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Federalism and Regional Equity: Building Partnerships or Transfer Dependencies ?

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1. Introduction

Constituent units of a nation state encompassing a large geographic area usually differ considerably in population size, resource base, economic and demographic composition of population and topography. These differences contribute to divergent levels and growth rates of incomes across sub-national units. Most nations, federal and unitary alike undertake policies to reduce regional disparities to ensure political and economic stability for the political union. In unitary countries, national government is relatively unconstrained to pursue policies to induce convergence in regional incomes. In federal countries, on the other hand, constituent units can undertake actions to mitigate the effects of federal policies. As shown in Figure 1, however, the task of reducing regional disparities is a daunting one and there is no assurance of success even in the long run. The figure shows that despite active policies these disparities persist in the long run both in federal and unitary countries alike. In the extreme case of China, Shanghai province has a per capita GDP that is 17 times that of Guizhou province. This paper shows that in fact the very policies adopted to overcome these disparities under some conditions ensure the long run deprivation of the disadvantaged regions.

Globalization introduces further complexities in meeting this challenge. Under globalization, skill mix and knowledge capital rather than the resource base of country determines its international competitiveness. Thus regions with less education and training and with a higher relative concentration of unskilled workers loose at the expense of regions with skilled workers. Thus globalization compounds the problems of regional convergence within nations.

This paper discusses the responses to this challenge in federal systems. In section 2, the paper outlines types of actions that may be helpful to the process. Section 3

discusses the downside risks of certain policies intended to deal with this issue. Finally, policy implications of earlier discussions are drawn.

2. Federalism and regional equity: Partnership for progress by securing an economic union

While most policies for regional convergence remain controversial, an area of emerging consensus is that free mobility of factors, goods and services and technological diffusion are the most important factors for regional convergence. This explains why regional convergence has not worked well in Russia and especially in China. In both these countries state policies have actively discouraged migration and technical diffusion. In federal countries, securing an economic union remains high on policy agenda and it is pursued through a variety of instruments as discussed below:

(i) Preservation of the Internal Common Market

Preservation of an internal common market remains an important area of concern to most nations undertaking decentralization. Sub-national governments in their pursuit of attracting labor and capital may indulge in beggar-thy-neighbor policies and in the process erect barriers to goods and factor mobility. Thus decentralization of government regulatory functions creates a potential for disharmonious economic relations among sub-national units. Accordingly, regulation of economic activity such as trade and investment is generally best left to the federal/central government. It should be noted, however, that central governments themselves may pursue policies detrimental to the internal common market. Therefore, as suggested by Boadway (1992), constitutional guarantees for free domestic flow of goods and services may be the best alternative to assigning regulatory responsibilities solely to the center.

The Constitutions of mature federations typically provide: a free trade clause (as in Australia, Canada and Switzerland); federal regulatory power over interstate commerce (as in Australia, Canada, Germany, USA, and Switzerland) and individual mobility rights (as in most federations). In the USA, two constraints imposed by the Constitution on state powers are (see Rafuse, 1991: 3):

The commerce clause (article I, & 8): “The Congress shall have power.....To regulate commerce with foreign nations, and among the several states, and with the Indian Tribes.”

- - The due process clause (amendment XIV, & 1): “No state shall ... deprive any person of life, liberty, or property, without due process of law.”
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The Indonesian Constitution embodies a free trade and mobility clause. But in a large majority of developing countries, internal common market is impeded both by sub-national government policies supported by the center as well as formal and informal impediments to labor and capital mobility. For example, in India and Pakistan, local governments rely on a tax on inter-municipal trade (octroi tax) as the predominant source of revenues. In China, mobility rights of individuals are severely constrained by the operation of “hukou” system of household registration which is used to determine eligibility for grain rations, employment, housing and health care.

(ii) Tax Harmonization and Coordination

Tax competition among jurisdictions can be beneficial by encouraging cost-effectiveness and fiscal accountability in state governments. It can also by itself lead to a certain amount of tax harmonization. At the same time, decentralized tax policies can cause certain inefficiencies and inequities in a federation as well as lead to excessive administrative costs. Tax harmonization is intended to preserve the best features of tax decentralization while avoiding its disadvantages.

