Comparative Reflections on Emerging Challenges in Fiscal Federalism

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Fiscal federalism is concerned with economic decision making in federal system of government in which public sector decisions are taken at various orders of government. Federal countries differ a great deal in their choices as to the character of fiscal federalism, specifically, how the division of fiscal powers is allocated among various spheres and the associated fiscal arrangements. Further fiscal arrangements resulting from these choices are usually subject to periodic review and redefinition in federal countries to adapt to changing circumstances within and beyond nations. In Canada, such a periodic review (the sunset clause) is mandated by law, whereas in other federal countries changes may occur simply as a result of how various constitutional provisions and laws are interpreted by courts (as in Australia and the USA) or by various orders of government, as in the majority of 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 new "borderless" world economy. The following paragraphs highlight a few important challenges and emerging responses in sample federal countries.

Major Challenges to Constitutional Federalism

1. Division of fiscal powers

The information revolution and globalization are posing special challenges to constitutional assignment within nations. The information revolution, by letting the sun shine on government operations, empowers citizens to demand greater accountability from their governments. With globalization, it is becoming apparent that nation-states are too small to tackle larger things in life and too large to address the smaller things Globalization and the information revolution represent a gradual shift to supra-national regimes and local governance. In adapting to this world, there is a growing tension among various orders of governments in federal systems to re-position their roles in order to retain relevance. One continuing source of such tension and two emerging trends are discernible in the countries included in this volume. One continuing source of tension is the vertical fiscal gaps, or the mismatch between revenue means and expenditure needs at lower orders of government.

Vertical fiscal gaps and revenue autonomy at subnational orders remains an area of concern in those federal countries where the centralization of taxing powers is greater than necessary to meet federal expenditures inclusive of its spending power; this results in undue influence on subnational policies to meet national objectives through the use of fiscal transfers. This is a concern at the state level/order in Australia, Germany, India, Malaysia, Nigeria, Russia, Spain, and South Africa. In Nigeria, there is a special concern regarding 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, *Länder,* and local governments. A consensus is yet to be formed on a new vision of fiscal federalism in Germany.

The two emerging trends in shifting balance of powers within nations are: (a) a steady erosion in the role of the states/provinces – the second (intermediate) sphere; and (b) an enhanced but redefined role of local government in multi-order governance.

(a) Diminishing relevance of the intermediate order of government or towards an hour glass model of federalism

The federal governments in Brazil, Canada, India, Germany, India, Malaysia, and Russia have carved out a larger role in areas of federal-state shared rule. In Brazil, entitlements and earmarked revenues are the restraining influences on budgetary flexibility at the state level/order. In South Africa the responsibility for social security financing has been taken over by the national government. In the USA, the federal government is assuming an ever widening role in policy making areas of shared rule, while devolving implementation responsibilities to state and local governments. This is frequently done through unfunded mandates or with inadequate financing. In both Canada and the USA, federal governments are partly financing their debts through reduced fiscal transfers to provinces/states.

Another dimension of emerging federal-state conflict is that in federal countries with dual federalism, as in Australia, Canada and the USA, where local governments are the handmaiden of state governments, federal governments are attempting to build direct relationship with local governments and in the process are by-passing state governments. This is a concern in Brazil, Canada, and USA where state governments are having increasingly diminished relevance in people's lives, although their constitutional roles remain strong. This is making vertical coordination more difficult and also impacting on the state's ability to deal with fiscal inequities within their boundaries. In India, federal government retains a strong role in state affairs through appointment of federal officials to key state executive decision making positions. Overall, the role of the intermediate order of government in federal systems is on the wane with the exception of Switzerland, where the cantons have a stronger constitutional role as well as stronger support from local residents.

(b) New vision of local governance but some resistance from state governments

Globalization and the information revolution, on the other hand, are strengthening localization and broadening the role of local governments in network governance at the local level/order. This requires local governments to operate as purchasers of local services and facilitators of government networks beyond government providers, gatekeepers, and overseers of state and national governments in areas of shared rule. Nevertheless, local governments are facing some resistance from their state governments in social policy areas. In Brazil, India, and Nigeria, local governments have constitutional status and as a result, a greater ability to defend their roles. In Switzerland, direct democracy provisions assure a strong role for local governments and in both Brazil and Switzerland, local governments have an expansive and autonomous role in local governance. In other federal countries, the ability of local governments to fend for themselves depends upon the citizen empowerment engendered by the information revolution. Russia stands out as an example where such a defence could not be mounted. In Canada, some of the provinces have centralized school finance. In South Africa, primary health care has been reallocated to the provincial order of government.

