Comparative Conclusions on Fiscal Federalism

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Fiscal federalism is concerned with the public finances of the various orders of government in a federal system. Federal countries differ a great deal in their choices – specifically, how the division of fiscal powers is allocated among various orders and the associated fiscal arrangements. Further, some aspects of fiscal arrangements, such as intergovernmental fiscal transfers, resulting from these choices can be subject to periodic review (e.g., the five-year sunset clause in Canada) and redefinition in order to adapt to changing circumstances within and beyond nations. Changes in these arrangements may also occur simply as a result of how various constitutional provisions and laws are interpreted by courts (as in Australia and the United States) or by various orders of government, as in all federal countries. In recent years, these choices have come under significant additional strain from the great changes arising from the information revolution and the emergence of a "borderless" world economy. This chapter reviews the practice of fiscal federalism in twelve case study countries and highlights the findings and lessons from these experiences.

Section 1 of this chapter provides a general discussion of the fiscal federalism features of selected federations. This is followed by comparative reflections on the division of fiscal powers in section 2. The allocation of spending and regulatory responsibilities is discussed, and attention is paid to issues in revenue-raising responsibilities, including the financing of capital investments. Issues in macroeconomic management and economic coordination are discussed in section 3. Section 4 highlights the practice of intergovernmental fiscal transfers and pays special attention to transfers whose purpose is to reduce regional fiscal disparities. A final section draws some general conclusions from these experiences.

1 SALIENT FEATURES OF SELECTED FEDERATIONS

The twelve federations (of these Spain and South Africa have unitary constitutions but are considered quasi-federations in practice) reviewed in this book represent a diverse sample in terms of demographics, level of economic development, affinity with stylized models of federalism, and features of fiscal federalism. In our sample, Switzerland is the smallest and the second richest federation with a population of 8 million and a per capita GDP of $37,465 (2002). India is the largest and poorest federation, with a population of 1.1 billion and a per capita GDP of $666 (2004) (see table 1). The sample federations also present diverse models of federalism. Australia, India, and Russia bear affinity to the layer-cake model of dual federalism, with a strong national-government role in the federal system. Under such a model, the responsibilities of the federal and state governments are distinct and separate, and there is a hierarchical relationship among the various orders of government, with the federal government at the apex. In India, the federal government has the residual powers and paramountcy on the shared rule, and it can even change state boundaries. Both Spain and Malaysia can be characterized as asymmetric layer-cake models of dual federalism. In Spain, Navarre and the Basque country and, to a lesser extent, the states of Sabah and Sarawak in Malaysia enjoy autonomous status and are treated more equally than are other constituent units of the federation. Canada, Switzerland, and the United States resemble the coordinate-authority model of dual federalism. Under the coordinate-authority model of dual federalism, states enjoy significant autonomy, and local governments are simply creatures of the states with a limited or no direct relationship with the federal government. Germany and South Africa embody features of cooperative federalism with interdependent (hierarchical) spheres of government, but in these countries the federal government assumes an almost exclusive role in legislative authority for policy and standards, and the intermediate order primarily acts as the implementing agent. Nigeria has a three-tier hierarchical system with a strong federal government. Brazil, by contrast, presents itself as a cooperative-federalism model with three independent spheres of government. Brazil, India, Nigeria, and South Africa have constitutionally recognized local governments, whereas in all other federations local governments are creatures of the regional (province/state) governments.

Countries with a federal form of government vary considerably in terms of federal influence on state governments. Such influence is very strong in Australia, Germany, India, Malaysia, Nigeria, Russia, Spain, and South Africa; it is weak in Brazil, Canada, Switzerland, and the United

Table 1
A comparison of selected fiscal systems

Selected indicators	*Australia*	*Brazil*	*Canada*	*Germany*	*India*	*Malaysia*	*Nigeria*	*Russia*	*Spain*	*South Africa*	*Switzerland*	*United States*
2004 Population (million)	20	184	32	82	1090	24	130	144	40	47	8	296
Area (000 sq. km.)	7687	8512	9985	357	3288	330	924	17075	505	1223	41	9631
2004 GDP per capita (US$000)	32	4	35	33	0.7	5	0.5	4	24	5	37 (2002)	42
Character of federalism*	Dual LC	Cooperative, independent	Dual CA	Cooperative interdependent	Dual CA	Dual LC, asymmetric	Cooperative, interdependent	Dual LC	Dual LC asymmetric	Cooperative interdependent	Dual CA	Dual CA
The character of fiscal federalism	2-tier centralized	3-tier decentralized	2-tier decentralized	2-tier centralized integrated	3-tier centralized	2-tier centralized	3-tier centralized	2-tier centralized	2-tier centralized	3-tier centralized	2-tier decentralized	2-tier decentralized
Local government constitutional status	No	Yes	No	No	Yes	No	Yes	No	No	Yes	Yes	No
Actual state control of local government	Strong	Weak	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Strong	Varies from fairly strong to fairly weak
Range of local government responsibilities	Limited	Extensive	Extensive	Limited	Limited	Limited	Limited	Limited	Limited	Limited	Extensive	Extensive
Federal/interstate equalization performance	Strong; revenue and expenditure	Fair	Strong; revenue disparities reduced	Strong; revenue and some expenditure	Fair	Fair	Fair	Fair	Fair	Fair	Fair	Weak

Table 1
A comparison of selected fiscal systems (*Continued*)