Inefficiencies from decentralized decision-making can occur in a variety of ways. For one, states may implement policies that discriminate in favor of their own residents and businesses relative to those of other states. They may also engage in beggar-thy-neighbor policies intended to attract economic activity from other states. Inefficiency may also occur simply from the fact that distortions will arise from different tax structures chosen independently by state governments with no strategic objective in mind. Inefficiencies also can occur if state tax systems adopt different conventions for dealing with businesses (and residents) that operate in more than one jurisdiction at the same time. This can lead to double taxation of some forms of income and non-taxation of others. State tax systems may also introduce inequities as mobility of persons would encourage them to abandon progressivity. Administration costs are also likely to be excessive in an uncoordinated tax system (see Boadway, Roberts and Shah, 1994). Thus tax harmonization and coordination contribute to efficiency of internal common market, reduce collection and compliance costs and help to achieve national standards of equity.

European Union has placed a strong emphasis on tax coordination issues. Canada has used tax collection agreements, tax abatement and tax base sharing to harmonize the tax system. The German federation emphasizes uniformity of tax bases by assigning the tax legislation to the federal government. In developing countries, due to tax centralization, tax coordination issues are relevant only for larger federations such as India and Brazil. In Brazil, the use of ICMS (origin based) as a tool for attracting capital inflow from other regions has become an area of emerging conflict among states. Despite the fact that the Council of States sought to harmonize ICMS base and rates, there is evidence that some of the tax concessions refused by the Council are practiced by many states anyway. States can also resort to tax base reductions or grant un-indexed payment deferrals (Longo 1994). For example, some northeastern states have offered fifteen years ICMS tax deferral to industry. In an inflationary environment such a measure can serve as an important inducement for attracting capital from elsewhere in the country (Shah, 1991).

(iii) Intergovernmental Fiscal Transfers

Federal-state transfers in a federal system serve important objectives: alleviating structural imbalances, correcting for fiscal inefficiencies and inequities, providing compensation for benefit spill-outs and achieving fiscal harmonization. The most important critical consideration is that the grant design must be consistent with grant objectives.
In industrialized countries, two types of transfers dominate: conditional transfers to achieve national standards and equalization transfers to deal with regional equity. A third

transfer that would be desirable would be for regional stabilization. Such a temporary transfer would be linked to the rate of change (rather than the level) of economic activity. In developing countries, with a handful of exceptions, conditional transfers are of pork-barrel (PB) variety and equalization transfers with an explicit standard of equalization are not practiced. Instead, passing-the-buck (PB) transfers in the form of tax-by-tax sharing and revenue sharing with multiple factors are used. With limited or no tax decentralization, PB type transfers in developing world finance majority of subnational expenditures. In the process, they build transfer dependencies and discourage development of responsive and accountable governance (see Shah, 1997). Ehdaie (1994) provides empirical support for this proposition. He concludes that simultaneous decentralization of the national government's taxing and spending powers, by directly linking the costs and benefits of public provision, tends to reduce the size of the public sector. Expenditure decentralization accompanied by revenue sharing delinks responsibility and accountability and thereby fails to achieve this result.

In general, PB type transfers create incentives for subnational governments to undertake decisions that are contrary to their long run economic interests in the absence of such transfers. Thus they impede natural adjustment responses leading to a vicious cycle of perpetual deprivation for less developed regions (see also Courchene, 1996 and Shah, 1996 for a further discussion).

Industrial country experience shows that successful decentralization cannot be achieved in the absence of a well designed fiscal transfers program. The design of these transfers must be simple, transparent and consistent with their objectives. Properly structured transfers can enhance competition for the supply of public services, accountability of the fiscal system and fiscal coordination just as general revenue sharing has the potential to undermine it. Experiences of Indonesia and Pakistan offer important insights in grant design. For example, Indonesia's education and health grants use simple and objectively quantifiable indicators in allocation of funds and conditions for the continued eligibility of these grants emphasize objective standards as to access to these services. Indonesian grants for public sector wages on the other hand, represents an example of not so thoughtful design as it introduces incentives for higher public employment at subnational levels. Pakistan's matching grant for resource mobilization, similarly rewards relatively richer provinces for additional tax effort. It also calls into question the credibility of federal commitment as the federal government has not been able to meet its commitment arising from this grant program.

