INTRODUCTION

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In this collection of four essays, we provide a review of the relevant literature and discussion of best practices in four major areas of fiscal management in federations. The first essay examines how federations deal with imbalances between expenditure responsibilities and revenue-raising capacities in two contexts – between national and regional governments, and among regional governments. The second essay looks at processes to adjust these methods of dealing with imbalances as conditions within the federation change. Both of these essays focus on the experience of two mature federations, Australia and Canada, that have a long history and considerable experience with these issues.

The third essay in the collection deals with issues of managing macroeconomic stabilization policy within federations. Complementing that analysis, the fourth essay focuses on issues specifically related to federations' government borrowing and debt policy. Both of these essays look at developing federations, Mexico and Brazil in particular, to embed the discussion in actual experience.

These essays were commissioned by the Forum of Federations. The Institute for Public Economics at the University of Alberta is pleased to collaborate with the Forum to provide pratitioners in emerging federations with our current understanding of best practices for fiscal management in federal states.

KEY LESSONS FOR POLICY-MAKERS

- **Dealing with fiscal imbalances**

The division of spending and revenue responsibilities in federations is primarily determined by their constitutions – modified by convention and history of judicial interpretation. Successful federations can operate with very different divisions of such responsibilities, ranging from highly centralized to highly stabilized. If the divisions of spending and revenue responsibilities are not matched, a vertical fiscal imbalance will exist. Such imbalances are addressed through intergovernmental transfers. Such transfers may be conditional or unconditional. In federations that assign major spending responsibilities to regional governments, transfers are often unconditional.

Intergovernmental transfers are also used to address imbalances between regions. [These transfers can be based on revenue-raising capacity, expenditure need, or both characteristic of such transfers is whether they are gross or net schemes.] In gross schemes (such as in Canada), transfers are not self-limiting. National governments often attach additional, ad hoc conditions to these schemes to limit fiscal risk.

- **Adjusting to changing conditions**

The need to periodically adjust fiscal relations between governments is common to all federations. Processes for adjusting fiscal relations in federations vary widely. In parliamentary systems, processes tend to rely on "executive federalism" based on intergovernmental negotiation. The process for agreeing on adjustments to fiscal relations may be formal or informal. For example, while Australia uses formal mechanisms (the Loan Council, the Commonwealth Grants Commission and the Council of Australian Governments), Canada relies almost entirely on informal meetings of officials, finance ministers and first ministers.

These different approaches are the result of differences in the structure of government (i.e., the lack of a regionally elected Senate in Canada), the degree of ethnic and cultural difference between regions (French-speaking Quebec versus English-speaking provinces), and the predominant values of society (regional equity in Australia versus regional autonomy in Canada).

- **Macroeconomic management**

The long-run objective of the fiscal authorities should be to provide the desired level of public services and infrastructure within a sustainable fiscal framework – where the budgets of all governments are balanced in the medium term. Fiscal management is more complex in federal states because of the interdependence of national and subnational governments' finances arising from shared revenue and expenditure responsibilities.

Prospects for sustainable fiscal policy are improved when each order of government has 1) clearly delineated expenditure responsibilities; 2) access to significant non-transfer, own-source revenue; and 3) borrows without the support or guarantee of the other order of government. Evidence from Argentina, Brazil and Mexico suggests that these three factors are important predictors of the success of emerging federations in attaining sustainable fiscal positions.

The assignment of primary responsibility for stabilizing the economy in the face of macroeconomic fluctuations may rest with either national or subnational governments. The optimal assignment will depend on whether macroeconomic fluctuations are normally national in scope or confined to particular regions. To be effective in stabilizing regional shocks, subnational governments must have access to revenue sources that are sensitive to economic conditions so that automatic stabilizers can work.

- **Debt management**

Borrowing by regional governments in a federation may have important effects on other regions or the national government. Such effects may extend to higher interest rates, impacts on creditworthiness and pressure to monetize debt and thereby increase inflation rates. At the operational level, uncoordinated borrowing may lead to credit constraints if large issues come on the market in close proximity. Large borrowings by national governments may have similar impacts on regions.

There are three general approaches to coordinating debt management in federations: the co-operative approach, administrative control by the national government and the strict rules-based approach. Experience with emerging federations shows that the rules-based approach works best. A key prerequisite for successful debt management in federations is the existence of timely, reliable information on the state of regional and national government finances.

Rules-based approaches should include a clear and comprehensive definition of debt, outline the required response and penalty for non-compliance and, to prevent inflationary effects, prohibit regional government borrowing from central or state-owned banks. Credible, no-bailout policies by the national government should be encouraged and transfer systems should be designed to increase predictability and stability for regional governments.

In closing, it is our hope that these essays provide practitioners in emerging federations with practical guidance regarding best practices for fiscal management in federal states. Ongoing dialogue between practitioners and academic researchers is an important strength of the Canadian federation, and we welcome opportunities to interact with federalism practitioners and researchers emerging federations.

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