

**Forum of Federations**

700-325 Dalhousie Street  
Ottawa, Ontario K1N 7G2 Canada  
Tel.: (613) 244-3360 Fax: (613) 244-3372  
Email: forum@forumfed.org

**Forum des fédérations**

700-325, rue Dalhousie  
Ottawa (Ontario) K1N 7G2 Canada  
Tél.: (613) 244-3360 Téléc.: (613) 244-3372  
Courrier électronique : forum@forumfed.org

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

Charlottetown, Prince Edward Island  
October 28-29, 2002

---

**COMPARING EQUALIZATION IN FEDERATIONS**  
(as delivered 28 October 2002)

By R.L. Watts

---

**1. THE LIMITATIONS AND VALUE OF COMPARATIVE ANALYSIS**

As a strong believer in the value of comparative analyses of financial relations within federations. I want to begin by briefly pointing to the limitations and value of comparative analyses.

The discussion at this conference has already made it clear that there is no single model of federalism or of federal financial relations that is universally applicable everywhere. The basic notion of federalism, involving the combination within a single political system of shared rule for some purposes, and constituent unit self-rule for other purposes so that neither order of government is constitutionally subordinate to the other, has been applied extensively. Indeed, there are today in the world 24 federations in the

world encompassing 40% of the world's population - but in many different forms to fit varied circumstances.

On issues like equalization these federations have been dealing with similar issues but in different ways to fit their particular circumstances. One cannot, therefore, just pick institutional models off a shelf. Equalization arrangements have had to be adapted to meet the specific context within which they are being applied.

As long as the cautions about the transferability of institutions are kept firmly in mind, there is a genuine value in comparative analyses, such as those at this conference. Many of the basic problems of federal financial arrangements are common not only to virtually all federations but also to most systems of multi-level governance, including such decentralized multi-level unions as the United Kingdom, Italy or Japan, and to confederal-federal hybrids such as the European Union. Examples are the need to correct vertical financial imbalances between expenditure responsibilities and financial resources, pressures for financial equalization to correct horizontal imbalances among the constituent units, the need for coordination of distributed taxing powers, the need for regular or periodic adjustment of financial arrangements, the need to foster rather than hinder economic development, and the important relation of these to the political context, institutions and processes. Comparative studies help to identify options that might otherwise be overlooked, and to identify consequences of different alternatives that might otherwise not be foreseen. Furthermore, comparisons may provide not only positive, but negative lessons, enabling us to learn both from the successes and the difficulties of arrangements and processes in other countries.

## 2. THE IMPORTANCE OF THE POLITICAL CONTEXT

In the study of federal and intergovernmental financial relations there is an important body of literature, largely written by economists, which covers much useful ground in the comparison of intergovernmental financial arrangements in analytical and normative terms. I think particularly of such authors as Musgrave, Oates, McLure, Buchanan, Bird, Boadway and many others who have written about allocation of taxing powers and expenditures, correcting imbalances, equalization to correct disparities among constituent units, and the use of conditional and unconditional transfers, using the concepts of economic efficiency and equality.

Useful as they are, one of the *major* points I want to emphasize tonight, is that it is even more important to consider the broader social and political context within which these financial arrangements operate. I think this has already been borne out in the presentations at this conference. In virtually all federal and intergovernmental systems, the financial arrangements have invariably constituted an important, indeed crucial, aspect of their *political* operation. Their political importance derives from the fact that the scope and character of their financial resources play a large part in determining the relative political and economic roles and influence of the different governments within the polity, are a major means for facilitating flexibility and adjustment to meet changing policy needs, and shape the public attitudes about the costs and benefits of the activities of different governments. Indeed, this political significance places financial arrangements between federal and constituent unit governments at the heart of the processes of intergovernmental relations. Intergovernmental financial arrangements are, therefore, not simply technical issues, but inevitably controversial *political* issues. Hence, my emphasis that understanding intergovernmental financial relations cannot be

achieved purely analytically and technically in isolation from the broader political context, and from the social fragmentation and diversity and the political institutions with which they interact.

The particular dynamics and specific intergovernmental financial arrangements will be affected by the degree and kinds of homogeneity or social diversity, for instance: what is the significance of differences in language, religion, ethnic origin, and historical development? It will also be influenced by such factors: How many provinces or states or there? What are their relative sizes in terms of population and economic activity? How different are they in terms of per capita income or natural resource wealth? What is its political geography: compact or dispersed?

Different political and constitutional arrangements also affect intergovernmental financial relations. This is illustrated by the impact in Canada of the parliamentary form of our federal institutions and by the distinctive character of our constitutional distribution of powers.

Other parliamentary federations such as Australia, Germany and India, by contrast with the United States and Switzerland which incorporate the separation of executive and legislative powers within their institutions, have shared with Canada a tendency for executive predominance at both levels. This has led “executive federalism” as the predominant arena for intergovernmental relations, including those concerning financial arrangements.

