidised sector relatively cheaper, prompting communities to shift more of their budgets there.[66]

69. The Medicaid program in the United States serves as a prime example of conditional matching grants, where federal funds match state expenditures to encourage healthcare investments[67] (Sutter, 2016). In Spain, public transportation subsidies are tied to local contributions to enhance transit systems.[68] In the United Kingdom, the Affordable Housing Program[69] (Box 4), and in France, initiatives supporting renewable energy projects, also operate on a matching basis where local funds are supplemented by national contributions to promote development in these sectors.

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[65] While SNGs often prefer the flexibility of unconditional non-matching transfers to address their local needs, grantors sometimes opt for a more focused strategy to guarantee funding is channeled towards key national interests.

[66] Moreover, conditional matching grants can also indirectly support the acquisition of other public goods and services due to the 'fungibility effect'. This effect implies that actual spending in the designated area may be less than the grant amount, allowing the surplus to be used for other services or tax relief (Shah, 2006).

[67] Available from: https://www.medicaid.gov/.

[68] Available from: https://elpais.com/economia/2023-12-27/la-gratuidad-del-transporte-publico-de-trenes-y-autocares-se-mantendra-en-2024.html.

[69] Available from: https://www.housing.org.uk/our-work/building-new-homes/AHP-2021-26/.

70. However, matching requirements can sometimes lead to unintended financial redistributions that do not necessarily benefit the intended communities. For example, in Denmark, matching grants have been criticised for causing increased spending and higher taxation. In developing countries, where financial resources are more limited, these matching requirements may prevent poorer regions from fully benefiting from the grants, thus worsening regional disparities (Lotz, 2006).

71. Conditional matching grants are divided into open-ended and closed-ended types. ***Open-ended conditional matching grants*** provide unlimited matching funds, which can correct inefficiencies from spillovers or externalities by adjusting the amount or rate of matching to the scale of the spillover.[70] However, they may not adequately address disparities in fiscal capacity, as wealthier SNGs are better positioned to meet the matching criteria than those with fewer resources, potentially undermining the system's fairness. Addressing this may require additional support to improve the fiscal health of economically weaker SNGs (Shah, 2006).

72. Conversely, ***closed-ended conditional matching grants*** have a predefined maximum limit, which helps authorities manage financial disbursements more effectively. This arrangement enhances accountability and transparency in spending. Nevertheless, these grants, often earmarked for particular services or projects, can lead to inefficiencies by encouraging disproportionate spending in designated areas, potentially neglecting other critical sectors.

Box 4. Country case: United Kingdom

During the analysed period, IFTs in the United Kingdom exhibited two distinct patterns. Initially, in the early 2000s, coinciding with the start of the devolution process, grants saw a gradual increase of approximately 2% of GDP. This upward trend reached its peak in 2010 with the implementation of the austerity program, aimed at addressing fiscal sustainability issues stemming from the global financial crisis. According to the data presented in Figure 11, this period of fiscal consolidation lasted a decade until the onset of the pandemic in 2020. That year, there was a marked increase in grants, reversing seven years of decline, with the most substantial rise observed in the economic affairs sector.

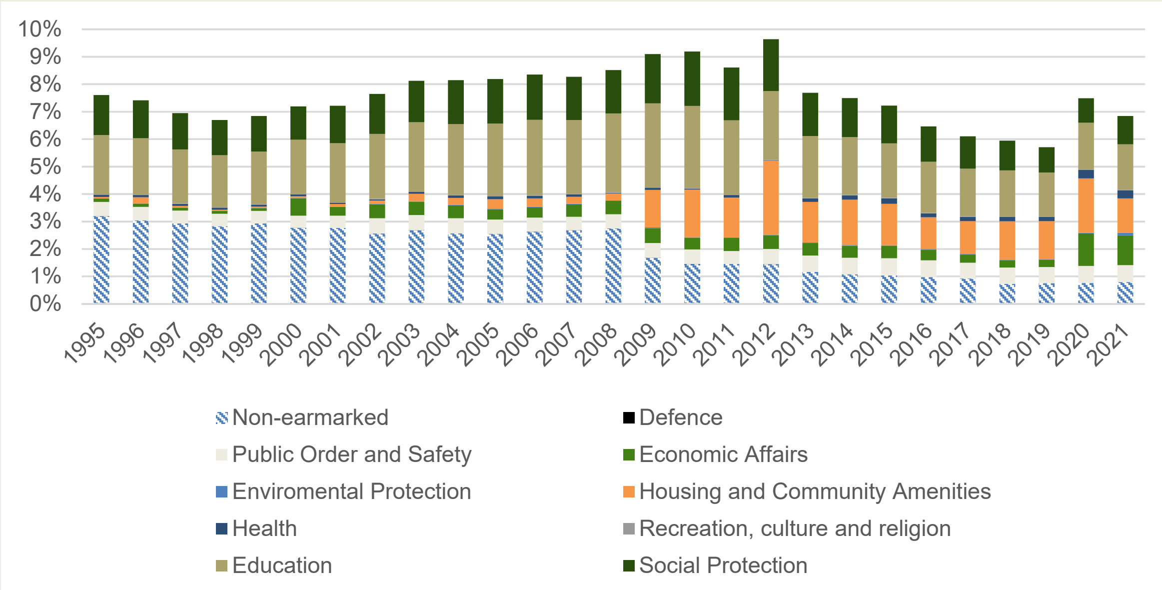
In parallel, the composition of transfers has also shifted. Grants for general public services, which are not earmarked, began to significantly decline starting in 2009 and have continued to do so. On the other hand, transfers for housing and community amenities have been on the rise since 2009. This increase is largely attributed to the expansion of the Housing Benefit, which, although administered locally, is financed by the central government. Notably, housing-related transfers constitute only 1.5% of total transfers across the OECD, yet they represent 18.3% of all transfers in the UK.

The distribution of the UK´s grants across policy areas is very balanced. Education is the largest category, followed closely by three others of equal importance: housing, economic affairs and social protection. As housing grants, public order and safety transfers are also disproportionately high when compared to any other OECD country covered by the database.