Selected indicators	*Australia*	*Brazil*	*Canada*	*Germany*	*India*	*Malaysia*	*Nigeria*	*Russia*	*Spain*	*South Africa*	*Switzerland*	*United States*
	disparities reduced substan- tially		substan- tially	disparities reduced substantially								
Output-based conditional transfers	No	Yes	Yes	No	No	No	No	No	No	No	No	Yes
State tax per- formance	Weak	Strong	Strong	Strong	Fair	Weak	Weak	Fair	Fair	Weak	Strong	Strong
Local fiscal autonomy	Fair	Fair	Strong	Fair	Weak	Weak	Weak	Fair	Fair	Fair	Strong	Strong
Equalization formula	Paternal capacity and need	Implicit and piecemeal	Paternal fiscal capacity	Fraternal fiscal capac- ity	Implicit and piecemeal	Paternal capacity and need	Implicit and piecemeal	Paternal fiscal capacity	Implicit	Paternal capacity and need	Mixed capacity and need	Implicit and piecemeal
Equalization standard	Implicit	Implicit	Explicit	Explicit	Implicit	Iimplicit	Implicit	Explicit	Implicit	Implicit	Implicit	None
State tax base conformity	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	No	No
State tax rate uniformity	Yes	Yes	No	Yes	No	No	Yes	No	No	Yes	No	No
State-local gross revenues more or less match responsibility	Yes	Yes	Yes	Yes	No	No	No	No	Yes	Yes	Yes	Yes

Note: * – constitutionally recognized fiscal tiers; LC – layer cake model; CA- coordinate authority model
Source: Author's impressions

States. In the latter group of countries, federal influence over state expenditures is quite limited, and state governments have considerable authority to determine their own tax bases and tax rates (see tables 2 and 3). In centralized federations, conditional grants by the federal government play a large role in influencing the priorities of regional and local governments. In Australia, a centralized federation, the federal government is constitutionally required to follow regionally differentiated policies.

Federal countries also vary according to the process of provincial/state influence on national policies. In some countries, there is a clear separation of national and state institutions ("executive" or "interstate" federalism) and the two levels interact through meetings of officials and ministers, as in Australia, Brazil, Canada, India, Malaysia, Nigeria, Spain, and Switzerland. In Germany and South Africa, state governments have a direct voice in national institutions; that is, in both these countries, state governments are represented in the second house of parliament – the *Bundesrat* in Germany and the Council of the Provinces in South Africa ("intrastate" federalism). This is to be expected in view of the primacy of national legislation in all functions and the need for state government inputs for such legislation in these countries. Such arrangements, however, limit the autonomy of both the federal and state governments in Germany, creating an indecision trap associated with this "spaghetti-bowl" politics, as suggested by Feld and von Hagen (see chapter on Germany). In Russia, the Federation Council (upper chamber), as envisaged by the Constitution, was expected to have the governor and the speaker of the legislature of each region represented in it. The Constitution has now been amended to have the one executive member nominated by the governor and the one legislative assembly member nominated by the legislative assembly of each region represented in the Federation Council, thereby weakening the regional influence at the centre. This comes in the wake of an important change in the election of governors – no longer directly elected but nominated by Russia's president and appointed by the regional legislature. In Brazil, India, Malaysia, and the United States, regional and local coalitions play an important role in the second chamber of the national legislature. This role may not support the positions taken by states' executives and therefore works to diffuse regional tensions. In Brazil, because all states have equal representation in the Senate, small states in the northeast have a disproportionate influence on the federal system. In Canada, the members of the second chamber are nominated by the prime minister; therefore, the Senate is considered to be more technocratic in its orientation as members are often appointed based upon recognition of their service achievements in government, politics, or business.

Table 2
Fiscal decentralization to provinces/states

					Federal-state intergovernmental transfers:								
Country	*Range of provincial/state government responsibilities*	*Provincial government influence on national policies*	*National government influence on provincial policies*	*Provincial/state revenues finance majority of provincial expenditure*	*Important/unimportant*	*Predominant emphasis on conditional grants/unconditional grants/tax sharing/revenue sharing*	*Fiscal capacity equalization*	*Expenditure needs equalization*	*Ability to borrow from domestic banks/higher orders of government*	*Ability to issue domestic bonds*	*Ability to borrow from foreign banks*	*Ability to issue foreign bonds*	*Overall fiscal decentralization to provinces/states*
Australia	Extensive	Weak	Strong	No	Important	Unconditional grants and conditional grants	Yes	Yes	Yes	Yes	Yes	Yes	High
Brazil	Extensive	Fair	Fair	Yes	Important	Revenue sharing and conditional grants	No	Yes	No	Yes	No	Yes	High
Canada	Extensive	Strong	Weak	Yes	Important	Equalization and conditional grants	Yes	No	Yes	Yes	Yes	Yes	High
Germany	Extensive	Strong	Strong	Yes	Important	Equalization and conditional grants	Yes	No	Yes	Yes	Yes	Yes	Medium
India	Extensive	Fair	Strong	Yes	Important	Revenue sharing & conditional grants	No	Yes	Yes	Yes	No	No	Medium
Malaysia	Limited	Weak	Strong	No	Important	Revenue sharing	No	Yes	Yes	Yes	No	No	Low

Table 2
Fiscal decentralization to provinces/states (*Continued*)

Country	*Range of provincial/state government responsibilities*	*Provincial government influence on national policies*	*National government influence on provincial policies*	*Provincial/state revenues finance majority of provincial expenditure*	*Federal-state intergovernmental transfers:* *Important/unimportant*	*Federal-state intergovernmental transfers:* *Predominant emphasis on conditional grants/unconditional grants/tax sharing/revenue sharing*	*Fiscal capacity equalization*	*Expenditure needs equalization*	*Ability to borrow from domestic banks/higher orders of government*	*Ability to issue domestic bonds*	*Ability to borrow from foreign banks*	*Ability to issue foreign bonds*	*Overall fiscal decentralization to provinces/states*
Nigeria	Extensive	Fair	Strong	No	Important	Revenue sharing and conditional grants	No	Yes	Yes	Yes	No	No	Medium
Russia	Extensive	Weak	Strong	No	Important	Equalization and conditional grants	Yes	Yes	Yes	Yes	Yes	No	Medium
Spain	Extensive	Fair	Strong	Yes	Important	Revenue sharing, and conditional grants	No	Yes	Yes	Yes	Yes	Yes	Medium
South Africa	Extensive	Weak	Strong	No	Important	Unconditional grants and conditional grants	No	Yes	Yes	Yes	No	No	Low
Switzerland	Extensive	Strong	Weak	Yes	Important	Equalization and conditional grants	Yes	Yes	Yes	Yes	Yes	Yes	High
United States	Extensive	Fair	Fair	Yes	Unimportant	Conditional grants	No	No	Yes	Yes	Yes	Yes	High