The role of fiscal transfers in enhancing competition for the supply of public goods should also not be overlooked. For example, transfers for basic health and primary education could be made available to both public and not-for-profit private sector on equal basis using as criteria, the demographics of the population served, school age population and student enrollments etc. This would promote competition and innovation as both public and private institutions would compete for public funding. Chile permits Catholic schools access to public education financing. The Canadian provinces allow individual residents to choose among public and private schools for the receipt of their property tax dollars. Such an option has introduced strong incentives for public and private schools to improve

their performances and be competitive. Such financing options are especially attractive for providing greater access to public services in rural areas.

Fiscal Equalization

As we noted earlier, regional inequity is an area of concern for decentralized fiscal systems and most such systems attempt to deal with it through the spending powers of the national government or through fraternal programs. Mature federations such as Australia, Canada and Germany have formal equalization programs. This important feature of decentralization has not received adequate attention in the design of institutions in developing countries. Despite serious horizontal fiscal imbalances in a large number of developing countries, explicit equalization programs are untried, although equalization objectives are implicitly attempted in the general revenue sharing mechanisms used in Brazil, Colombia, India, Mexico, Nigeria and Pakistan. These mechanisms typically combine diverse and conflicting objectives into the same formula and fall significantly short on individual objectives. Because these formulas lack explicit equalization standards, they fail to address regional equity objectives satisfactorily.

(iv) Facilitating Local Access to Credit

Local access to credit requires well functioning financial markets and credit worthy local governments. These pre-requisites are easily met in industrial countries. In spite of this, traditions for assisting local governments by higher level governments are well established in these countries. An interest subsidy to state and local borrowing is available in the USA as the interest income of such bonds is exempt from federal taxation. Needless to say, such a subsidy has many distortionary effects: it favors richer jurisdictions and higher income individuals; it discriminates against non-debt sources of finance such as reserves and equity; it favors investments by local governments rather than autonomous bodies and it discourages private sector participation in the form of concessions and BOT alternatives. Various US states assist borrowing by small local governments through the establishment of municipal bond banks (MBBs). MBBs are established as autonomous state agencies that issue tax exempt securities to investors and apply the proceeds to purchase collective bond issue of several local governments. By pooling a number of smaller issues and by using superior credit rating of the state, MBBs reduce the cost of borrowing to smaller communities (see World Bank, 1996 and El Daher, 1996).
In Canada, most provinces assist local governments with the engineering, financial and economic analysis of projects. Local governments in Alberta, British Columbia and Nova Scotia are assisted in their borrowing through provincial finance corporations which use the higher credit ratings of the province to lower costs of funds for local governments. Some provinces, notably Manitoba and Quebec, assist in the preparation and marketing of local debt. Canadian provincial governments on occasion have also provided debt relief to their local governments. Autonomous agencies run on commercial principles to assist local borrowing exist in western Europe and Japan. In Denmark, local governments have collectively established a cooperative municipal bank. In UK the Public Works Loan Board channels central financing to local public works.

An important lesson arising from industrial countries' experience is that municipal finance corporations operate well when they are run on commercial principles and compete for capital and borrowers. In such an environment, such agencies allow pooling of risk, better utilize economies of scale and bring to bear their knowledge of local governments and their financing potentials to provide access to commercial credit on more favorable terms (see McMillan, 1996).

In developing countries, undeveloped markets for long term credit and weak municipal creditworthiness limit municipal access to credit. Nevertheless, the predominant central government policy emphasis is on central controls and consequently less attention has been paid to assistance for borrowing. In a few countries such assistance is available through specialized institutions and central guarantees to jump start municipal access to credit. Ecuador, Indonesia, Jordon, Morocco, Philippines and Tunisia have established municipal development banks/funds/facilities for local borrowing. These institutions are quite fragile, not likely to be sustainable and open to political influences. Interest rate subsidies provided through these institutions impede emerging capital market alternatives. Colombia and the Czech Republic provide a rediscount facility to facilitate local access to commercial credit. Thailand has established a guarantee fund to assist local governments and the private sector in financing of infrastructure investments (see Gouarne, 1996).