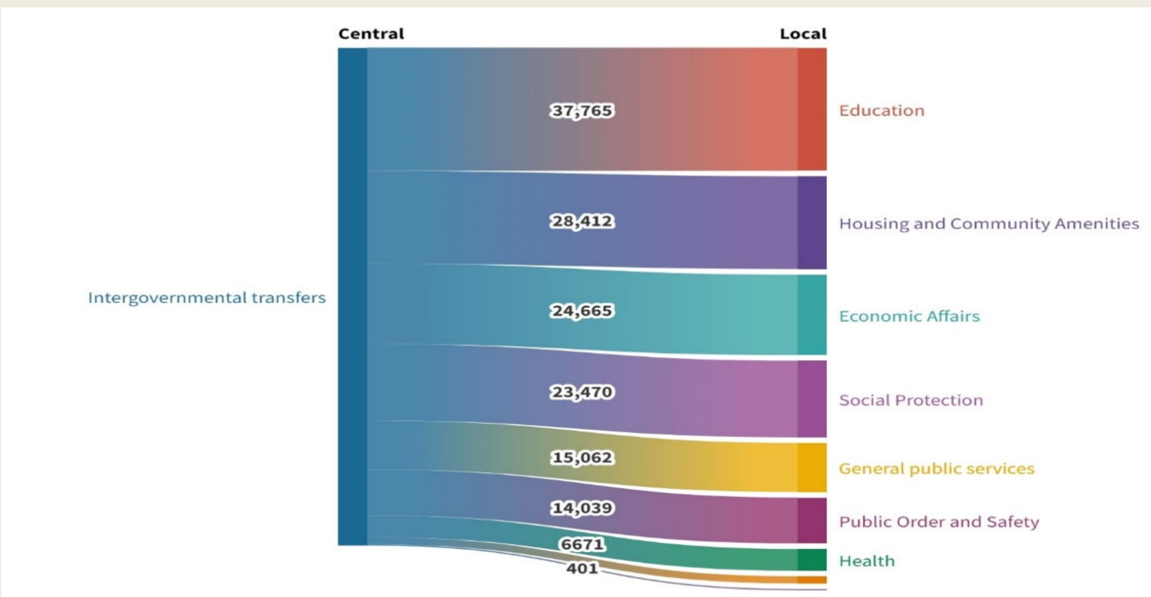
[70] Spillovers arise when a service financed by one local government also benefits neighboring areas that do not financially contribute, typically resulting in the service being underprovided.

Figure 11. Intergovernmental transfers paid by the central to local governments in the UK

Panel A. Transfers over time by COFOG area (% of GDP)



Panel B. Transfers paid by COFOG area (GBP millions)



Source: elaboration based on the OECD Fiscal Decentralisation database.

Table 1. Overview of IFTs: Types, objectives and incentives across OECD countries

Types of Grants	Objectives	Desired Incentives	Undesired Incentives	Commonality in OECD Countries (Examples)
Unconditional				
Equalisation Grants	- Reduce fiscal disparities across jurisdictions - Distribute funds in a predictable and transparent manner - Consider factors like population, area and fiscal capacity	- Promote fairness and equity in resource distribution - Support regions with less revenue capacity - Enhance budgetary planning for all governments - Motivate recipient governments to optimise their revenue generation and efficiently manage public services	- Overly complex formulas can disincentivise SNGs from maximising their revenue sources, leading to underutilisation of their tax bases - Reliance on detailed, outdated data imposes subjective decisions that can undermine trust and co-operation between governments - Disregard of economic cycles	Common (e.g. Canada's Federal Equalisation Program[71] / Germany's Financial Equalisation System[72])
Revenue Sharing	- Supplement SNG´s revenues without specific directives - Distribute funds in a predictable and transparent manner - Enhance inter-jurisdictional equity	- Support regions with less revenue capacity - Provide stable, predictable funding for SNGs - Enhance budgetary planning for all governments	- Can disincentivise SNGs from maximising their revenue sources, leading to underutilisation of their tax bases and dependence on central funds - Can lead to inefficiencies or misallocation of resources in the absence of precise accountability mechanisms	Common (e.g. Germany's VAT Tax Sharing[73] / Australia's GST Redistribution[74])
Gap-filling transfers	- Bridge the fiscal gap between SNG revenues and expenditures	- Ensure SNGs can meet expenditure needs - Mitigates service delivery gaps	- Promote overreliance on central government transfers - Can disincentivise SNGs from maximising their revenue sources, leading to underutilisation of their tax bases	Less common (e.g. Spain's Inter-territorial Compensation Fund[75]/ Canada´s Territorial Formula Financing)
Area conditional				
Block Grants	- Support broad categories of subnational expenditures - Intermediary position between general-purpose and specific-purpose transfers	- While focusing on a specific area, still allow flexibility to SNGs - Counteract the flypaper effect, promoting more efficient spending - Promote tailored service delivery and policy innovation	- Can lead to inefficiencies or misallocation of resources in the absence of clear accountability mechanisms - Reliance on detailed data, often unavailable - May not adequately cover program costs	Common (e.g., US Community Development Block Grants (CDBG)[76] / Canada Health Transfer[77]/US Social Services Block Grant).

[71] Available from: https://www.canada.ca/en/department-finance/programs/federal-transfers/equalisation.html.

[72] Available from: www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Oeffentliche_Finanzen/Foederale_Finanzbeziehungen/Laenderfinanzausgleich/laenderfinanzausgleich.html.

[73] Available from: https://www.bundesfinanzministerium.de/Web/EN/Issues/Taxation/VAT/vat.html.

[74] Available from: https://www.cgc.gov.au/.

[75] Available from: https://www.fondoseuropeos.hacienda.gob.es/sitios/dgfc/en-GB/ipr/oipr/fci/paginas/inicio.aspx.

[76] Available from: https://www.hud.gov/program_offices/comm_planning/cdbg.

[77] Available from: https://www.canada.ca/en/department-finance/programs/federal-transfers/canada-health-transfer.html.

Conditional				
Earmarked non-matching grants	- Provide financial resources for specific purposes without requiring matching funds - Support regions, especially those with limited fiscal capacities - Align with broader central government objectives	- Ensure funds are directed toward specific high-priority areas - Ensure even regions with limited resources can undertake specific projects or programs - Reduce the financial burden on regions with limited fiscal capacities	- Can distort local priorities if conditions are too stringent or misaligned with local needs - May be seen as central government overreach, with a lack of local priority alignment	Less Common (e.g., UK Pupil Premium[78] / Canada Cultural Spaces Fund[79])
Earmarked matching open-ended grants	- Subsidise services with spillover benefits - Encourage SNGs to invest in specific areas - Align with broader central government objectives	- Stimulate greater scrutiny and local ownership of projects - Promote shared responsibility between different levels of government	- Requirement to match funds might deter poorer regions, leading to disparities in service provision - Can lead to inefficiencies or misallocation of resources due to income and substitution effects	Common (e.g., US Medicaid[80] / UK Affordable Housing Program[81])
Earmarked matching closed-ended grants	- Provide subsidies with a cap on matching funds - Encourage SNGs to invest in specific areas - Align with broader central government objectives	- Increase accountability, enhance cost transparency - Allows better budget control for grantors - Promote shared responsibility between different levels of government	- Requirement to match funds might deter poorer regions, leading to disparities in service provision - May lead to overspending in targeted areas, neglecting other sectors	Less common (e.g. France's *Contrat de Plan État-Région* (CPER)[82]/ Australia's Roads to Recovery Program[83])
Performance-Oriented Transfers	- Reward SNGs that achieve specific benchmarks - Emphasise results and outcomes. Input flexibility is paramount. - Contractual platform with pre-specified targets	- Promote efficiency, effectiveness, transparency and accountability in service delivery - Ensure funds are used for their intended purpose	- Conditions must be attached to outputs, as opposed to outcomes, which are subject to interferences beyond the control of policymakers. - Limited by data availability - Potential for data manipulation	Less Common (e.g. US Race to the Top Grant[84] / Australia´s National Health Reform Agreement[85]/ New Zealand's Performance-Based Research Fund)[86]

[78] Available from: https://www.gov.uk/government/publications/pupil-premium/pupil-premium.