Table 3
Fiscal decentralization to local governments

Country	*Local governments are creatures of provinces/ states*	*Range of local government responsibilities*	*Local government influence on state/ provincial policy*	*Local government influence on federal policy*	*Local fiscal capacity equalization*	*Local expenditure needs equalization*	*Ability to borrow from domestic banks*	*Ability to issue domestic bonds*	*Overall fiscal decentraliza-tion to local governments*
Australia	Yes	Limited	Weak	Weak	Yes	Yes	Yes	No	Low
Brazil	No	Extensive	Weak	Weak	No	Yes	No	Yes	High
Canada	Yes	Extensive	Weak	Weak	Yes	Yes	Yes	Yes	High
Germany	Yes	Extensive	Weak	Weak	Yes	Yes	Yes	Yes	High
India	Yes	Limited	Weak	Weak	No	Yes	No	Yes	Low
Malaysia	Yes	Limited	Weak	Weak	No	Yes	No	No	Low
Nigeria	No	Extensive	Weak	Weak	No	Yes	Yes	Yes	Medium
Russia	Yes	Extensive	Weak	Weak	Yes	Yes	Yes	Yes	Medium
Spain	Yes	Extensive	Weak	Weak	Yes	Yes	Yes	Yes	Medium
South Africa	No	Extensive	Weak	Fair	No	Yes	Yes	Yes	High
Switzerland	Yes	Extensive	Fair	Fair	Yes	Yes	Yes	Yes	High
United States	Yes	Extensive	Weak	Weak	No	Yes	Yes	Yes	High

In some federal countries, constitutional provisions require all legislation to recognize that ultimate power rests with the people. For example, all legislation in Canada must conform to the Canadian Charter of Rights. In Switzerland, a confederation by law but a federal country in practice, direct-democracy provisions empower citizens to hold government to account (e.g., all major legislative changes require approval by referendum). In Malaysia, the Clients' Charter empowers citizens to hold governments to account in the event specified public service standards are not met.

Regional income disparities, however, are significant in most of the case study countries. These disparities are the largest for South Africa and the smallest for the United States.

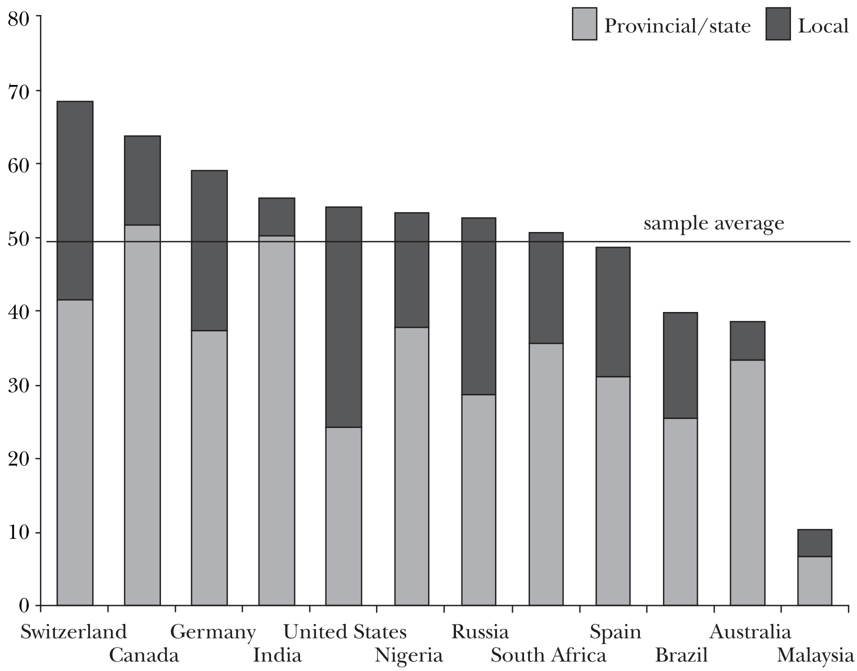
2 DIVISION OF FISCAL POWERS

Allocation of Spending and Regulatory Powers

The constitutional division of power on the spending and regulatory responsibilities in the case study countries generally conforms to the subsidiarity principle. India, Malaysia, and South Africa are the exceptions, where, responding to historical legacies, a dominant federal role was carved out by the constitution and, in the case of India, further cemented by a centrally appointed unified civil service. The practice in most federal countries, as a result of historical, cultural, and institutional factors and legal-judicial interpretations varies widely, and most federal countries, with the exception of Canada, have allowed a wider federal role than originally envisaged by the framers of the constitution. The original federal role was largely limited to services of national scope such as "peace, order and good government." This role was later expanded due to wars and judicial interpretation of the constitution, as in Australia and the United States; threats of secession, as in India and Russia; issues in combating terrorism and promoting racial equality, as in the United States; natural-resource management and environmental protection, as in Brazil, Nigeria, and the United States; debt management and fiscal discipline, as in Brazil; protection of the indigenous majority, as in Malaysia; or, more commonly, federal use of regulatory or spending powers in order to achieve national objectives in securing a common economic union, as in most of the case study countries. The use of federal regulatory powers often results in unfunded or underfunded mandates, whereas the use of conditional matching grants can lead to fiscal stress for regional and local governments.

The overall role of the intermediate orders of government is the strongest in Switzerland and Canada; fairly strong in the United States, Brazil, and Australia; and relatively weak in other federations, with the weakest

Figure 1
Subnational expenditure as a% of total government expenditure



Sources: Various chapters in this volume; *Government Finance Statistics Yearbook* (various issues) Washington, DC: International Monetary Fund.

being in South Africa. However, this role remains large in all the case study countries with regard to the delivery of social and infrastructure services, with the exceptions of Malaysia and South Africa, where such services are centralized. In Canada, provinces have a role in immigration policy and in regulating securities and labour markets, thus creating the potential for inefficiencies in the internal common market.

