

**Conference on  
Fiscal Equalization and Economic Development Policy within Federations**

Charlottetown, Prince Edward Island

By David Parks

The "Fiscal Equalization and Economic Development Policy within Federations" conference, organized by the Forum of Federations in partnership with the Prince Edward Island Provincial Treasury, was held in Charlottetown, Prince Edward Island, October 28 - 29, 2002.

The Forum of Federations recruited practitioners and experts from six countries: Argentina, Australia, Canada, Germany, Spain, and the United States. Paul Bernd Spahn of Germany also delivered a presentation on the European Union while Ron Neuman of the Manitoba Department of Finance spoke on fiscal relations in South Africa. The conference was opened by Ms. Patricia Mella, Provincial Treasurer of Prince Edward Island, while Dr. Ronald Watts delivered a dinner address comparing national equalization experiences.

The first session was opened by Paul Bernd Spahn, who spoke on the federal aspects of the European Union. After observing that the European Union possesses many federal characteristics, Mr. Spahn noted that the EU can't be considered truly federal as competencies have been only partially transferred; institutional integration is limited and has focused mainly on the economic sphere, leaving defense and foreign policy at the national level.

The EU structural funds do have an equalizing nature, particularly for member states such as Greece, Portugal and Spain. The EU is not focusing on redistribution and instead prefers strategic investment and co-financing of projects. The cohesion fund is admittedly small and has very little redistributive effect. Politically there is no indication that expansion is related to explicit regional equalization. Some countries are more supportive of equalization than others, depending on the sector. The most likely scenario is targeted development funds for the new member states rather than a formal equalization scheme.

William Fox, Professor of Economics at the University of Tennessee, delivered a presentation on the economic structure of the United States. Although the lower income states are found mainly in the south of the country, high and low income states can be found all over the nation. As there is no formal federal revenue sharing/equalization structure, a low-income state's increased fiscal capacity vis-à-vis its wealthy neighbour is often not the result of federal planning, but rather private sector activity or political lobbying for federal investment. On the spending side there are equalization components to the Medicaid program, as federal matching funds are inversely related to the per capita income of the State. As well - depending on the state - there may be equalizing factors in the revenue sharing arrangements between state and local governments.

Mario Albert, Assistant Deputy Minister of the Finance Department of the Government of Quebec, was the discussant for the first session and provided commentary on the presentations of Mr. Spahn and Mr. Fox. Mr. Albert noted that - with respect to the United States - decentralization is not occurring if the share of provincial/state/local spending is increasing while the federal governments is limiting these entities' ability to raise revenues. In order for equalization to be effective, there has to be respect for decentralized decision making. Equalization should be unconditional, not ear-marked, as tied funding essentially renders the constituent unit as an administrator of a program.

During the luncheon, Ron Neuman of the Manitoba Department of Finance spoke on fiscal relations in South Africa. Mr. Neuman outlined the intergovernmental fiscal relations and institutions that have been developed to address vertical and horizontal fiscal imbalances. The Financial and Fiscal Commission (FFC), appointed by the President, has the power to review and make recommendations to Parliament, the provincial legislatures and local governments. An interesting feature of the FFC is that, although Parliament is not required to follow its recommendations, it must address the FFC recommendations in the annual Division of Revenue Bill explaining why they have chosen not to respond to a particular proposal. As a result, the FFC has considerable influence, although its recommendations are not binding on government.

In the afternoon session, Malcolm Nicholas of the Commonwealth Grants Commission of Australia delivered a presentation on the fiscal arrangements between the federal and state governments in his country. The Commonwealth Grants Commission is an apolitical and appointed independent body that makes recommendations on how to increase the fiscal capacity of the states. Approximately 50% of equalization assistance is untied, and based on both revenue and expenditure assessments. Although the Commission makes the recommendations on how the state shares of untied assistance should be distributed, the Federal Treasury - in consultation with the State Treasury Departments - makes the final decisions. The states do not contribute directly to the equalization fund, and there is a strong public consensus that national standards for public services are desirable, and that a minimum level of services and opportunity should be available throughout the Commonwealth. Despite this general sentiment, equalization has come under attack from some wealthier state governments that consider the redistribution to be too extreme.

The presentation on Australia was followed by a presentation on the Spanish model, delivered by Teresa Garcia-Mila, an economist at the Universitat Pompeu Fabra, Barcelona Spain. Garcia-Mila observed that the structure of the federal model is asymmetrical and this has large implications for equalization arrangements. The asymmetry occurs between the two communities participating in the Foral scheme (Basque Country and Navarra) and the other 16 communities who participate in what is known as a Common scheme. The former have the authority to raise taxes locally while the latter have limited authority in this area.

Under the Foral scheme, taxes are paid to the regional governments and are not remitted to the central government. Instead, the regions compensate the central governments for services provided to the region. The 15 autonomous regions under the Common regime

receive transfers from the central government, transfers that comprise their main source of revenue and indicate a high level of vertical imbalance. The grants are both conditional (by sector) and unconditional (general purpose) and the redistribution is based on both fiscal capacity (linked to population and level of development).