[79] Available from: https://www.canada.ca/en/canadian-heritage/services/funding/cultural-spaces-fund.html.

[80] Available from: https://www.medicaid.gov/.

[81] Available from: https://www.gov.uk/government/collections/affordable-homes-programme-2021-to-2026.

[82] Available from: https://www.centre-inffo.fr/site-regions-formation/en-cours-dans-les-regions/accords-de-prefiguration-des-contrats-de-plan-etat-region-cper.

[83] Available from: https://investment.infrastructure.gov.au/about/local-initiatives/roads-recovery-program.

[84] Available from: https://eric.ed.gov/?id=ED557422.

[85] Available from: https://www.health.gov.au/our-work/2020-25-national-health-reform-agreement-nhra.

[86] Available from: https://www.tec.govt.nz/funding/funding-and-performance/funding/fund-finder/pbrf/.

5. Recent and emerging trends in intergovernmental fiscal transfer design

73. Even if the last decade has not seen radical changes in the field of IFTs, recent trends and emerging practices suggest potential reforms are likely in the horizon. This section will first assess the impact of the COVID-19 pandemic on IFT systems using the newly available data, then explore innovative practices such as performance-oriented grants, and consider IFTs in the context of regional policy, welfare enhancement, and the potential impacts of new budgeting practices.

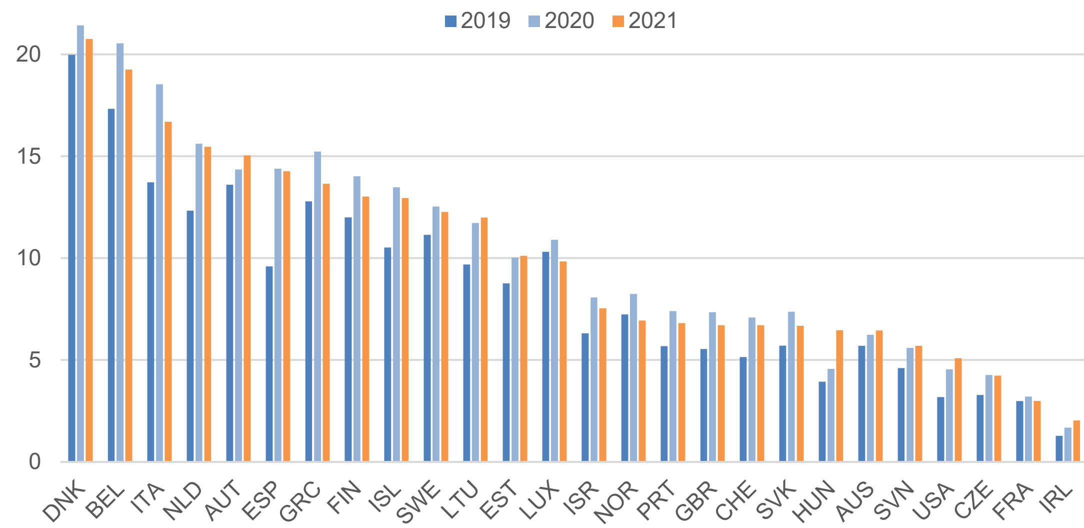
5.1. The impact of the COVID-19 pandemic on IFTs

74. The newly developed data table on IFTs provides insights into how the COVID-19 pandemic's effect on the reliance of SNGs on central government grants. Figure 12 illustrates that in 2020, the total volume of transfers from central governments increased for every country included in the study, to a larger or a lower extent. Notably, Spain and Italy experienced the most significant increases in transfers, with both countries seeing rises of 4.8 percentage points of GDP in transfers. Not by coincidence, these countries were severely hit by the pandemic's initial wave, facing severe public health and economic challenges. Other countries, including Iceland, the Netherlands and Belgium also registered notable increases in transfers in 2020. Furthermore, excess death rates serve as an essential metric for assessing the impact of COVID-19. These rates, which track the number of deaths from all causes relative to expected levels under normal circumstances, show that while Spain and Italy were significantly affected, other countries like Belgium, France and the United Kingdom, exhibited similar patterns in excess death rates during the pandemic (Aron et al., 2024).

75. In contrast, the evolution of grants in 2021, a year still marked by pandemic-related restrictions in most countries, was more heterogeneous. Although transfers remained larger than in 2019 for all countries except Luxembourg and Norway, most countries experienced a reduction in transfers from the central government compared to 2020. However, about a third of the countries either increased their transfers or maintained the same level. This pattern was especially pronounced in countries where transfers as a percentage of GDP were among the lowest, including Hungary, Australia, Slovenia, the United States, the Czech Republic and Ireland.

Figure 12. Total intergovernmental transfers paid by central governments

% of GDP



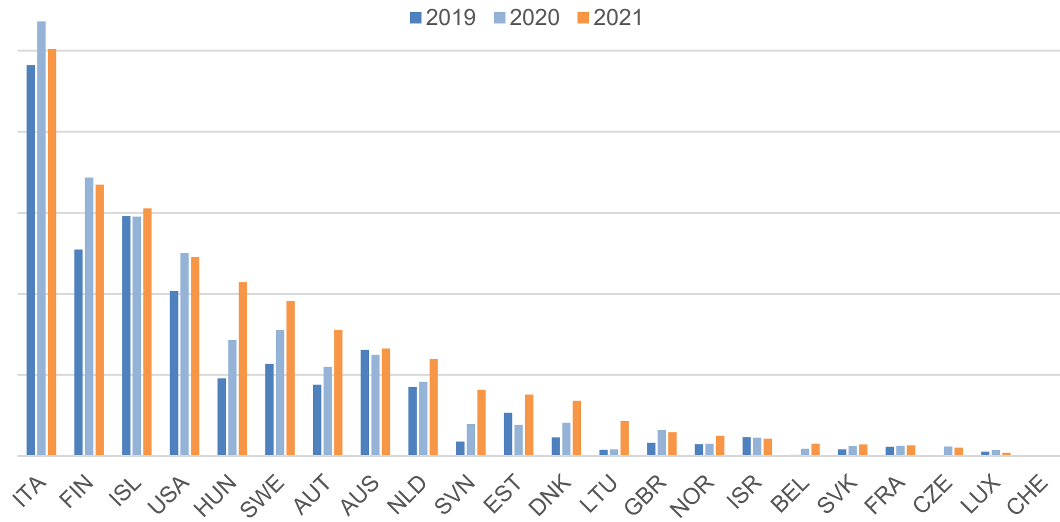
Source: elaboration based on the OECD Fiscal Decentralisation database.

76. As previously mentioned, the central government had to intervene to support SNGs (and Social Security) in maintaining the provision of public services like healthcare, education and social assistance, which are often decentralised. However, as indicated by Figures 13, 14 and 15, earmarked transfers for these specific policy areas did not experience the most significant changes during the pandemic.