Local government responsibilities are extensive in Switzerland, the United States, Brazil, and Canada; quite restricted in Spain, India, Russia and Malaysia; and highly constrained in Australia (see figure 1). In Spain, basic education and basic health care are intermediate-order responsibilities. In Russia, several local services, such as public transit, roads, and fire prevention, are regional government functions, whereas local police protection and local tax collection are federal responsibilities. In Australia, local governments play an insignificant role in public service delivery and are primarily responsible for property-oriented services such as garbage collection and street maintenance and cleaning.

Overall, with the exception of Spain, Brazil, Australia, and Malaysia, subnational expenditures in the case study countries account for 50 percent or more of consolidated public expenditures, with state and local governments in Switzerland and Canada accounting for more than 60 percent of such expenditures (see Figure 1).

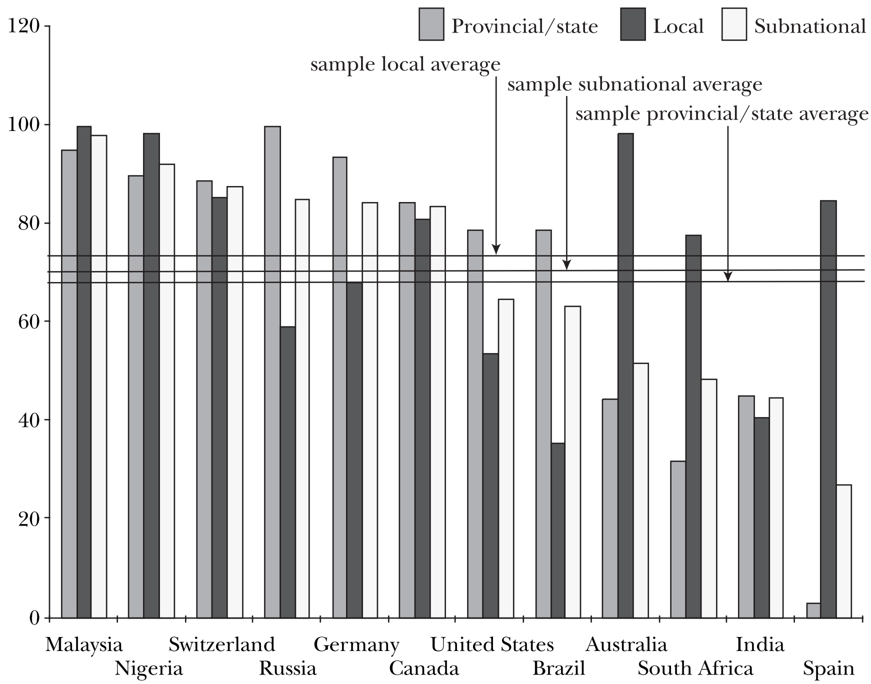
Shared rule is sometimes a source of confusion and conflict. In Canada, the provinces have attempted to limit the federal spending power in social services by entering into a social union framework agreement with the federal government. In Germany, where the intertwining of federal and state powers is an issue, the Federalism Reform Act, 2006, limits federal laws requiring the consent of the *Bundesrat* (second chamber) to specified areas and also gives states flexibility to deviate from a federal law in its implementation. In Switzerland, ambiguity with regard to shared rule is avoided by having intergovernmental agreements and contracts. In the United States, Russia, and South Africa, unfunded or underfunded federal mandates represent sources of concern for state (province/region) governments.

Allocation of taxing Powers

Taxing powers (tax base and rate determination and tax collection) are highly centralized (75 percent or more central revenues) in Malaysia, South Africa, and Australia; centralized (60 percent to 75 percent of revenues collected by the centre) in Brazil, India, Russia, and the United States; highly decentralized in Switzerland (37 percent of total revenues collected by the centre); and decentralized (40 per cent to 50 percent at the centre) in Canada and Nigeria. Other countries fall in the intermediate range. In Russia, the centralization of tax administration has resulted in a weaker effort in collecting state (regional) and local taxes.

The tax powers of state governments are wide in Switzerland, Canada, the United States, Brazil, and Nigeria and are quite restrained in South Africa, Australia, Spain, and Malaysia (figure 2). Expenditure autonomy as determined by the percentage of expenditures financed by the own-source revenues of states is high in Malaysia, Nigeria, Switzerland, Germany, Canada, and the United States but low in India and Spain (with the exception of the two regions) (figure 3). State tax autonomy (having responsibility for base and rate determination of own taxes) is high in Australia, Canada, Switzerland, the United States, Nigeria, India, and Brazil but constrained in Germany, Spain, Malaysia, and Russia. In the latter countries, states may be given some discretion in setting tax rates but tax-base determination is a federal responsibility. Further, regional governments in Russia do not have revenue autonomy. Taxing e-commerce and mobile factors are important issues imposing limitations on state finances in the United States and India.

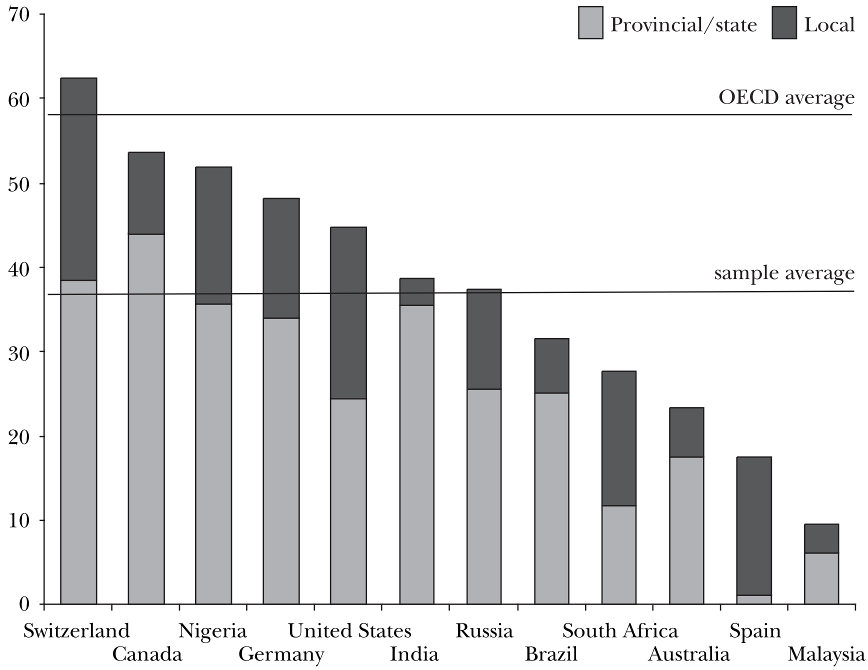
Figure 2
Subnational own-revenues as a% of subnational expenditure



Sources: Various chapters in this volume; *Government Finance Statistics Yearbook* (various issues) Washington, DC: International Monetary Fund.