In the constitutional distribution of powers, most federations have emphasized interdependence and have incorporated in their constitutions large areas of concurrent jurisdiction. The Canadian Constitution, however, has been distinctive in formally

emphasizing the exclusive jurisdiction of each order of government. It is true that, in practice, overlaps have proved unavoidable, but the formal constitutional emphasis upon exclusive areas of jurisdiction has affected media interpretations and public attitudes about intergovernmental relations. In Canada these have particularly emphasized the competitive and zero-sum character of these relations.

I found particularly interesting the discussion this morning about the cases of the European Union and the United States and why neither has a strong program of financial equalization. In both cases this is clearly a reflection of their political context. The confederal aspects of the European Union hybrid political structure helps to explain why the redistribution function is politically more difficult where the legislative base relies on intergovernmental agreement rather than upon a federal government with its own direct electoral base. And in the United States, the separation of legislative and executive powers within both levels of government has led to a particularly strong emphasis on the principle of financial responsibility, i.e. the principle that the government that has the nasty job of levying the taxes should ensure accountability by imposing the conditions under which the more pleasant task of spending the proceeds is undertaken, particularly in a system where the executive in another level of government is not directly accountable to its own legislature.

The federal financial system in any federation, then, must be assessed within its political framework. From this I draw an important lesson. In the end what is more important than the precise nature of the technical solutions are the processes and procedures through which they have reached these solutions. As Richard Bird has pointed out (see Banting et al, *The Future of Fiscal Federalism* (Kingston, 1994, p. 304)

particularly important is who determines the rules of the game, how are the rules changed, what is the role and representation of the constituent units in the process, and what is the institutional framework for assessing and developing the framework of financial relations.

3.        EQUALIZATION A COMMON ELEMENT OF MOST  
INTERGOVERNMENTAL FINANCIAL ARRANGEMENTS

This conference is focusing particularly upon equalization and upon its relationship to economic development. Given the corrosive effect upon political cohesion of disparities among regions in revenue capacities and needs, some form of equalization transfers to correct horizontal imbalances has been typical of the financial arrangements in nearly all federations, although the actual extent and form of these transfers has varied enormously. Furthermore, since the values of revenue resources and expenditure responsibilities inevitably change over time, most federations have also had to develop processes and institutions for the periodic adjustment of the financial arrangements in a way that is not dependent solely upon the unilateral decisions of the central government, a situation that would undermine a truly federal relationship.

4.        INTERRELATION OF EQUALIZATION AND ECONOMIC DEVELOPMENT

A fundamental issue underlying the title of this conference is the relationship between financial equalization and economic development, and this issue has already been touched upon at this conference. At the recent International Conference on Federalism held in August in St. Gallen, Switzerland, one of the major topics for discussion was equalization arrangements. The debate there tended to become polarized

between two different points of view. One was that in the context of increasing globalization financial resources should not be redistributed away from those regions and locations which are most competitive internationally, and that equalization transfers simply establish a system whereby provincial inefficiency is rewarded and international competitiveness is hindered. The criticism of the disincentive effects of equalization is increasingly heard these days in the economically stronger constituent units in many federations, including Germany, Switzerland and Canada.

The counter-argument was also expressed strongly at the St.Gallen international conference, not the least by President Villiger of Switzerland and Stéphane Dion of Canada, both of whom participated in the discussions. They argued not only for the importance of equity among citizens in different cantons or provinces as important for federal cohesion, itself an important prerequisite for effective economic development, but also that equalization promotes *economic efficiency* by reducing internal migration that is motivated solely by fiscal differences and not by economic fundamentals. Moreover, to those who argue that the decline of equalization payments in the wake of increased economic development serves as a disincentive, they both emphasized that the fact that equalization declines when a constituent unit's fiscal capacity increases, does not prevent that unit from taking action to develop its natural resources or promote any other form of economic development.

No doubt, this debate will continue, but what is important is that in any design of an equalization scheme within a federation, the scheme should be seen as creating a level playing field for all regions, no more but no less.

## 5. EQUALIZATION TRANSFERS

Systems of “equalization” transfers to correct horizontal imbalances arise from the view, commonly held in federations, that all citizens wherever they live should be entitled to comparable services without having to be subjected to excessively different tax rates. Further, equalization transfers have usually been regarded as particularly important because disparities among regions within a territorially diverse society have almost invariably had a corrosive effect upon political cohesion within a federation. Indeed, for this reason, in most Europeans, equalization transfers have been labelled “solidarity” transfers.