77. First, as expected, healthcare-related grants saw an increase in most countries during the pandemic. However, the rise in healthcare grants was not as substantial as might have been expected and not enough to avoid losing relative weight in total transfers, as other categories were even more pronounced. Hungary, Finland, Sweden and Austria recorded the most significant increases in healthcare earmarked transfers among OECD countries during the pandemic. Israel, which experienced a relatively mild impact from the virus, was the only country where the central government's healthcare transfers relative to GDP in 2021 were lower than in the pre-pandemic period. The increases in healthcare spending and transfers were driven by the need to employ additional medical staff, procure ventilators, expand hospital capacity, establish temporary healthcare facilities, secure medication supplies, and purchase vaccines.

Figure 13. Health intergovernmental transfers paid by central governments

% of GDP

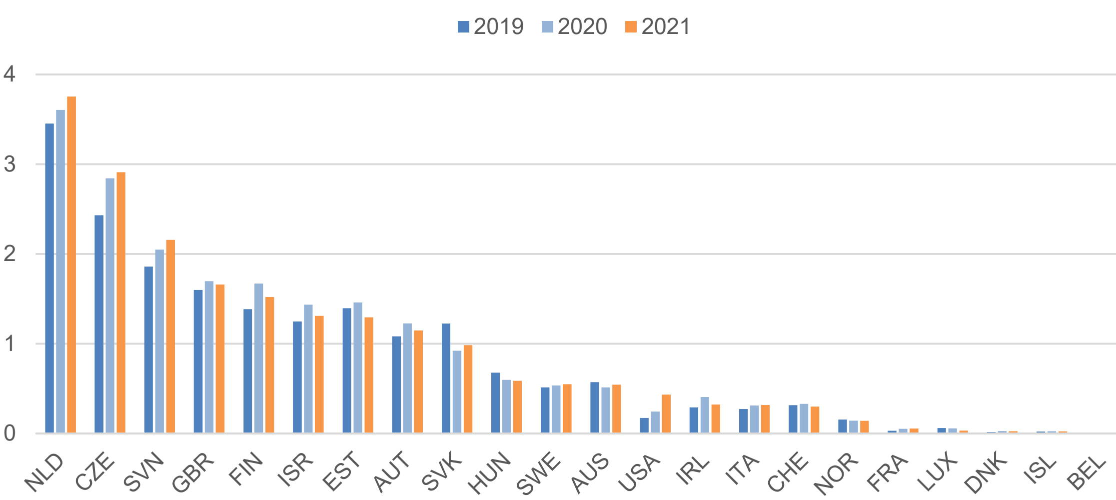


Source: elaboration based on the OECD Fiscal Decentralisation database.

78. Second, a similar pattern is observed for grants devoted to education, which saw the most significant increases in the Czech Republic, the United States, Finland and Slovenia. The pandemic forced an urgent transition from traditional classroom instruction to fully online and, subsequently, hybrid models of education in schools and universities. This change required the refurbishment and digital upgrading of educational facilities. Additionally, students needed to obtain devices like tablets or computers and secure reliable broadband internet access to participate in lessons conducted via streaming.

Figure 14. Education intergovernmental transfers paid by central governments

% of GDP

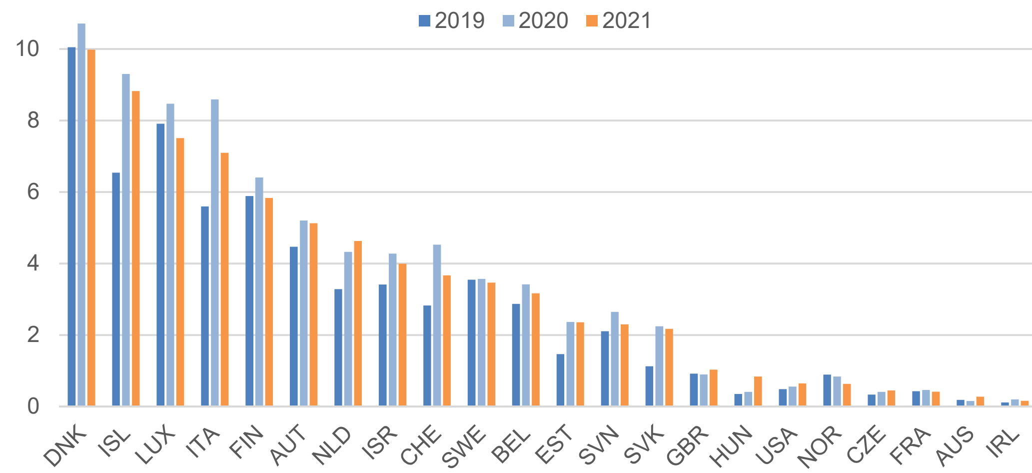


Source: elaboration based on the OECD Fiscal Decentralisation database.

79. Third, the increase in earmarked grants for Social Protection was more pronounced than in the previous two categories. Social Protection transfers typically represent a larger portion of total transfers, accounting for more than half in countries such as Luxembourg, Iceland, Switzerland, and nearly in Denmark. The economic lockdowns initiated in early 2020 to control the spread of the virus significantly impacted the income generation of millions of households across OECD countries. In response, central governments implemented comprehensive social protection measures, including employment safeguard schemes, extraordinary unemployment benefits and minimum income programs. These initiatives, primarily administered by Social Security, accounted for the notable rise in earmarked transfers in Italy, Iceland and Switzerland, as illustrated in Figure 15.

Figure 15. Social Protection intergovernmental transfers paid by central governments

% of GDP

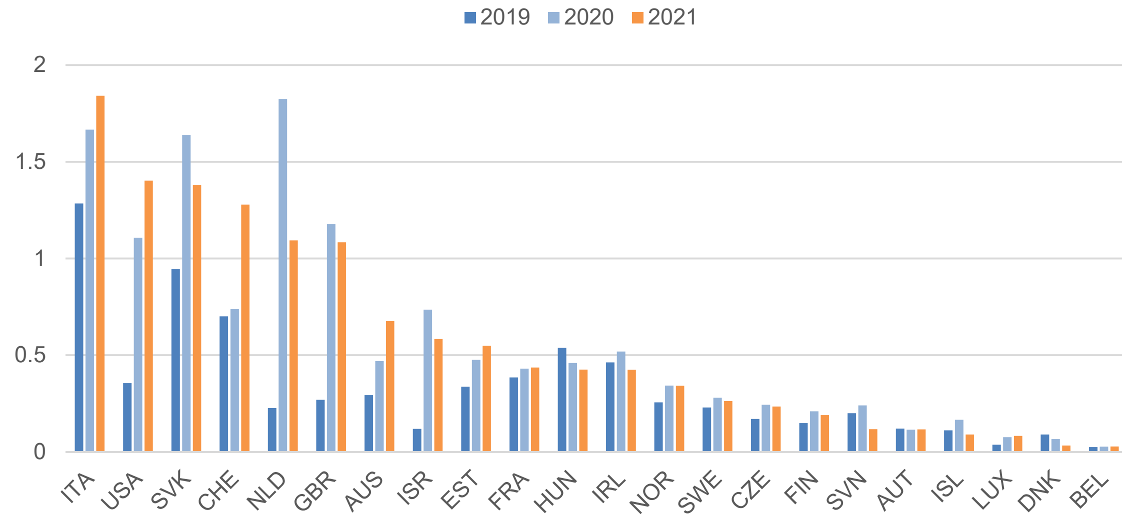


Source: elaboration based on the OECD Fiscal Decentralisation database.