The income and the sales tax system is harmonized in Australia, Canada, Germany, Malaysia, Russia, Spain, and Switzerland; it is not harmonized in Brazil, India, and the United States. The lack of a harmonized tax system leads to high compliance costs for firms and individuals operating in a multistate environment. In the United States, the federal Constitution's interstate commerce clause acts as a break against state taxes distorting interstate commerce; in addition, states are prohibited from taxing internal and external trade. In India, on the contrary, taxes on the interstate trade of goods is an important source of state revenues. In Brazil, sales taxation is uncoordinated among the federal, state, and local governments. The Brazilian Council of State Finance Ministers (CONFAZ) has attempted to harmonize the state VATs but with limited success. Fiscal incentives through the state VAT system in Brazil have resulted in fiscal wars among states. In Canada, income tax harmonization was achieved through offering federal incentives to follow a common tax base. Sales tax harmonization through similar incentives had only partial success. Canada also introduced an important innovation in the

Figure 3
Subnational own source revenues resources as a% of total government revenues



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institutionalization of tax administration by creating an independent agency with oversight by federal and provincial orders and the private sector. In other countries, tax harmonization has been achieved by centralizing tax-base determination and/or tax collection.

The case study countries, with the exception of Nigeria, follow the golden rule principle in borrowing (i.e., borrowing for capital spending only), and they primarily depend on capital-market discipline to restrain such borrowing by state and local governments. In Nigeria, all borrowings by state and local governments require prior federal approval. In Malaysia, local borrowing is subject to state government supervision. Such direct borrowing is typically discouraged; instead, private-sector participation in infrastructure provision is encouraged. In Brazil, external debt requires approval by the federal Senate, and all borrowing is subject to legislated fiscal rules. Several federal countries have special arrangements to assist state and local borrowing for capital projects. In Australia, the Australian Loan Council facilitates such borrowing by making data on public finances available to the capital markets. In Canada, provincial Crown corporations that run on commercial principles assist local borrowing. In the United States, state bond banks (private agencies) collate local borrowing demands and issue bonds for the pooled demand. Also in the United States, interest on such borrowing by state and local governments is deductible against federal income-tax liability – providing a direct federal subsidy for such borrowing. In Switzerland, the Cooperative Centre of Swiss Local Communities provides capital finance to local governments.

There is no evidence of a race to the bottom due to state and local tax autonomy in the case study countries. Most countries do not show any serious tax competition, and where such competition has surfaced – such as in Brazil, Switzerland, and, to a more limited extent, India, Canada, and the United States – it has not resulted in a lower tax effort and lower quality of state and local public services.

In general, taxing powers in the sample countries are more centralized than dictated by fiscal federalism principles. Many factors may have been involved in achieving this result. This may have happened partly because most nations placed a premium on tax harmonization. Also, shifting expenditures downward was politically more feasible than allowing finance to follow function, and state and local politicians were less than enthusiastic about assuming taxing powers but very interested in receiving fiscal transfers from the national government with little accountability to local taxpayers.

Vertical Fiscal Gaps

A downside of over-centralized tax powers with decentralized expenditure responsibility is the creation of vertical fiscal gaps, or the mismatch between revenue means and expenditure needs among state and local governments (see table 4 for details). Vertical fiscal gaps and revenue autonomy in subnational governments remain concerns in those federal countries where the centralization of taxing powers is greater than is necessary to meet federal expenditures and federal fiscal transfers to meet national objectives as this results in extensive use of conditional transfers to exert undue influence on subnational policies. Further, such large gaps create democratic accountability deficits as state and local governments experience the pleasure of spending money without having to justify additional spending to their taxpayers. This is a concern for state governments in Australia, Germany, India, Malaysia, Nigeria, Russia, Spain, and South Africa. In Nigeria, there is a special concern about the central assignment of resource revenues. In Germany, these concerns are prompting a wider review of the assignment problem and a rethinking of the division of powers among federal, *Land,* and local governments. A consensus is yet to be formed on a new vision of fiscal federalism in Germany.

Table 4
Vertical fiscal gaps

		Revenue share			*Fiscal gap*	
Country	*Level of government*	*Before transfer*	*After transfer*	*Expenditure share*	*Before transfer*	*After transfer*
Australia (2003–04)	National	0.76	0.56	0.61	0.15	–0.06
	Provincial/state	0.18	0.37	0.34	–0.16	0.04
	Local	0.06	0.07	0.05	0.01	0.02
Brazil (2003)	National	0.68	0.55	0.60	0.08	–0.05
	Provincial/state	0.25	0.27	0.26	0.00	0.01
	Local	0.06	0.18	0.14	–0.08	0.04
Canada (2005)	National	0.46	0.42	0.36	0.10	0.06
	Provincial/state	0.44	0.48	0.52	–0.08	–0.04
	Local	0.10	0.10	0.12	–0.02	–0.02
Germany (2002)	National	0.52	0.40	0.41	0.11	–0.01
	Provincial/state	0.34	0.37	0.37	–0.03	–0.01
	Local	0.14	0.23	0.22	–0.08	0.02
India (2002)	National	0.61	0.42	0.45	0.17	–0.03
	Provincial/state	0.36	0.53	0.50	–0.15	0.03
	Local	0.03	0.05	0.05	–0.02	0.00
Malaysia (2003)	National	0.91	0.85	0.90	0.01	–0.05
	Provincial/state	0.06	0.09	0.07	–0.01	0.02
	Local	0.03	0.06	0.03	0.00	0.03
Nigeria (2004)	National	0.48	0.43	0.46	0.02	–0.03
	Provincial/state	0.36	0.40	0.38	–0.02	0.02
	Local	0.16	0.17	0.16	0.00	0.01
Russia (2004)	National	0.63	0.55	0.47	0.15	0.07
	Provincial/state	0.26	0.28	0.29	–0.03	0.00
	Local	0.12	0.17	0.24	–0.12	–0.07
Spain (2002)	National	0.53	0.27	0.51	0.02	–0.24
	Provincial/state	0.29	0.49	0.31	–0.03	0.17
	Local	0.18	0.24	0.18	0.01	0.07

