SPECIAL SECTION:

Dividing taxes, resources and debt in federations

Rethinking fiscal federalism

Some emerging imperatives for cities and regions facing globalization and the Information Revolution

BY *ANWAR M. SHAH*

Fiscal federalism deals with economic decision-making in federal systems of government in which public sector decisions are taken by various orders of government.

Federal countries differ a great deal in their choices about the character of fiscal federalism, specifically, how the division of fiscal powers is allocated among various tiers and the associated fiscal arrangements.

For example, Brazil, Canada and Switzerland are highly decentralized federations, whereas Australia, Germany, Malaysia and Spain are relatively centralized. Allocation of fiscal powers among members may also be asymmetric. For example, some members may be less equal, and thus enjoy a lower degree of autonomy because of special circumstances, than others. This is the case for Jammu and Kashmir in India and Chechnya in Russia.

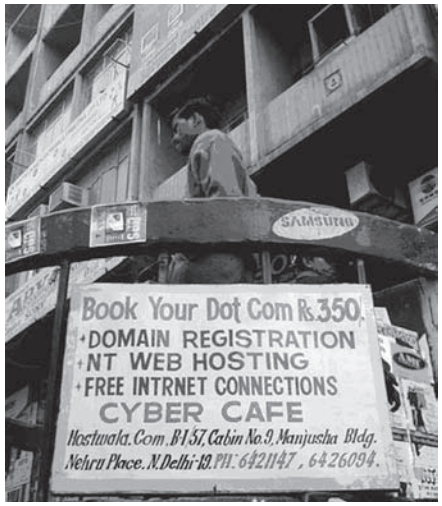

Photo: Sarai: the new media initiative, Delhi

Meeting the Information Revolution in New Delhi. New technology and world markets often go hand-in-hand.

Or some members may be treated more equally than others, for example, Sabah and Sarawak in Malaysia and Quebec in Canada.

Or a federal system can give members the choice to be unequal or more equal, such as opting-in and opting-out options in Canada; Spanish agreements with the breakaway devolving regions; and European Union treaty exceptions for Britain and Denmark.

Fiscal arrangements resulting from these choices are usually subject to periodic review and redefinition to adapt to changing circumstances, both within and beyond national borders. In Canada, such a periodic review (the sunset clause) is mandated by law, whereas in other federal countries changes can occur simply as a result of how various constitutional provisions and laws are interpreted by the courts, as in Australia and the United States, or by various orders of government, as in the majority of federal countries.

In recent years, these choices have come under significant strain from the sweeping changes arising from the Information Revolution and the emergence of a new "borderless" world economy. This article highlights a few key common divergent challenges in federal countries, as well as emerging local responses.

Challenges to constitutional federalism

The Information Revolution and globalization pose special challenges to constitutional assignment within nations. The Information Revolution, by allowing transparency for government operations, empowers citizens to demand greater accountability from their governments. With globalization, it is becoming apparent that, as Daniel Bell wrote, "nation-states are too small to tackle large things in life and too large to address small things."

Globalization and the Information Revolution represent a gradual shift to supra-national regimes and local governance. In adapting to this world, there is growing tension among various orders of governments in federal systems to re-position their roles in order to retain relevance. One continuing source of tension is vertical fiscal gaps, or the mismatch between revenue means and expenditure needs at lower orders of government.

Vertical fiscal gaps and revenue autonomy at sub-national orders of government remain areas of concern in federal countries where the centralization of taxation powers is greater than necessary to meet federal expenditures, inclusive of its spending power. This leads to undue central influence and political control over sub-national policies, and can even undermine bottom-up accountability. This is a concern at the state level in Australia, Germany, India, Mexico, Canada, Malaysia, Nigeria, Russia, Spain and South Africa.

In Nigeria, there is a special concern about the central assignment of resource revenues. In Germany, such

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concerns are prompting a wider review of the assignment problem and a rethinking of the division of powers among the three orders of government: federal, *Länder* and municipal. A consensus has yet to be formed on a new vision of fiscal federalism in Germany.

The two emerging trends in the shifting balance of powers within nations are: (a) a steady erosion in the role of the states/provinces — and (b) an enhanced, but redefined, role for local governments in multi-order governance.