80. However, the most significant relative increase in IFTs during 2020 was observed in the Economic Affairs category, as detailed in Figure 16. This COFOG category includes sectors like transport and communication, which were heavily impacted by mobility restrictions and curfews. Notably, transfers in the Netherlands increased nine-fold, in Israel seven-fold, in the UK four-fold, and there were also substantial increases in the United States. Switzerland experienced a similar increase but with a year’s delay. These statistics reveal that for numerous OECD countries, Economic Affairs became the primary conduit for fiscal support to SNGs during the pandemic.

Figure 16. Economic Affairs intergovernmental transfers paid by central governments

% of GDP



Source: elaboration based on the OECD Fiscal Decentralisation database.

81. Finally, Figure 17 explains the negligible growth in transfers in some remaining countries. Because of their institutional, often federal tradition, they opted for non-earmarked transfers instead of support linked to specific policy areas. This approach was particularly evident in Spain, Greece and Portugal, where earmarking of grants is not customary, and to a significant extent in Lithuania, Norway and Belgium. Nevertheless, the absence of earmarking to specific policy areas does not imply that health-related factors were overlooked in the allocation of grants, as illustrated in the example provided in Box 5.

Box 5. Fondo COVID: Spanish central support program for regions

In June 2021, the Spanish central government established an unconditional, non-refundable transfer program worth EUR 16 billion for regional governments, aimed at ensuring the continuity of decentralised public services, notably healthcare, education and social assistance, amidst a sharp increase in expenditure demands and falling tax revenues. The Fund was not part of the regular regional funding system, but it was created as an additional liquidity mechanism.

The program comprised four different transfers that were distributed based on criteria related to health, education, and decreased tax revenue:

- *The healthcare system (until May 2020)*: EUR 6 billion was allocated according to the following formula: protected population (a proxy that provides more weight to older population; 35%), patients in ICU (30%), hospitalised patients (25%), PCR tests carried out (10%). Since Madrid was one of the regions most severely affected by the pandemic in Europe, this region received a large amount of transfers of this first section of the Fondo COVID (around ¼ of the total despite its population only representing 14% of total Spanish inhabitants).
- *The healthcare system (until November 2020)*: EUR 3 billion was distributed using the same criteria but with adjusted weights. The protected population was given higher percentages (45%) at the cost of patients in ICU (25%) and hospitalised patients (20%) since the hospitals' collapse was corrected during the summer of 2020. Therefore, the distribution of funds across regions in per capita terms becomes more even in this case.
- *Education*: EUR 2 billion was allocated based on the distribution of the school-age population. In particular, the 0-16 age population (80%) and the 17-24 age population (20%). Mediterranean regions were the most benefited by this transfer due to their younger demography structure.
- *Decreased tax revenue*: EUR 5 billion compensated for reduced economic activity, applying a formula that considered tax revenue decline (50%), adjusted population (the spending needs proxy commonly used for equalisation; 34%) and public transport revenue loss (16%). Consequently, 40% of the fund went to support Catalonia and Madrid due to their high density.

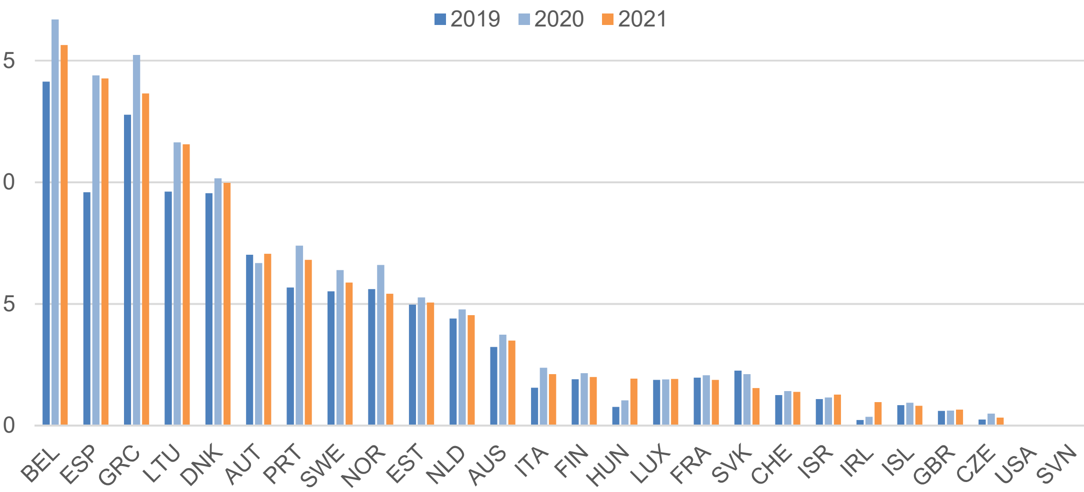
Interestingly, although the four transfers were computed following different criteria linked to healthcare, education and tax revenue losses, following the tradition of the Spanish intergovernmental fiscal relations model, they were non-earmarked. This means that regions could decide how to use the money, preserving regional spending autonomy despite the increase in transfer dependence. The so-called "Foral regions", this is the Basque Country and Navarre, which are financed through a model based on a broad tax autonomy and no central support, took part in Fondo COVID, but were excluded from the fourth transfer.

One year later, in 2021, a new fund named "Extraordinary Fund" was created. It distributed an additional EUR 13.5 billion across regions, according to their relative adjusted population. Although its objective was to reinforce regional finances due to the consequences of the pandemic, its size (close to 10% of the total funding provided by the regular regional funding system) raised questions on whether regions were overfunded during the pandemic. Yet, regional debt remained at high levels. Autonomous Communities' debt increased by 2.8% in 2021, being the fifth lowest absolute increase since 2000. However, it decreased in relative terms. Indeed, the debt/GDP ratio fell by 1.6 percentage points in 2021, the second largest reduction since 2000, and at the end of 2023, regional debt represented 22.2% of GDP, being the lowest figure since 2013. Around 60% of it is owned by the central government. Some experts and regions are calling for temporary arrangements that ensure sufficient levels of regional funding, in response to the lack of political agreement for a more comprehensive reform of the regional funding system.

Source: Spanish Ministry of the Treasury and Regional Governments.

Figure 17. General Public Services intergovernmental transfers paid by central governments

% of GDP



Source: elaboration based on the OECD Fiscal Decentralisation database.