Table 4
Vertical fiscal gaps (*Continued*)

Country	Level of government	Revenue share: Before transfer	Revenue share: After transfer	Expenditure share	Fiscal gap: Before transfer	Fiscal gap: After transfer
South Africa (2002)	National	0.82	0.36	0.49	0.33	–0.13
	Provincial/state	0.01	0.46	0.36	–0.34	0.10
	Local	0.16	0.18	0.15	0.01	0.03
Switzerland (2002)	National	0.37	0.30	0.31	0.06	–0.01
	Provincial/state	0.38	0.42	0.42	–0.03	0.00
	Local	0.24	0.28	0.27	–0.03	0.01
United States (2004)	National	0.55	0.44	0.46	0.09	–0.02
	Provincial/state	0.25	0.29	0.24	0.01	0.05
	Local	0.20	0.27	0.30	–0.10	–0.03

Sources: Various chapters in this volume; *Government Finance Statistics Yearbook* (various issues) Washington, DC: International Monetary Fund.

3 FISCAL FEDERALISM AND MACROECONOMIC MANAGEMENT

Federal fiscal systems aspire to provide safeguards against the threat of centralized exploitation as well as decentralized opportunistic behaviour while decision making remains close to the people. In fact, federalism represents either a "coming together" or a "holding together" of constituent geographic units to take advantage of the greatness and littleness of nations. But federal fiscal systems whose purpose is to accommodate such "coming together" or "holding together" may pose some risks for macro stability. Two main issues raised by the case study countries on this count are (1) fiscal discipline and (2) intergovernmental competition.

Fiscal Prudence and Fiscal Discipline under "Fend-for-Yourself" Federalism

Fiscal lack of discipline among subnational governments is a matter of concern in federal countries in view of significant subnational autonomy combined with an opportunity for a federal bailout. In mature federations, fiscal policy coordination to sustain fiscal discipline is exercised through both executive and legislative federalism as well as by instituting 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 referendums for new taxing and spending initiatives. Most mature federations also specify "no bailout" provisions in setting up central banks. In the presence of an explicit or even implicit bailout guarantee and preferential loans from the banking sector, printing of money by subnational governments is possible, thereby fuelling inflation. Recent experiences with fiscal adjustment programs suggest that, while legislated fiscal rules are neither necessary nor sufficient for successful fiscal adjustment, they can help forge a 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 multiparty coalition governments (India) or in countries with a separation of legislative and executive functions (United States 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, Spain, Russia, and South Africa.

Brazil's success with fiscal rules from 2001–07 is particularly remarkable. Germany, however, could not achieve fiscal discipline on the part of the Länder, even with fiscal rules, because the federal Constitutional Court had blessed federal bailouts, thereby creating soft budget constraints for them. A more recent decision (November 2006) by the same court to disallow a requested bailout by Berlin indicates a reversal of such policies. In the United States, fiscal conservatism on the part of states ensures fiscal discipline, but pork-barrel politics in the federal government has not been restrained by fiscal rules. Australia and Canada achieved the same results without having any legislated fiscal rules, whereas fiscal discipline continues to be a problem even though Germany has legislated fiscal rules. The Swiss experience is the most instructive with regard to sustained fiscal discipline. Two important instruments create incentives for cantons to maintain fiscal discipline. First, fiscal referendums allow citizens the opportunity to veto any government program; second, the legal provision enacted in some cantons to set aside a fraction of a fiscal surplus in good times works like a "debt brake" for rainy days (in the United States, these are called rainy-day funds).

Intergovernmental Competition

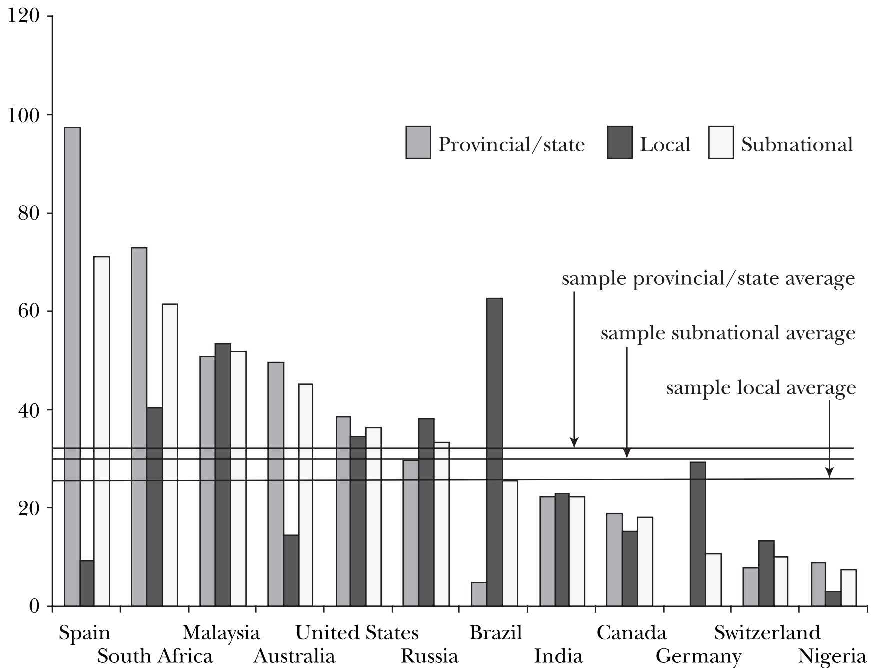
Competition among state and local governments is quite common in most federal systems. It occurs through lobbying for employment by: generating federal or private-sector projects, including military bases; encouraging domestic and foreign direct investment; providing incentives and subsidies for attracting capital and labour; supplying public infrastructure to facilitate business location; providing a differentiated menu of local public services; offering one-stop windows for licensing and registration; and pursuing endless other ways of demonstrating an open-door policy for new capital and skilled labour. State and local governments also compete among themselves by erecting trade and tariff walls to protect local industry and business. They also try to out-compete each other in exporting tax burdens to non-residents and obtaining a higher share of federal fiscal transfers where feasible.