Diminishing relevance of states and provinces

The federal governments of Brazil, Canada, Germany, India, Malaysia, and Russia have carved out larger roles in areas of federal-state shared rule. In Brazil, entitlements and earmarked revenues are the restraints on budgetary flexibility at the state level. In South Africa, the task of social security financing has been taken over by the national government. The federal government in the U.S. is assuming an ever-widening role in policy-making areas of shared jurisdiction, while devolving implementation responsibilities to state and local governments.

This is frequently done through unfunded mandates, or with inadequate financing. In Canada and the U.S., the federal governments are partly financing their debts through reduced fiscal transfers to provinces/states.

Another dimension of emerging federal-state conflict has arisen in countries where the federal government and the states or provinces are both constitutionally recognized orders of government such as in Australia, Canada and the U.S., and where local governments are the handmaidens of state governments. In these countries, federal authorities are attempting to build direct relationships with local governments, and in the process are bypassing state governments.

This is a concern in Brazil, Canada and the U.S., where the economic relevance of state governments to people's lives is decreasing, although their constitutional and political roles remain strong. This is making vertical co-ordination more difficult and is also hampering the state governments' ability to deal with fiscal inequities within their boundaries.

Photo: Cristiano Sant'Anna, Porto Alegre

Counterpoint to globalization: the World Social Forum was set up to balance the World Economic Forum of Davos, Switzerland. The WSF met in Porto Alegre, Brazil, in 2003 and 2005.

In India, the federal government retains a strong role in state affairs through the appointment of federal officials to key state executive decision-making positions. Overall, the role of the intermediate order of government in federal systems is on the wane, with the exception of Switzerland, where the cantons have a stronger constitutional role as well as stronger support from local residents. However, cantons in Switzerland are similar to local governments in large federations such as Canada, the U.S. and India.

Resistance to a new vision of local governance

Globalization and the Information Revolution, on the other hand, are strengthening localization and broadening the role of local governments in network governance. This requires local governments to operate as purchasers of local services and facilitators of government networks, beyond government providers, gatekeepers and overseers of state and national governments in areas of shared rule.

Nevertheless, local governments are facing some resistance from their state governments in social policy areas. In Brazil, India and Nigeria, local governments have constitutional status, and thus, a greater ability to defend their roles. In Switzerland, direct democracy provisions assure a strong role for local governments and in both Brazil and Switzerland, local governments play an expansive and autonomous role in their jurisdiction.

In most other federal countries, local governments are wards of the state with little autonomy. The ability of local governments to fend for themselves depends upon the citizen empowerment engendered by the Information Revolution, that is, citizens' awareness of their rights and responsibilities to hold governments to account in view of the transparency and sunshine on government operations brought about by the Information Revolution.

Russia stands out as an example where such a defence could not be mounted. In Canada, some of the provinces have centralized school finances. In South Africa, primary health care has been reallocated to the provincial order of government. In most countries, local governments lack fiscal autonomy and have limited or no access to dynamic, productive tax bases, whereas demand for their services is growing fast. In the U.S. and Canada, existing local tax bases, especially those linked to property, are overtaxed with no room to grow. In the U.S., this problem is compounded by limits on raising local revenues and unfunded mandates in environmental and social spending.

Bridging the fiscal divide within nations

The fiscal divide within nations represents an important element of the economic divide they experience. This is because reasonably comparable levels of public services at reasonably comparable levels of taxation foster mobility of the factors of production (land, labour and capital) and mobility of goods, as well as help foster a common economic union.

Most mature federations, with the important exception of the U.S., attempt to address regional fiscal disparities through a program of fiscal equalization. In the U.S., there is no federal program, but state education financing uses equalization principles. In Canada, such a program is enshrined in the Canadian Constitution and has even been described as "the glue that holds the federation together."

Most equalization programs are federally financed with the exception of those in Germany and Switzerland. In Germany, wealthy states make progressive contributions to the equalization pool and the poor states receive funds from this pool. In Switzerland, a new equalization program, starting in 2008, will operate with a mixed pool of contributions from the federal government and wealthier cantons.