5.2. Performance-oriented grants

82. ***Performance-oriented grants*** (PBG), or output-based grants, are inherent to service delivery contracts, rooted in the principles of new public management[87] and new institutional economics.[88] These grants condition the allocation of resources on achieving specific outcomes,[89] incentivising SNGs to align their efforts with overarching objectives. They aim to improve public sector accountability and governance by focusing on performance, allowing flexibility in program design while stipulating conditions for achieving specific results. Public managers are encouraged to monitor a range of indicators, from inputs to outcomes, to ensure this results-driven approach[90] (Shah, 2006).

83. In practical terms, annual assessments evaluate SNG performance, adjusting their grant amounts accordingly to reward or penalise them based on their achievements. They are categorised into multi-sectoral PBGs, which use process indicators focusing on governance, planning, budgeting, public financial management, and transparency to evaluate performance; and sector-specific PBGs, which typically tie performance criteria to service delivery "output" indicators, although "process" indicators are also common (Steffensen, 2010; Shotton & Gankhuyag, 2021).

[87] The new public management paradigm promotes a competitive service delivery environment by offering financing to all providers, both governmental and non-governmental, based on service delivery contracts (Lapuente & Van de Walle, 2020).

[88] The new institutional economics perspective highlights the challenges arising from information asymmetry between citizens – acting as principals and public officials – acting as agents. Citizens often face high transaction costs in holding officials accountable due to limited information. Performance-oriented grants address this by linking financing to service delivery performance, thereby empowering citizens with more information and reducing their transaction costs.

[89] Such as improvements in environmental standards, educational quality, or healthcare delivery.

[90] This shift towards performance results promotes joint ownership and accountability between the public and officials, highlighting the importance of mutual trust and partnership in meeting shared goals.

84. Recent trends have highlighted an increase in the adoption of PBGs. They are often integrated with pre-existing IFTs, whether unconditional or earmarked, and offer clear rewards for improved performance by SNGs in both service provision and governance[91] (Martinez-Vazquez, 2011). Sector-specific PBGs have been used in the health sector in countries like Argentina, Brazil and India. These grants allocate funds to subnational entities and health service providers based on their performance in general processes and specific health service results. Additionally, they have been used to provide ecological transfers in Brazil, France and Portugal, aimed at motivating investments in environmental conservation and to coordinate fiscal policies with ecological sustainability goals (Musgrove, 2011; UNICEF, 2013; Loft et al., 2016; Drost et al., 2017; Wetzel & Viñuela, 2020).

85. The effectiveness of sector-specific PBGs is more straightforward to determine compared to multi-sectoral PBGs, which are often linked with unconditional grants.[92] Evidence mainly indicates that multi-sectoral PBGs lead to better annual performance scores for SNGs, focusing on their compliance with planning and public financial management processes rather than on measurable improvements in spending quality or service delivery outcomes.[93] While it is assumed that improved process compliance will lead to better outcomes, solid proof of this connection is scarce. This underscores the necessity for more in-depth research. Additionally, there is a concern that these grants may disproportionately favour jurisdictions with stronger administrative capacities. So far, the focus of these grants has been more on promoting compliance with financial and administrative standards than on directly enhancing service delivery quality (Shotton & Gankhuyag, 2021).

86. However, the implementation of PBGs faces certain limitations, particularly concerning the availability of granular data at the local or regional level. Accurate and detailed data are crucial for measuring performance effectively, but such data may not always be readily available or reliable, especially in smaller or less developed regions. This scarcity of detailed information can hinder the accurate assessment of program outcomes and the overall effectiveness of the grants. Additionally, these grants often entail a principal-agent issue, as it is usually the SNGs that possess the relevant data for measuring performance. This scenario can lead to potential conflicts of interest, where the SNGs might have incentives to present data in a way that favours their performance, regardless of the actual outcomes.[94]

87. Moreover, such grants can inadvertently result in unequal funding allocations. For instance, during the 13th Central Finance Commission period in India,[95] health sector transfers were based on improvements in local infant mortality rates (IMR), leading to significant disparities in funding across states.[96] This was due to the policy's oversight in recognising the diverse challenges faced by states in

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[91] Therefore, PBGs combine the flexibility of unconditional grants with an unconventional form of conditionality

[92] For example, Argentina's Plan Nacer health grants (Gertler & Giovagnoli, 2014), and Indonesia´s performance-based initiatives (Brinkerhoff & Wetterberg, 2013)

[93] Multi-sectoral PBG schemes typically evaluate SNG performance using criteria related to administrative processes (such as planning and budgeting) or fundamental procedural outputs (like the production of plans and reports). This approach serves as an indirect measure of the effectiveness of public financial management and service delivery. The preference for process-oriented metrics over direct measures of service delivery outcomes stems from the difficulties in accurately and equitably assessing SNGs based on these more intricate results.

[94] This issue underscores the need for robust mechanisms to ensure data integrity and impartiality in performance assessment.

[95] For the years 2010-15. Available from:
https://finance.cg.gov.in/15%20Finance%20Commission/15fc/13thFCReport-Eng.pdf.

[96] With allocations ranging from as much as INR 200 per capita to less than INR 1.

improving IMRs from their initial levels.[97] This example highlights the complexities and potential drawbacks in crafting PBGs.

88. In this context, a challenge to adequately implement PBGs is to establish a connection between performance and service outputs or outcomes. For multi-sectoral PBGs, assessing service delivery comparatively across SNGs is complex due to the diversity of services they offer. Similarly, in specific sectors of PGGs, applying output or outcome indicators is possible but demands considerable preparatory work.[98] Additionally, even when PBGs are linked to output or outcome achievements, it is essential to conduct preliminary baseline studies to ensure rewards are accurately aligned. Nonetheless, factors outside the control of SNGs can influence these outcomes, rendering measures based on compliance more straightforward and justifiable.

89. Additionally, the effectiveness of PBGs hinges on the appropriate sizing of the "top-up" rewards. Inadequate PBG amounts or improperly calibrated distribution can weaken the intended motivational impact. The PBG allocation formula needs to be straightforward and transparent, enabling SNGs to more clearly see the connection between their performance and the rewards received. Ensuring that performance assessments are unbiased and fair is also crucial. Employing external entities, such as private firms or research institutions, to conduct these evaluations can add a layer of impartiality and adhere to budgetary timelines.[99] Furthermore, the long-term success of PBG systems relies on securing political endorsement from central government officials to maintain the integrity of the PBG outcomes and to counteract any discontent from SNGs that either fail to receive PBGs or challenge the fairness of the assessment outcomes. While it is premature to conclusively assess the efficacy of PBGs, they offer a promising avenue for innovation in fiscal policy, warranting further experimentation (Martinez-Vazquez, 2011).

5.3. Synergies between IFTs and regional policy

90. Recent academic discussions have underscored the importance of achieving equilibrium between the efficient delivery of public goods and services and pursuing broader objectives like regional development and adherence to national policies. This requires the crafting of IFTs that not only support local service provision but also contribute to these wider objectives. For example, transfers intended to support lagging regions should be structured to address immediate fiscal shortfalls while also encouraging long-term economic growth and development (Ter-Minassian, 2021).