In conclusion, the menu of choices available to local governments for financing capital projects are quite limited and available alternatives are not conducive to developing a sustainable institutional environment for such finance. This is because macroeconomic instability and lack of fiscal discipline and appropriate regulatory regimes has impeded the development of financial and capital markets. In addition, revenue capacity at the local level is limited due to tax centralization. A first transitory step to provide limited credit market access to local governments may be to establish municipal finance corporations run on commercial principles and to encourage the development of municipal rating agencies to assist in such borrowing. Tax decentralization is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending.

(iv) Social Risk Management Through Transfer Payments and Social Insurance

Along with the provision of public goods and services, transfer payments to persons and businesses comprise most of government expenditures (especially in industrialized countries). Some of these transfers are for redistributive purposes in the ordinary sense, and some are for industrial policy or regional development purposes. Some are also for redistribution in the social insurance sense, such as unemployment insurance, health insurance and public pensions. Several factors bear on the assignment of responsibility for transfers. In the case of transfers to business, many economists would argue that they should not be used in the first place. But, given that they are, they are likely to be more distortionary if used at the provincial level than at the federal level. This is because the objective of subsidies is typically to increase capital investments by firms, which is mobile across provinces. As for transfers to individuals, since most of them are for redistributive purposes, their assignment revolves around the extent to which the federal level of government assumes primary responsibility for equity. From an economic point

of view, transfers are just negative direct taxes. One can argue that transfers should be controlled by the same level of government that controls direct taxes so that they can be integrated for equity purposes and harmonized across the nation for efficiency purposes.

The case for integration at the central level is enhanced when one recognizes the several types of transfers that may exist to address different dimensions of equity or social insurance. There is an advantage of coordinating unemployment insurance with the income tax system or pensions with payments to the poor. Decentralizing transfers to individuals to the provinces will likely lead to inefficiencies in the internal common market, fiscal inequities and inter-jurisdictional beggar-thy-neighbor policies.

(v) Mitigating Adverse Consequences of Globalization

Globalization of economic activity poses special challenges to fiscal federalism. With globalization, it is increasingly becoming apparent that nation states are too small to tackle large things in life and too large to address small things.

In the emerging borderless world economy, interests of residents as citizens are often at odds with their interests as consumers. In securing their interests as consumers in the world economy, individuals are increasingly seeking localization and regionalization of public decision making to better safeguard their interests. With greater mobility of capital, and loosening of regulatory environment for foreign direct investment, local governments as providers of infrastructure related services would serve as more appropriate channels for attracting such investment than national governments. As borders become more porous, cities are expected to replace countries in transnational economic alliances as people across Europe are already discovering that national governments has diminishing relevance in their lives. They are increasingly more inclined to link their identities and allegiances to cities and regions.

With mobility of capital and other inputs, skills rather than resource endowments will determine international competitiveness. Education and training typically however is sub-national government responsibility. Therefore, there would a need to realign this responsibility by giving the national government a greater role in skills enhancement. The new economic environment will also polarize the distribution of income in favor of skilled workers accentuating income inequalities and regional disparities. Since the national governments may not have the means to deal with this social policy fallout, sub-national governments working in tandem with national governments would have to devise strategies in dealing with the emerging crisis in social policy.