Preserving intergovernmental competition and decentralized decision making are important for responsive and accountable local governance in federal countries. The Swiss and the American experiences demonstrate the positive impacts of such a competition. "Beggar-thy-neighbour" policies have the potential to undermine these gains from decentralized decision making, as demonstrated by the recent "race to the bottom" experience in Spain and the so-called "fiscal wars" in Brazil and Switzerland. State inheritance taxes have been eliminated through interjurisdictional competition for rich residents in Australia, Canada, and Switzerland. In Switzerland, such competition is further advanced through regressive income tax schedules. Mergers of cantons to abate such competition in Switzerland have been ruled out by referendums. To limit the adverse effects of such competition, a partnership approach that facilitates a common economic union through the free mobility of factors by ensuring common minimum standards of public services, no barriers to trade, and wider information and technological access offers the best policy alternative in regional integration and internal cohesion within federal nations. It is not a matter of "to compete or to cooperate" but, rather, of how to make sure that all parties compete and cooperate but do not cheat.

4 INTERGOVERNMENTAL FISCAL TRANSFERS

In all the case study countries, the federal government collects more revenue than is needed to satisfy its own expenditure/regulatory responsibilities. Such fiscal surplus enables the federal government to use its spending power to pursue national objectives through the use of fiscal transfers. These transfers help achieve national objectives while supporting decentralized decision making. Federal government fiscal transfers finance nearly two-thirds of subnational expenditures in Spain and South Africa and less than 20 percent of such expenditures in Canada, Switzerland, and Nigeria (figure 4). The design of such transfers plays a critical role for efficiency, equity, and accountability in a federal system. Three important objectives of such transfers in the case study countries are (1) bridging

Figure 4
Transfers as a % of subnational expenditure



Sources: Various chapters in this volume; *Government Finance Statistics Yearbook* (various issues) Washington, DC: International Monetary Fund.

vertical fiscal gaps, (2) bridging the fiscal divide within nations, and (3) securing a common economic union through establishing national minimum standards in social and infrastructure services. The following paragraphs discuss how these objectives are addressed through fiscal transfers in the case study countries.

Bridging vertical fiscal gaps

Vertical fiscal gaps, at least at the conceptual level, are largely a non-issue in Canada, the United States, and Switzerland because state governments have sufficient fiscal powers to overcome such gaps. In Canada, the federal government used tax abatement as well as incentives for tax-base sharing to overcome such a gap in the past. These vertical gaps represent a significant issue in the remaining case study countries as they have centralized tax administration and constrained state and local taxing powers. To overcome such gaps, general revenue sharing, with a multitude of equalization components, is being used in Brazil, India, Malaysia, and Nigeria. Ironically, in India such revenue sharing uses 1971 population data as the basis for allocating finds among states; in Brazil, state and municipal coefficients are frozen at 1988 levels. Tax-base sharing and tax-by-tax sharing is used in Germany; fiscal need equalization grants are used in Australia, Russia, and Spain (mostly historical expenditures). For most countries in our sample, fiscal transfers reverse the fiscal position of the federal government from surplus to deficit (see table 4).

Bridging the fiscal divide within nations

The fiscal divide within nations represents an important element of the economic divide within nations. Such a divide is a matter of concern in all the case study countries, with the important exception of the United States. In Canada, such a divide is accentuated by provincial ownership of natural resources and soaring oil and gas prices. Fiscal equalization programs, with the objective of enabling constituent units to provide reasonably comparable levels of public services at reasonably comparable levels of taxation, are frequently advocated to overcome such a divide. Such programs are expected to foster goods and factor mobility and help secure a common economic union.

Among the case study countries, Australia, Canada, Germany, Malaysia, Russia, Spain, and Switzerland attempt to address regional fiscal disparities through a program of fiscal equalization. In the United States, there is no federal program because factor mobility has served to bridge fiscal and economic differences to a great extent, although such differences within states remain a matter of policy concern. And, for that reason, state education finance typically uses equalization principles. In Canada, such a program is enshrined in the Canadian Constitution and is termed "the glue that holds the federation together." Such programs in the case study countries are federally financed, with the exception of Germany and Switzerland. In Germany, wealthy states make progressive contributions to the equalization pool, and the poor states receive from this pool. In Switzerland, the new equalization program, effective in 2008, has a mixed pool of contributions from the federal government and wealthier cantons. In Russia, equalization programs conducted by regions for local equalization use the mixed approach.

All the case study countries with an equalization program have some focus on fiscal-capacity equalization. Australia, in addition, has a comprehensive approach to fiscal-need equalization. Spain equalizes fiscal need based on historical expenditures, and both Russia and Malaysia consider partial equalization of expenditure needs based on selected need indicators. The Canadian and German equalization programs use an explicit fiscal-capacity standard of equalization that determines both the total pool as well as allocations across constituent units. Such a principled approach to equalization is desirable as it results in greater transparency and objectivity in allocating equalization payments. All other programs utilize a fixed pool but use allocation formulae to determine allocation across units.

The equity and efficiency implications of equalization programs are a source of continuing debate in most federal countries. In Australia, the complexity introduced by expenditure-needs compensation is an important source of discontent with the existing formula. In Canada, provincial ownership of natural resources is a major source of provincial fiscal disparities, and the treatment of natural-resource revenues in the equalization program remains contentious. In Germany, the applications of overly progressive equalization formulae result in a reversal of fortunes for some rich jurisdictions. Some rich Länder in Germany have, in the past, taken this matter to the Constitutional Court to limit their contributions to the equalization pool. In Spain, the asymmetric treatment of autonomous communities (charter regime) and the rest of the regions (common regime) for equalization purposes is a continuing source of contention. In Brazil, India, Malaysia, Nigeria, Russia, and South Africa, much controversy and debate is generated by the equity and efficiency impacts of existing programs. In Nigeria, arbitrary use of the Federation Account (resource revenue pool) to retire federal debt and revenue-sharing formula components, especially the 13 percent share for derivation component, are sources of concern (especially for the Niger delta region).