91. In examining the role of transfers in bridging development gaps across jurisdictions, fiscal equalisation frequently emerges at the forefront due to its role in promoting equity. Sometimes, fiscal equalisation is even conflated with regional development policy, especially in countries where the two are closely linked within the fiscal equalisation framework (Dougherty et al., 2022; OECD, 2023). While fiscal equalisation and regional development funds are both employed to mitigate territorial disparities,[100] fiscal equalisation systems, despite narrowing fiscal gaps, do not always effectively spur regional development or directly influence regional income equality. In contrast, regional development funds specifically target the root causes of a region's challenges, such as income disparities, demographic shifts,

[97] States with initially lower IMRs, which had more difficulty making further improvements, received less funding.

[98] Assessing the quality and volume of services requires extensive on-the-ground research, and comparing outcomes among SNGs is further complicated by their different starting conditions.

[99] Nonetheless, overseeing these external assessors to guarantee high-quality, timely evaluations presents its own set of difficulties.

[100] Regional development is typically supported through direct subsidies, like regional development funds, and indirect means. These indirect methods encompass tax incentives, concessions, credits, special economic zones and tax reliefs.

deindustrialisation, and skill gaps, aiming to level the playing field between different areas and populations. Thus, strategically aligning these two policies offers a more holistic strategy for achieving national goals.

92. Financial transfers are paramount in reallocating resources to the most needy areas, effectively bridging fiscal equalisation and regional development efforts. However, the precise impact of these mechanisms on regional development remains unclear. There is a notable lack of research on how fiscal equalisation system designs influence regional economic growth and on the formulation of regional policies that could enhance the benefits of fiscal equalisation (Padovano, 2007). Yet, there is a growing consensus towards respecting the "one tool for each objective" approach, leaving both policies coordinated but separated (Dougherty & Montes-Nebreda, 2023a).

93. Future research should start by conducting a comprehensive survey of fiscal equalisation mechanisms, fiscal instruments and regional development strategies tailored to the specific context of each country. This survey should detail the characteristics and scope of fiscal equalisation methods, the diversity and scale of fiscal instruments aimed at regional development, and the features of regional development policies intended to reduce regional income disparities. Furthermore, the establishment of a database that includes both quantitative and qualitative indicators of equalisation mechanisms and fiscal tools can enable a systematic approach to quantitatively assess policy synergies and offer recommendations for refining equalisation mechanisms, fiscal instruments, and regional development strategies.

5.4. Frameworks for enhancing welfare through IFT design

94. Scholarly literature frequently revisits the theme of frameworks that assess and improve the welfare impacts of decentralised policies, aiming to integrate incentives that improve equity and efficiency across government levels. This evolving literature, which continues to evolve, has recently concentrated on the dynamics of competition between jurisdictions. Central to these efforts is the concept of Pigouvian taxes, designed to align private actions with their broader societal impacts by taxing activities that produce negative externalities and subsidising those yielding positive societal benefits.[101] This principle aims to ensure that the private cost of an activity mirrors its true cost to society, thus steering behaviour towards socially beneficial outcomes.[102]

95. The application of Pigouvian taxes varies, with each method affecting income distribution in distinct ways. Common strategies include imposing a tax to mitigate negative externalities or to promote positive behaviours, adjusting the perceived cost of activities to encourage more socially desirable outcomes.[103] Nevertheless, challenges like imperfect information and enforcement costs complicate their implementation. Successfully leveraging Pigouvian taxes to achieve their intended effects demands a careful balance between the level of taxation and the resulting change in behaviour, requiring a deep understanding of the economic and social dynamics involved. Thus, the effectiveness of Pigouvian taxes is dependent on accurately evaluating the societal costs and benefits and meticulously crafting the tax mechanism to fulfil the desired social and economic goals (Shah, 2023).

96. Recent discussions in the literature, including work by Agrawal et al. (2023b), introduce a new framework for understanding the welfare effects of decentralised policies, particularly IFTs within competitive jurisdictions.[104] This framework builds on Dahlby's (2008) well-known concept of Marginal Cost

[101] Introduced by economist Arthur Pigou, Pigouvian taxes aim to internalise externalities to correct market failures and guide behaviour towards outcomes that are more beneficial for society.

[102] For instance, imposing a general tax on the population and using the revenue to encourage reduced use of pollutants like gasoline alters consumer behaviour by increasing the perceived cost of the pollutant. This method differs in its impact on consumer welfare compared to a direct tax on the pollutant itself.

[103] The effect on individual welfare can differ, contingent on the tax's specifics and the targeted activity.

[104] Particularly when local policies have spillover effects.

of Public Funds, by using the Marginal Value of Public Funds (MVPF) and the concept of Marginal Corrective Transfer (MCT) to evaluate the dynamics between local and federal government decisions.

97. The MVPF, considered at both local and societal levels, is crucial for assessing the benefits of public spending against the costs associated with raising funds.[105] The MCT aims to reconcile these two levels of MVPF, by adjusting federal transfers to local governments. This adjustment aims to address the welfare shortfalls caused by decentralised decision-making that fails to account for the effects of policies across jurisdictions. By comparing the local MVPF with the societal MVPF, the MCT provides a quantitative and targeted method to ensure that local government actions are in harmony with broader societal welfare goals.[106] This methodology offers a fresh lens through which to view fiscal policy evaluation and design, especially in federal systems, underscoring the importance of acknowledging externalities and the dynamics of decentralised governance. Moreover, the MCT's adaptability to real-world policy scenarios highlights its significance and a growing interest in methodologies that reconcile local actions with societal welfare outcomes.[107]

98. Nonetheless, this framework encounters limitations. For instance, when external effects are exceedingly large, the ideal matching grant rate becomes infinite. This suggests that to adequately address the externalities, centralisation of the concerned public service might be the most effective solution. Moreover, determining optimal grant rates where they are finite requires detailed and accurate estimates of relevant elasticities. Even with access to such data, governments may not always act in a benevolent manner but could be influenced by self-interest or political agendas (Agrawal et al., 2023a).

5.5. Intergovernmental fiscal transfers and innovative budgeting practices

99. As mentioned before, in recent years, OECD countries have not introduced radical innovations in the field of IFTs, primarily due to the political complexities and conflicting interests associated with their reform. In contrast, there have been notable advancements in budgeting practices, ranging from incorporating new perspectives to traditional budgeting approaches and methodologies to expanding the temporal scope of budget planning. Given the close relationship between grants and budgets, innovations in central or general government budgeting practices could influence IFT design. This section will first introduce recent innovative budgeting practices to later provide some examples of how they could contribute to transforming transfer frameworks.

100. The relationship between fiscal transfers and public budgets is deeply intertwined. Indeed, as explained in Section 2 (Figure 4), transfers from central governments can represent up to 90% of revenue for subnational governments in some OECD countries, while it is common for this transfer dependency to reach 50%. This close relationship between grants and budgets suggests that new budgeting practices could impact IFT design, similar to the influence observed with performance-based grants[108] (OECD, 2019).