Most federations have had a formal systematic scheme of equalization transfers. The United States, as Bill Fox has pointed out, is a notable exception. There, what efforts at equalization have occurred have been dispersed over a variety of programs, often cancelling each other out in their cumulative equalizing effect. But while most other federations have had some formal system of equalization grants, their extent and form, as we have already seen at this conference, has varied enormously. *First*, the scope of such transfers has historically been greater in countries such as Germany and Australia than in others such as Canada and Switzerland. *Second*, while in Germany, a large component of the equalization transfers takes the form of interstate transfers, equalization elsewhere has been achieved wholly by differential *federal* transfers to compensate the poorer units. *Third*, in most cases, as in Canada, the effort to correct horizontal imbalances has focused primarily on adjusting for the differential revenue capacities of the regional units, but in some federations, most notably Australia, there has been an effort to account as well for differential expenditure needs. *Fourth*, the basis of determination of equalization

transfers to regional units of government has varied. There are those that are based on intergovernmentally agreed or even constitutionally stipulated formulae as in Switzerland, Canada, Germany, Austria, Malaysia, Belgium and Spain, although in some of these cases the process of agreement on a formula has been dominated by the federal government. In others, such as Australia, India and South Africa, the allocations have been largely based on the recommendations to the federal government of standing or periodic independent commissions which may themselves use a variety of formulae to arrive at their recommendations.

In efforts at revenue equalization *four* issues have had to be addressed, as Bernard Dafflon and François Vaillancourt noted in their background paper on Equalization prepared for the St. Gallen International Conference on Federalism (see B. Dafflon and F. Vaillancourt, “Problems of Equalization in Federal Systems” in International Conference on Federalism, St. Gallen, 2002, *Federalism in a Changing World – Learning from Each Other: Conference Reader*, p. 479-505). The *first* concerns the source and importance of the tax revenues that are to be shared and redistributed. The *second* is the ranking of various regional units according to some indicator of entitlement to equalization. The *third* is the design of the formula for allocating equalization transfers. The *fourth* is to determine whether the redistribution formula should aim at complete equalization or simply at a significant closing of gaps.

In the designing of systems of equalization transfers, Bernard Dafflon and François Vaillancourt also identified six further issues worth noting. (1) Should the approach be one of a representative tax system or be based on a macro indicator of per capita income which is more difficult to measure precisely? (2) Should not only revenue

equalization, but cost equalization be taken into account as in Australia and also to some extent Switzerland? (3) Should explicit equalization transfers be separately defined as in Canada or Germany or be part of transfer schemes pursuing other goals, as is the case with some transfers in Switzerland and is the predominant mode in the United States? (4) What is the role of implicit equalization in public policies that do not use transfers to the constituent unite governments, such as social security schemes, unemployment insurance, and federal infrastructure programs that spend proportionally more in poor regions than rich ones? (5) When statistical data is limited (such as in third world federations) and reliance has to be on imperfect indicators of wealth and taxable capacity, what are the most useful bases for designing an equalization system? (6) Where there are significant ethnic and linguistic differences within a federation, can equalization contribute to the survival of these groups by lowering the pressures for mobility?

The question is sometimes raised whether there is a relationship between the degree of decentralization within a federation and the need for equalization arrangements. In practice this does not always appear to be the case. Richard Bird has rightly noted that the extent of equalization in different federations has not related directly to the extent of regional disparities or any other simple causal factor. Two general factors would appear to affect the emphasis upon equalization. The *first* is the importance of the prevailing political culture and the degree to which it emphasizes equality of citizens and the uniformity of the services available to them. The *second* is the degree to which greater decentralization within a federation is itself the result of social fragmentation producing stronger pressures for regional distinctiveness, autonomy, and resistance to dependency on federal funding aimed at inducing uniformity. For example, egalitarian Australians,

blessed with comparatively modest disparities in revenue capacity compared to many other federations, as Malcolm Nicholas has pointed out this afternoon, have over the years, gone to greater lengths in their efforts to equalize than Canada. In this respect Germany has been similar, although the absorption of the new eastern Länder has added some new stresses in the past decade. On the other hand, as we noted this morning, the United States with relatively large interstate disparities but no formal systematic equalization scheme at all, appears to have had a much greater tolerance to horizontal imbalances. Switzerland and Canada, two of the most decentralized federations and influenced by their linguistic, religious and cultural diversity, lie somewhere between these two extremes. Clearly, then, a major factor effecting variations in the tolerance for horizontal financial imbalances in different federations has been the relative value placed in their prevailing political cultures upon equity as opposed to non-centralization and regional autonomy.

## 6. PROCESS AND INSTITUTIONS FOR ADJUSTMENT

As I have already noted, key factors in the operation of equalization systems are the political processes and procedures by which they are established and modified. Since the values of revenue resources and the cost of expenditure responsibilities inevitably change over time, in practice regular or periodic adjustment to equalization systems has been required. An illustration has been the recent and current negotiations in Germany and Switzerland over modifications to their equalization systems.