Institutional Approaches to the Design and Practice of Equalization Transfers

The case study countries use diverse approaches to institutional arrangements for equalization transfers. These diverse arrangements have been designed to suit the contexts of individual countries. In Spain, Switzerland, Malaysia, Russia, and South Africa, the federal ministry of finance or treasury is responsible for decisions on the total pool and allocation among constituent units. In Brazil, the total pool is determined by the Constitution, and the federal Senate determines the allocation for state and local governments. In Australia, India, and Nigeria (semi-independent), independent grant commissions are entrusted with making recommendations on the formula for allocating such transfers, whereas the total pool is predetermined by legislation. In Canada, intergovernmental forums make the initial determination. These decisions are then endorsed and legislated by the federal Parliament and implemented by the federal Ministry of Finance. In Germany, a federal compact determines the allocation, which is legislated by the federal government and implemented by the Ministry of Finance.

While, on an a priori basis, no one institutional arrangement is preferable to another, experience has shown that independent grant commissions typically opt for greater complexity in designing such transfers, leading to much acrimony and debate. Leaving these decisions to the federal government alone, however, makes such transfers vulnerable to the whims of the regime in power. Intergovernmental forums offer a second-best alternative by having all relevant stakeholders involved in the decisions on such transfers.

Setting national minimum standards through output-based fiscal transfers

Setting national minimum standards in regional-local services serves both efficiency (creating an internal common market) and equity (treating all citizens equally regardless of their place of residence). Such standards can be attained by conditional non-matching grants, in which the conditions reflect national output-based efficiency and equity concerns and there is a financial penalty associated with failure to comply with any of the conditions. Conditions are thus imposed not on the specific use of grant funds but on the attainment of standards in quality, access, and level of services. Such output-based grants do not affect state-local government incentives for cost efficiency, but they do encourage compliance with nationally specified standards for access, quality, and level of services. Properly designed conditional non-matching output-based transfers can create incentives for innovative and competitive approaches to improved service delivery and results-based accountability in the public sector. Input-based grants fail to create such an accountability environment. Although output-based (performance-oriented) grants are best suited to the grantor's objectives and are simpler to administer than are traditional input-based conditional transfers, they are rarely practised in the sample federal countries. Prominent notable exceptions are education and health finance in Brazil, Canada, and South Africa, and highway finance in the United States. The reasons have to do with the incentives faced by politicians and bureaucrats. Such grants empower clients while weakening the sphere for opportunism and pork-barrel politics. The incentives they create strengthen the accountability of political and bureaucratic elites to citizens and weaken their ability to peddle influence and build bureaucratic empires. Their focus on value for money exposes corruption, inefficiency, and waste. Not surprisingly, this type of grant is opposed by potential losers.

In most of the case study countries, with a few notable exceptions, federal conditional grants use input-based conditionality. Such conditionality impairs state and local autonomy and is a source of conflict. Growing use of such grants is a matter of state and local concern in Australia, Germany, Spain, and Russia. Vertical fiscal gaps – differences between the revenue share and expenditure share before fiscal transfers – are very large for provinces in South Africa and states in Australia and India, but these are eliminated by fiscal transfers.

In Brazil and Canada, and to a limited extent in South Africa, education and health transfers focus on output and access-based conditionality. In the Unites States, federal fiscal transfers to state and local governments, with the important exception of highway grants, were in the past predominantly input-based conditional grant programs, although since the 1990s, an emphasis on shifting federal grants towards performance-based criteria is slowly emerging.

5 LESSONS LEARNED AND CONCLUDING REMARKS

The following lessons emerge from these diverse experiences.

- Clarity in responsibilities but periodic joint review is key to the successful working of the fiscal system. As Rudyard Kipling once said, there are 160 ways to design fiscal tiers, and every one of them is right. What matters is that constitutional and legal systems and institutions must provide for mechanisms to build societal consensus for new compacts in view of changing circumstances and be amenable to timely adjustments to implement such compacts.
- Asymmetric federalism arising from symmetric and uniform principles leads to amicable and sustainable outcomes.
- Finance should follow function to strengthen responsiveness and accountability to taxpayers.
- Fiscal rules accompanied by "gate keeper" intergovernmental committees provide a useful framework for fiscal discipline and fiscal policy coordination.
- To ensure fiscal discipline, all governments must be made to face the financial consequences of their decisions.
- Securing a common economic union through unimpeded goods and factor mobility and national minimum standards for social services and infrastructure is the best guarantee for political and economic stability and regional convergence in the long run.
- Institutional arrangements for managing intergovernmental conflicts play an important role in the smooth working of a federal system.
- Properly designed intergovernmental transfers can strengthen results-based accountability and also enhance competition for the supply of public goods, fiscal harmonization, state and local government accountability, and regional equity. Manna-from-heaven transfers or bilaterally negotiated transfers can build transfer dependencies that cause the slow economic strangulation of fiscally disadvantaged regions. All transfers must be open for periodic reviews.

- Societal norms and consensus on the roles of the various orders of government and limits to their authority are vital for the success of decentralized decision making. In the absence of such norms and consensus, direct central controls do not work, and intergovernmental gaming leads to dysfunctional constitutions. Direct-democracy provisions can be helpful in restraining governments.
- A clients' charter with specified standards of services and feedback and redress mechanisms can help strengthen government accountability to citizens.

In conclusion, the federal countries examined in this volume have shown a remarkable ability to adapt and to meet emerging challenges in fiscal federalism. While the challenges they face may be very similar, the solutions they discover and adopt are often 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.

NOTES

1 The author is grateful to Professor John Kincaid for helpful comments.