3. Paternalism and Regional Equity: Building Transfer Dependencies?

A paternalistic view of regional equity calls for aggressive central government fiscal and regulatory stance to mitigate regional disparities by discouraging out-migration of factors and protection of local industry against competition from the rest of the country. Examples of such policies include regional tax holidays and credits, regionally differentiated social benefits, protection for regional industries, central financing of

regional expenditures and direct central government expenditures. Please recall that in the partnership approach discussed earlier, the main thrust of policies was on creating an enabling environment for free mobility, competition and technological diffusion. Here in contrast, the emphasis is on creating protective barriers to nourish "infant" regions and to slow down if not to impede the natural adjustment mechanism. The problem is that such a policy environment may create an incentive structure that could undermine long run growth potential of a region. This dysfunctional result is termed as "transfer dependency" (see Courchene. 1995). Transfer dependency does not refer to overwhelming dependence of constituent units on central government handouts of revenues without accountability - although such a situation may be a contributing factor. Instead, transfer dependency refers to a situation where the central government's regional policies create incentives for individuals and sub-national governments to undertake actions that are not consistent with their long run interest in the absence of such policies. It also creates incentives for residents to stay in the region in view of the regionally differentiated income transfer policies. For example, recipient states/provinces can provide public sector wages that are above their productivity levels. They can run persistent trade deficits with other states but such deficits have little impact on wages and prices within the province as these deficits are typically financed by central government's redistributive policies. As a result, these policies impede market adjustment responses and lead to either maintaining or even worsening of existing income and employment disparities. Transfer dependency is said to exist when the following conditions hold:

(a) regional unemployment rates persistently higher than national average; and
(b) wages are higher than that indicated by labor productivity; and in extreme cases
(c) personal incomes higher than the GDP.

Atlantic Canada, North and Northeast Brazil, Balochistan province of Pakistan and Southern Italy suffer to a varying degree by the ill effects of such a transfer dependency. Thus the overwhelming generosity of the regional policies work to the disadvantage of recipient states and undermine their long run growth potential.

If one examines the country experiences with regional convergence, an obvious conclusion that can be drawn that whereas the partnership approach has yielded some degree of success, the paternalistic approach has not worked. In this context, examples from the U.S. experience are quite instructive. For example, Blanchard and Katz (1992) find that states that experience an adverse shock in demand experience out-migration. The partnership approach to regional disparities undertaken in the USA is highlighted by Lester Throw (1981) in reflecting upon the New England case. Throw argues that New England is prosperous today because it went through a painful transition from old dying industries to new growth industries. According to him, if Washington had protected New England's old dying industries, it may still be a depressed and sick state.

4. Concluding Remarks

Dealing with regional inequalities is a daunting task for development economists. There is no consensus as to what works and what does not work. Yet if one adopts a policy of

"doing no harm" when our level of ignorance is so high, then a clear policy lesson from a review of past experiences emerges. A partnership approach that facilitates an economic union through free mobility of factors by ensuring common minimum standards of public services and dismantling barriers to trade, and wider information and technological access offers the best policy alternative in regional integration.

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Annex 1. Evidence on Regional Disparities

China: ratio of per capita GDP – Shanghai vs Guizhou – 17 to 1 (Jian, Sachs and Winer, 1996, NBER paper)
Argentina: Unemployment rates by region: Max 18.5 (Santa fe) , min. 9.7 (Rio Gallegos)
Canada: Unemployment rates (UR) by province: Max 19.4 (NFLD) – Min. 6.6 (Sask)
GDP by province (high/low): 1.79
Australia: GDP by state/territory: (high/low): 1.51
India: GDP pc by state: (high/low): 4.2 Punjab vs Bihar
Spain: GDP pc by region (high /low): 2.1 Balearic Islands vs Extremadura
Russia: Per capita GDP (high/low): 12

Table A1. Within Nation Regional Disparities in Europe

Country	GDP Regional disp. (SD)	UR – Reg,Disp. (SD)
Belgium	26	3.7
Germany	30 (24)	4.4 (2.0)
France	29	2.4
Italy	27	7.5
Netherlands	12	0.8
Austria	29	1.1
Portugal	13	1.8
Finland	20	2.7
Sweden	11	1.7
UK	19	2.3
Western Europe (15)	27	5.9

[1] This note has been prepared for presentation at the Conference on Cooperative Federalism: Globalization and Democracy organized by the Presidency of the Federative Republic of Brazil, in Brasilia, May 9-11, 2000. The views presented here are those of the author alone and should not be attributed to the World Bank. Please send comments by e.mail to: ashah@worldbank.org