In terms of the actual procedures in federations for adjusting financial equalization transfers, *four* patterns can be identified. In Australia, India and South

Africa, although in different forms, standing or periodic expert commissions have been given the primary task of determining the distributive formulae and recommending these to the federal parliament. Nevertheless, this occurs within a context where there is considerable political intergovernmental deliberation in setting the framework for the work of the expert commissions.

In the case of the Australian Commonwealth Grants Commission and the Indian Finance Commissions, their independence and the fact that federal governments have generally accepted their recommendations has contributed to their effectiveness. For instance, Malcolm Nicholas has pointed out to us that the Commonwealth government has accepted all the Commonwealth Grants Commission recommendations since 1981. On the other hand, although the South African Financial and Fiscal Commission has been a constitutionally established body, with half of its members nominated by the provinces or local governments, its authority has been seriously undermined by the tendency of the national Minister and Department to treat it merely as an “ advisory” body and to overtly impose their own decision-making power.

A *second* pattern is the constitutional provision for a formal intergovernmental council, composed of federal and provincial representatives, as the overriding forum to reach agreement on changes to the financial arrangements at stipulated periodic intervals. The National Finance Commission in Pakistan is an example. But in Pakistan this form of institution has sometimes led to deadlocks and a failure to achieve intergovernmental agreement on needed changes for extended periods of time. In Malaysia, the National Finance Committee Council was intended to play a similar role, but because it had only

consultative authority, it never developed into an effective co-ordinating institution, and the Federal Ministry of Finance has come to dominate the process.

A *third* pattern is that found in Germany, Switzerland, Austria, the United States and Belgium, where transfers to states are determined by the federal legislature, but there is some effective participation of state governments, legislatures or interests within the federal institutions. A particularly notable example is the Land representatives in the German Bundesrat who take part in approving financial matters affecting the states and in constitutional amendments to the financial arrangements set out in the Constitution. Other examples are the cantonal legislators, some of whom may have dual membership in the federal parliament of Switzerland, the representatives of the state or community legislatures in the federal second chambers in Austria and Belgium, and the direct election of senators on a state-wide basis in the United States. In some of these federations independent ad hoc commissions have also been appointed from time to time to make recommendations to the federal government or legislature.

A *fourth* pattern is found in Canada, where the determination of the major components of intergovernmental financial arrangements, including the equalization transfers, is under the control of the federal government, whose legislature contains no effective representation of provincial governments or interests, because the appointed character of the Senate means that it has lacked political legitimacy. Not surprisingly, given the political significance of intergovernmental financial issues including equalization, these issues have, as a result, been subjected to extended discussion in the extra-parliamentary arena of innumerable committees of federal and provincial ministers

and officials, and they have been the source of much political polemics between federal and provincial governments.

It should be noted that in virtually all federations, but especially in those with parliamentary institutions where “executive federalism” has been the predominant character of intergovernmental relations, such as Australia, Germany, India and Canada, there has developed a proliferation of intergovernmental councils, commissions and committees to facilitate the negotiation and adjustment of the financial arrangements including those relating to equalization. Even when the ultimate constitutional authority to determine financial transfers rests elsewhere, these bodies and the political bargaining that occurs within them have been major determinants of the character of the equalization system and of modifications over time to it.

## 7. CONCLUSIONS

Let me conclude with nine brief points.

*One*, equalization is a common feature of both federal and decentralized unitary countries and has a history of some seventy years with Australia as the pioneer.

*Two*, the arrangements for equalization transfers have varied from federation to federation to take account of differing particular social and political circumstances.

*Three*, both equity and efficiency considerations have been used to justify equalization, with their relative weights varying with each country.

*Four*, any equalization scheme is both an economic *and* political choice which is, at least for some countries, crucial to their survival and prosperity.

*Five*, in most recent newer federations in Asia and Africa, financial equalization has followed the Australian model, being based on the assessment of both *revenue* capacities and specific *expenditure* needs.

*Six*, a fundamental feature of the dynamics of intergovernmental financial relations in all federations has been the underlying process of intergovernmental *political* bargaining, but the extent to which it has been truly “intergovernmental” has varied among federations.

*Seven*, the extent of equalization within federations appears to have varied with the extent to which their political culture has been marked by an emphasis upon equity and uniformity on one hand, and the strength of the desire for diversity and autonomy on the other.

*Eight*, experience does not suggest a direct correlation between the degree of decentralization and the intensity of the emphasis upon equalization.

*Nine*, the political institutions and context are a predominant factor in determining the financial arrangements within any federation, including those for equalization.

Finally, I look forward to the further deliberations of this conference and to the comparative conclusions that may be reached in the final concluding session tomorrow.