Miguel Asensio, Provincial Finance Minister of the Province of Santa Fé, Argentina, who spoke on fiscal arrangements in Argentina, made the final presentation of the first day. Argentina is one of the most decentralized countries in Latin America with approx 50 % of total spending happening at constituent unit level. Historically, the vertical fiscal imbalance is high. In the mid 1990s, almost 65 % of provincial expenditures were financed through federal transfers. Transfers take three forms: automatic, untied from revenue-sharing; automatic, tied to specific purposes; and discretionary transfers which must be negotiated. All three transfers are intimately related to redistributive efforts on the part of the federal government, and need, population and productive and fiscal capacity determine shares of -or entitlement to - tax revenues. Mr. Asensio noted that constitutional changes in the last decade have had considerable impact of fiscal relations in Argentina. In addition to establishing concurrence of the federal government in indirect taxation, the constitution now requires that all provincial governments agree to changes in the equalization structure. As these negotiations can be cumbersome, poorer provinces have fallen deeper into debt as borrowing has proved easier than renegotiating equalization arrangements.

Following the Mr. Asensio's presentation, discussant Sean Keenan of Finance Canada drew correlations between the equalization structure in Canada and the regions/countries covered during the session noting that Canada could be seen to "overequalize" in comparison with the other three countries. As well, the differences between Australia, Argentina and Spain demonstrate the relevance of historical context in determining fiscal relations between and among national and sub-national governments.

Later in the evening, the Province of Prince Edward Island sponsored a dinner for participants at which Dr Ron Watts delivered an informal address that provided a comprehensive overview of equalization arrangements in federal countries. Dr. Watts noted - among other things - that equalization in any federal system is both a political and economic choice that in many cases is essential for the survival and prosperity of the federation.

The first session of the second day began with a presentation on Germany by Paul Berndt Spahn. Vertical balance is maintained through the sharing of the Value Added Tax (VAT). The VAT is collected nationally and the federal government keeps 50.5% with the remainder going to the states. Mr. Spahn noted that horizontal imbalance in Germany is corrected mainly through the redistribution of the Value Added Tax by population. As well, there are asymmetrical gap-filling federal grants that are targeted to raise the fiscal ability of all states to 99.5% of the national average. Additional federal monies are directed to some units to alleviate the costs of political management and special burdens.

Following the presentation on Germany, Steve Perritaz delivered a presentation on fiscal arrangements in Switzerland. In Switzerland, equalization components are evident in three major policies, two of which flow from the Confederation to the Cantons and one of which goes the other way. The first two are a) conditional transfers or grants and b) revenue sharing through tax credit distribution. The latter sees the cantons contributing, based on ability and population, to the national social security program. All three are based on canton's fiscal capacity and are based on federal law designed to ensure minimum standards of essential public services without creating an unequal distribution of tax burdens among cantons. There are significant revenue sharing arrangements including the Federal direct tax and fuel tax. Over the last half century, practice has shifted from direct transfers to increasing revenue-raising capacities, the latter seen as less political and hierarchical. The pragmatic objective of equalization is to render cantonal disparities politically acceptable so that remaining differences do not endanger the cohesion of the Confederation.

Francois Vaillancourt of the Université de Montréal made the last country presentation of the day. Mr. Vaillancourt noted that it is important to distinguish between explicit and implicit equalization mechanisms. The former is determined by a formula that is designed to assist the poorer provinces to reach the fiscal capacity of five representative provinces. Although the formula is reviewed and amended periodically, it is a consistent mechanism through which the equalization transfers are developed. Implicit equalization, as described by Mr. Vaillancourt, encompasses the federal spending outside of explicit equalization program, spending that occurs through federal employment, unemployment insurance and health and welfare spending with weak conditionality. Mr. Vaillancourt attributed the disproportionate implicit equalization in the Atlantic Provinces to this region's political strength and questioned whether or not this advantage will be sustainable as Canada experiences continental economic integration.

Paul Hobson of Acadia University discussed the three papers, noting that the differences between the German, Swiss and Canadian models might be attributed to both historical and geographical factors. Mr. Hobson noted that within Canada there is no independent body tasked to examine and address fiscal inequalities and imbalances; it is primarily resolved through intergovernmental negotiations and House and Senate Committees. By contrast, these matters are decided by consensus in Switzerland while bilateral arrangements are often used to address specific fiscal imbalances in Germany, particularly in the Eastern Länder.

The final session of the day was a panel discussion of all speakers chaired by Annette Ryan of the Privy Council Office. Ms. Ryan posed a series of questions to the speakers and a stimulating discussion ensued. International and Canadian participants exchanged ideas on the role of equalization, the various ways to resolve and/or avoid disputes in this area, the political dimensions of regional economic development, and the influence of the global economy on domestic economic development strategies.

Approximately 30 Canadian participants attended the sessions, with representatives from all the provinces and territories as well as federal representatives from the Privy Council

Office and Finance Canada. Our partners at the PEI Provincial Treasury have made it clear on a number of occasions that they are pleased with the organization and implementation of the conference. They have also expressed great interest in working with the Forum of Federations on future events, including the upcoming workshop on "Fiscal Federalism in Canada and Argentina" that will take place in Buenos Aires on November 18 2002. At this event, the PEI Provincial Treasurer, Patricia Mella, will appear on a panel with Wayne Clifford, Alberta Intergovernmental and International Affairs, and Frank Des Rosiers from the Privy Council Office, Government of Canada.