There is a great diversity in the institutional arrangements that design, develop and administer such programs in federal countries. Brazil, India, Nigeria, Spain and South Africa take into account a multitude of fiscal capacity and need factors in determining equitable state shares in their revenue-sharing programs. Malaysia uses capitation grants, in which funds are paid on a per-person basis. Russia uses a hybrid fiscal capacity equalization program.

Fiscal equalization programs in Canada and Germany adjust fiscal capacity to a specified standard. The Australian program is more comprehensive and equalizes the fiscal capacity and fiscal needs of Australian states, constrained by a total pool of revenues from the goods and services tax.

The equity and efficiency implications of existing equalization programs are a source of continuing debate in most federal countries. In Australia, there is discontent with the existing formula and the resulting complexity introduced by expenditure needs compensation.

In Canada, provincial ownership of natural resources is a major source of provincial fiscal disparities, and the treatment of natural resource revenue in the equalization program remains contentious.

In Germany and Spain, the application of overly progressive equalization formulas results in a reversal of fortunes for some rich jurisdictions. Some wealthy *Länder* in Germany have in the past taken this matter to the country's Constitutional Court to limit their contributions to the equalization pool. In Brazil, India, Malaysia, Nigeria, Russia and South Africa, much controversy and debate is generated by the equity and efficiency impacts of existing programs.

"Fend-for-yourself" federalism

A lack of fiscal discipline at sub-national levels is a matter of concern in federal countries because there is significant sub-national autonomy combined with an opportunity for a federal bailout. In mature federations, fiscal policy co-ordination to sustain fiscal discipline is exercised both through executive and legislative federalism, and through formal and informal fiscal rules.

In recent years, legislated fiscal rules have come to command greater attention. These rules take the form of budgetary balance controls, debt restrictions, tax or expenditure controls, and referenda for new taxation and spending initiatives. Most mature federations do not permit "bailout" of any order of their governments by the central bank or by another order government. In the presence of an explicit or even implicit bailout guarantee and preferential loans from the banking sector, printing of money by sub-national governments is possible, thereby fuelling inflation.

Photo: Des Pink, Halifax

The last fish: equalization payments from the Canadian federal government helped the province of Newfoundland after the collapse of the cod fishery in the early 1990s.

Recent experiences with fiscal adjustment programs suggest that, while legislated fiscal rules are neither necessary nor sufficient for successful fiscal adjustment, they can be helpful for forging sustained political commitment to achieve better fiscal outcomes, especially in countries with divisive political institutions or coalition regimes. For example, such rules can be helpful in sustaining political commitment to reform in countries with proportional representation (Brazil) or multi-party coalition governments (India) or in countries with a separation of legislative and executive functions (the U.S. and Brazil).

Fiscal rules in such countries can help restrain pork-barrel politics and thereby improve fiscal discipline as has been demonstrated by the experiences in Brazil, India, Russia, and South Africa. Australia and Canada achieved the same results without having any legislated fiscal rules, in view of the commitment to fiscal discipline shown by the governments with parliamentary majorities. However, fiscal discipline continues to be a problem in Germany, even though that country has legislated fiscal rules.

The Swiss experience is most instructive as the country has sustained fiscal discipline. Two important instruments in Switzerland create incentives for cantons to maintain such discipline. First, fiscal referenda allow citizens the opportunity to veto any government program. Second, the legal provision enacted in some cantons to set aside a fraction of any fiscal surplus in good times works as a "debt brake" to prepare for rainy days.

Fragmentation of internal common markets

While preservation of an internal common market is the primary goal of all federal systems and also a critical determinant of their economic performance, removing impediments to such an economic union remains an unmet challenge in federal countries in the developing

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orders of government tax the same base, and this vertical fiscal externality offsets the tax reduction by some cantonal governments. The picture is completed by evidence of strategic tax setting by cantons and local jurisdictions. They, indeed, set their tax rates to attract desirable taxpayers, although other factors also affect their choices. Thus, the bottom line is that tax competition exists in Switzerland, but it is not as fierce as the tax rate differentials suggest.

Where does tax competition lead?