2. Bridging the fiscal divide within nations

The fiscal divide within nations represents an important element of the economic divide within nations. This is because reasonably comparable levels of public services at reasonably comparable levels of taxation foster mobility of people, capital, and tradable goods and help secure a common economic union.

Most mature federations, with the important exception of the USA, attempt to address regional fiscal disparities through a program of fiscal equalization. In the USA, there is no federal program, but state education finance uses equalization principles. In Canada, such a program is enshrined in the Canadian Constitution and is frequently termed by Canadian scholars and politicians as the glue that holds the federation together. Most equalization programs 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.

There is a great diversity in the institutional arrangements to design, develop, and administer such programs across federal countries. Brazil, India, Nigeria, Spain, and South Africa take into account a multitude of fiscal capacity and need factors in determining equitable state shares in a revenue sharing program. Malaysia uses capitation grants. Russia uses a hybrid fiscal capacity equalization program. Fiscal equalization programs in Canada and Germany equalize fiscal capacity to a specified standard. The Australian program is more comprehensive and equalizes both the fiscal capacity and fiscal needs of Australian states constrained by a total pool of revenues from the goods and services tax.

The equity and efficiency implications of exiting 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 and Spain, 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 Brazil, India, Malaysia, Nigeria, Russia, and South Africa much controversy and debate is generated by equity and efficiency impacts of existing programs.

3. Fiscal Prudence and Fiscal Discipline Under "Fend-for-Yourself" Federalism

Fiscal indiscipline at subnational levels/orders 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 both through executive and legislative federalism as well as 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 referendum 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 fueling inflation. Recent experiences with fiscal adjustment programs suggest that, while legislated fiscal rules are neither necessary nor sufficient for successful fiscal adjustment, they can be of help in forging sustained political commitment to achieve better fiscal outcomes, especially in countries with divisive political institutions or coalition regimes. For example, such rules can be helpful in sustaining political commitment to reform in countries with proportional representation (Brazil) or multi-party coalition governments (India) or in countries with a separation of legislative and executive functions (USA, Brazil). Fiscal rules in such countries can help restrain pork-barrel politics and thereby improve fiscal discipline as has been demonstrated by the experiences in Brazil, India, Russia, and South Africa. Australia and Canada achieved the same results without having any legislated fiscal rules, whereas fiscal discipline continues to be a problem even though Germany has legislated fiscal rules. The Swiss experience is the most instructive in having sustained fiscal discipline. Two important instruments create incentives for cantons to maintain fiscal discipline. First, fiscal referenda allow citizens the opportunity to veto any government program. Second, the legal provision enacted in some cantons to set aside a fraction of fiscal surplus in good times works like a "debt brake" for rainy days.

4. Intergovermental Competition

Competition among state and local governments is quite common place in most federal systems. It occurs through lobbying for employment – generating federal or private sector projects including military bases; encouragement of domestic and foreign direct investment; providing incentives and subsidies for attracting capital and labor; providing public infrastructure to facilitate business location; providing a differentiated menu of local public services; one stop windows for licensing and registration; and endless other ways of demonstrating an open-door policy for new capital and skilled workforce. 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 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-neighbor" policies have the potential to undermine these gains from decentralized decision making, as the recent "race to the bottom" experience in Spain indicates. To overcome this, a partnership approach that facilitates a common economic union through free mobility of factors by ensuring common minimum standards of public services, dismantling 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 how to make sure that all parties compete and cooperate but do not cheat.

Concluding Remarks

The federal countries examined in this publication have shown 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 always unique and local. This represents a remarkable attestation to the triumph of the spirit of federalism in its never-ending quest for balance and excellence in responsive, responsible, and accountable governance. The long march to attain new heights in inclusive governance continues.