101. The first budgetary innovation we will introduce is ***Well-being Budgeting***. This emerging technique emphasises the relevance of social spending in public budgets, aligning with the broader

[105] In this context, the framework accentuates the dilemmas posed by fiscal externalities—situations where one jurisdiction's decisions inadvertently affect others, often leading to a divergence between local and societal optimality.

[106] This is particularly pertinent in competitive jurisdictions, where the strategic interactions among neighbouring localities can intensify resource misallocation and welfare losses.

[107] Agrawal et al. (2023) conducted an analysis across six policy areas using data from the United States. Their findings reveal that spending on K-12 education yields the highest Marginal Corrective Transfer (MCT) values, indicating a strong positive impact. Conversely, state-level subsidies and tax credits aimed at attracting firms demonstrate the most negative MCT, suggesting these policies have a less favourable effect.

[108] Performance-based grants were also derived from budgeting innovations (OECD, 2019).

concept of measuring well-being beyond traditional GDP metrics. This means that it is not only relevant to examine how much public spending is devoted to a particular programme but also to assess the impact of public spending on citizens' daily well-being. New Zealand has been a pioneer in this area, incorporating a long-term and foresight-driven component into its entire budgetary process (OECD, 2024). Other OECD countries have also started to incorporate well-being and inequality considerations into their budget elaboration stages, with both *ex-ante* and *ex-post* inequality analyses becoming increasingly common. At the subnational level, the Wales Futures Generation Act of 2015 stands out as an example of a well-being budget oriented to youth, applying "youth-proofing" to all legislation passed by Wales (Future Generations Commissioner for Wales, 2015).

102. Second, ***Green Budgeting*** integrates and evaluates the climate and environmental impact of budgetary and fiscal policies, aligning them with national and international environmental commitments (Blazey & Lelong, 2022). Together with gender budgeting, this approach is the most popular among those listed in this section. By 2022, two-thirds of OECD countries had implemented green budgeting tools in their systems. This approach is also expanding rapidly, as eleven new countries joined this trend in only one year, between 2021 and 2022 (OECD, 2022), reflecting the growing awareness of climate change issues. Although most of the time, green budgeting is adopted at the central level, there are examples of regional governments implementing it (OECD, 2023a).

103. Third, through ***Gender Budgeting*** governments can identify budget measures that support gender equality. This approach can contribute to correcting gender biases in government decision-making processes and to identify ways to make progress towards real gender equality (OECD, 2023b). Similar to green budgeting, it has rapidly spread across OECD countries. By 2022, almost two-thirds of them had adopted some gender budgeting elements, compared to just one-third in 2016 (Gatt Rapa & Nicol, forthcoming).

104. Finally, the last budgeting emerging trend does not relate to its content but to its time framework. ***Multiannual budgeting*** strategies amplify the usual yearly time scope of public budgets by setting a long-term perspective (Moretti et al., 2023). This technique contributes to budgetary stability and financial sustainability as it allows governments to plan and better prepare for future challenges affecting spending demands and as well as revenue capacities, such as ageing or climate change megatrends. When multiannual budgeting strategies adopt very long-term frames, it entails carrying out a foresight exercise. Like the trends discussed in this section, it is primarily the central government that has the appropriate capabilities for implementation. Subnational execution can be challenging, especially since central governments may not always provide advance information on transfers to SNGs. Yet, some subnational examples exist, such as the one of Catalonia (Spain), whose regional administration has become a pioneer in multi-annual budgeting (Baños-Rovira, 2024).

105. But how could these innovations be translated into IFTs? They could represent the first step to incorporate well-being, green, gender and long-term objectives within IFT frameworks in a more explicit way. For instance, by incorporating related variables within transfer allocation formulas, as pioneered by Ecological Fiscal Transfers. There are two main channels through which this outcome could be materialised. On the one hand, new budgeting practices contribute to raising awareness on the mentioned issues among governments, also among SNGs, who have already begun to incorporate them in their own public accounts. As a consequence, opposition among SNGs in response to the central government's proposals to incorporate these perspectives in IFT reforms should be lowered. Addressing potential opposition is of key relevance, in particular in contexts where some jurisdictions could be worse off in terms of funding after a reform. In addition, budgeting practices not only raise awareness among governments, but also among citizens, who could better understand an IFT reform in the suggested sense after years of experience, for instance, with green or gender budgeting, avoiding the radical impact of suddenly observing that the transfers allocated to their local/regional public administration have changed.

106. On the other hand, the normalisation of emerging budgeting practices could pave the way for IFT reforms by providing the necessary data. As discussed for performance-based transfers, incorporating well-being, green or gender variables to transfer allocation formulas is a very data-intensive exercise. Coupled with the need for political and public support, this complexity represents a major challenge (Montes-Nebreda, 2023b). However, previous deployment of new budgeting practices at the subnational level would ensure that data is available.

107. To sum up, connecting key policy objectives such as social well-being, gender equality, or ecological transition with IFT frameworks could contribute to aligning international and national agendas and achieve committed objectives, thanks to subnational reinforced capacities and smarter incentive schemes (Lopez-Laborda et al., 2023). Conditioning funding on results in these spheres could send a stronger signal than budgeting practices alone, marking them as a preliminary step toward a more comprehensive fiscal reform.

6. Conclusion

108. In recent years, the field of IFTs has not experienced the innovations seen in past decades with fiscal federalism and decentralisation reforms. This stagnation could be attributed to the consolidation of programs that were still recently implemented, along with the political challenges of achieving consensus on this matter. Nevertheless, IFTs continue to play a pivotal role in mitigating fiscal disparities among SNGs. Despite possessing some degree of tax autonomy, these SNGs heavily depend on central grants to deliver fundamental services such as education and healthcare.

109. It is widely recognised that IFTs are highly specific to each country's context (Lago et al., 2024b). Although they may be inspired by common definitions and recommendations from the theoretical literature, their actual implementation is deeply influenced by the political culture and institutional traditions of each country. This report reflects the dichotomy between the common theoretical foundations and the unique practices of IFTs, analysing them from practical applications in Section 2 to theoretical discussions in Sections 3 and 4.

110. In practice, recent events like the COVID-19 pandemic have indeed affected the *status quo* of IFTs. However, it is still unclear whether these changes will be permanent or if the circumstances post-pandemic will closely resemble the situation before the pandemic. The data analysis in this paper was facilitated by the development of a new extension of the Fiscal Decentralisation database, which, for the first time in a decade, has been updated with new data on transfers by government function. Theoretically, the report delves into the primary objectives and dilemmas policymakers encounter when designing grant frameworks. It also builds on previous classifications of IFTs and advises on the selection of tools based on the desired incentives for SNGs.

111. Additionally, we identify recent trends in IFTs. While these trends have not yet led to significant overhauls of established IFT systems, mainly due to their limited scope or adoption across the OECD, they may gain prominence in the coming years. This is especially likely as there is growing awareness of the need for fiscal sustainability and economic efficiency, alongside broader concerns for social well-being, inequalities, and the challenges posed by environmental and climate issues.

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