Given that tax competition exists in Switzerland, does it have the effects that most proponents of tax harmonization fear? Empirical studies of the efficiency of tax competition in Switzerland largely indicate that tax competition enhances efficiency rather than reducing it. First, regional spillovers are less important than is often thought, or they balance each other out. In addition, the horizontal components of fiscal equalization internalize regional spillovers – that is, negative effects of one canton's policies on a neighbouring canton. Second, tax competition leads to lower spending and revenue in the cantons because there is lower tax revenue. Third, tax competition likewise shifts the revenue structure toward a greater use of fees and user charges. (However, larger user fees contribute to an increased inequality of after-tax income.) Fourth, it leads to higher overall labour productivity in the cantons, indicating higher efficiency as the cantons are forced to use their scarce resources at the lowest cost and according to citizens' preferences. However, tax competition also restricts the ability of cantons to redistribute income through broad-based tax-transfer programs, although cantons and local jurisdictions do conduct income redistribution nevertheless. Thus the federal level, with its system of social security and the highly progressive federal income tax, is more important for income redistribution.

A balanced approach

Tax competition between the Swiss cantons and local jurisdictions is thus a very important phenomenon. Given the empirical evidence, however, there are not strong grounds to justify a major tax harmonization at the moment. The Swiss fiscal constitution appears to be well-adapted to the advantages and disadvantages of its competitive federalism. In particular, the federal income tax system plays an important role as regulator of cantonal tax competition and is, thus, able to serve demands for individual equality. The new fiscal equalization system is supposed to lead to a fairer regional distribution of income. Further measures restricting cantonal fiscal competition will only increase inefficiency in the public sector.

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Moscow and regions share Russia's oil and gas revenues

quality and availability of public health and educational services, increasing housing for the population, improving the transportation infrastructure, the reconstruction and construction of projects in the communal infrastructure (gas- and water-supply systems, heating systems, etc.) and improving the environment. Thus, the resources of the Stabilization Fund, endowed by the taxes from oil and gas extraction, will ultimately be directed to decreasing regional disparities in living standards.

In conclusion, it is interesting to note that, despite the almost complete centralization of revenue from taxes on mining operations in the federal budget, high prices for oil and gas still allow oil- and gas-producing regions to raise significantly greater per-capita budgetary revenues than in other regions. This is achieved through the tax on the large profits of the oil- and gas-producing companies, and income taxes collected from the high wages of workers involved in oil and gas production. All income taxes paid by workers of these companies within a given region flow into the budget of that region, as does a portion of the taxes on profits of these companies, at a rate ranging from 13.5 per cent to 17.5 per cent. As a result, the Autonomous Areas of Nenetskiy, Yamalo-Nenetskiy and Khanty-Mansiyskiy rank first, second and third among Russian regions in terms of revenue per-capita.

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world. "Beggar-thy-neighbour" or "race-to-the-bottom" fiscal policies and barriers to the mobility of goods and factors of production have the potential to undermine gains from decentralized decision-making, as recent experiences in Brazil, India, Mexico and Spain indicate. The Canadian and U.S. federal systems have, on the other hand, successfully met this challenge by securing a common economic union.

Incentives for responsive governance

In most federal countries, especially in the developing world, intergovernmental transfers are focused on dividing the pie without regard to creating incentives for responsive and accountable service delivery. Revenue-sharing arrangements often discourage local taxation efforts and introduce perverse fiscal incentives through gap-filling approaches. Conditional transfers in most federal countries are focused on input controls and micromanagement, thereby undermining local autonomy. In a few countries such as the United States, they serve as a tool for pork-barrel politics. The practice of output-based transfers with conditions on standards and access to public services but having flexible choices in designing programs and in spending allocations to create incentives for results-based accountability is virtually non-existent. A notable exception is the Canadian Health Transfers (CHT) program by the federal government. The principal conditions of the CHT program are on the universality of access to health care and portability of health insurance across provinces.

The ability to adapt

Federal countries have shown a remarkable ability to adapt and to meet emerging challenges in fiscal federalism. While the challenges they face might be very similar, the solutions they discover and adopt are always unique and local. This represents a remarkable attestation to the triumph of the spirit of federalism in its never-ending quest for balance and excellence in responsive, responsible and accountable governance. The long march to attain new heights in inclusive governance continues.