

Nicholas Schmitt

Problems of Equalisation in Federal Systems – Revenue Equalisation versus Cost Equalisation

(Work Session 22)

1. Introduction

This topic is essentially technical. While participants at the work session hardly touched the quite complicated elements that constitute its title: revenue equalisation and cost equalisation, the input of these outstanding politicians and experts who have to deal on a day-to-day basis with equalisation, provided an excellent account of the reality of the matter.

Federalism is like the engine of a Formula 1 car: efficient but complicated. From this point of view, equalisation is typical of federalism. It reflects its complexity, because it encompasses financial, economical, political, legal and even ethical components. Moreover, it reflects the heterogeneity of federal systems, because problems (and solutions) are different from one country to the other.

This explains why the technical question (“How do we equalise?”) has been replaced by the ideological one (“Do we need equalisation?”), and why clear answers could not be given to the problems launched in this panel, even if interesting elements could be synthesised.

2. Lessons learned from Switzerland

Switzerland is a good example of the challenges linked to financial equalisation, because it is engaged in a process of re-drafting its policy.

2.1. The current system

Differences among cantons in terms of size, geography, population and economic potential are so great that, without equalisation measures, fiscal federalism would lead to intolerable regional disparities. For instance, the largest cantons have a natural burden: for example many expensive roads have to be built. Certain rural areas benefit from services provided by agglomerations, but do not pay for them. Large tax disparities drive to movements against federalism.

The federal government must therefore equalise burdens that are not fault of the cantons. Therefore, it intervenes to correct the primary distribution of resources between the cantons with three main policy measures which aim to strengthen structurally weak regions: fiscal equalisation, agricultural aid policy and assistance to mountain areas.

Three sets of federal equalisation programmes have been developed since 1959: firstly, conditional federal grants to the cantons; secondly, revenue sharing of certain federal tax revenues, and thirdly contributions by the cantons to certain social security expenditures (Dafflon, 1999).

2.2. Critics of the system

The current system favours cantons that are already strong. The two main elements of the transfer system (federal grants and revenue-sharing quotas of

federal direct tax) are deficient in their redistribution from a quantitative point of view. Moreover, the allocation of the greater part of federal contributions is linked to similar investment by the cantons themselves through residual expenditures.

2.3. The new system

Switzerland is about to reform its equalisation policy.¹ Key features of the new draft are: clear definition of responsibilities and powers; protection of the lower level; separation when joint tasks are performed; linking of local power to incentives; economic thinking as part of the implementation of the principle; careful financing of the task; avoidance of wrong incentives. Its objective is to allow cantons to maintain their potential to fulfil tasks and to maintain autonomy. It is based on four principles, which show that an equalisation policy should not be reduced to fiscal equalisation:

- Measures on assignment of competences and tasks: subsidiarity will become a federal principle and legally binding;
- Reform of cooperation between confederation and cantons: some joint tasks will be formally identified;
- Strengthening inter-cantonal cooperation: a catalogue will be edited, and there should be financial equalisation for tasks accomplished at the super-cantonal level;
- Fiscal equalisation in strict terms.

Among the features that characterise the new system, are three funds that allow for unconditional transfers and horizontal equalisation.²

3. Lessons learned from Canada

In Canada, the fiscal capacities of less well-off provinces are raised to 97% of the national average through the equalisation program. Moreover, there are no conditions attached to the formal equalisation program.

As a result, equalisation is strongly supported by federal and provincial governments (and even by those which do not receive equalisation payments) and – most importantly – by the general public.

4. Lessons learned from Australia

This seems to be the world's most egalitarian country. States are quite similar and the majority of population lives in large cities. As a result, the main feature of financial equalisation is connected to the underlying value of equality: all Australians should have access to the same level of public goods and services.

The key to equalisation is the Grant Commission. Exhaustive enquiries provide it with information on the situation of different states, their advantages and disabilities. It favours vertical transfer payments over horizontal. States have limited revenue: 50% of their income comes from federal transfers.

Financial equalisation seems to be accepted, despite the fact that the Grant Commission is a paradigm of independence and obscurity. For instance, it distinguishes between disabilities or natural advantages, whose scientific delimitation remains problematic.

5. Lessons learned from Germany

Financial equalisation in Germany has a political dimension, with a judicial touch. The system is considered as one of the most stable in the world.³

Following an appeal by three Länder, the Karlsruhe Constitutional Court ruled in November 1999 that the equalisation system would have to be reformed by 2005. In the wake of this decision, the federal government and the 16 Länder agreed on a new equalisation scheme at the end of June 2001: donor states as well as recipient states are expected to be better-off. The new system aims on the one hand to allow the donor Länder to keep a higher portion of their above-average tax revenue. On the other hand, the recipient Länder will benefit from an increase in the contribution made by the Bund to the revenue equalisation system, and from a higher weighting for municipal revenues (64% instead of 50% at the present time), since recipient Länder tend to have less wealthy municipalities than donor Länder.

6. Why financial equalisation?

The technical dimension cannot be separated from the question of principle: why financial equalisation? Federalism has four main functions that have to be constantly improved:

- To create favourable environment;
- To create an efficient and flexible system;
- To create a certain competition among sub-national entities;
- To implement the principle of subsidiarity.

Besides competition, it is an open question as to how a federal system can tolerate differences. It is necessary for the survival of the federation that states and citizens should feel a certain level of solidarity. Horizontal gaps are increasing, not only in the four federations we have examined, but also in countries like Brazil or Argentina. The main purpose of financial equalisation is to address disparities among sub-national governments, i.e. to reduce the gap between revenue means across regions. Such policies are typically adopted in order to ensure equity among citizens, notably by ensuring that citizens have access to reasonably comparable levels of public services at reasonably comparable levels of taxation, regardless of their region of residence.

Some experts are opposed to any form of financial equalisation, arguing that it destroys the very basis of democracy and market freedom (Nef, 2002), but they seem to form a minority. The evidence that equalisation creates a trap is not convincing. Why should a government be less efficient with equalisation money? Politicians have voters whom they need to convince of their efficiency, and obviously voters do not accept a government that does not create conditions for economic growth.

In Canada, the output is very high, even among growing provinces. Nevertheless, knowledge about equalisation remains limited. In Quebec for instance, almost nobody knows that it exists, and citizens believe that Quebec is donor, when it is in fact a recipient.

Equalisation also has side effects that can be beneficial. For instance, the reduction of internal migration motivated only by fiscal differences promotes economic efficiency. In Canada, this may have helped to maintain the

presence of Francophone in Quebec. Equalisation allows less well-off provinces to provide similar public services at similar levels of taxation, and therefore reduces fiscally induced migration.

Another argument is linked to globalisation. Recent economic collapses (Enron or Worldcom in United States, Swissair in Switzerland) have shown that the market has its limits. It is not possible to let it influence the life of regions without any state intervention, because this could lead to severe economic and social problems.

Financial equalisation can therefore be perceived as a political question and even – if we dare say it – as an ethical one, with a cultural dimension.

Canada, Switzerland and Germany have entrenched the principle of equalisation at least in their constitutions. This shows its basic importance.

The ethical nature of equalisation can also be shown from the care to be taken about terminology. Instead of “poor” states, it is preferable to speak of “less rich” or “financially weaker” ones.

7. How to implement financial equalisation?

Life is a jungle and inequalities are everywhere. Participants agreed about the need to “socialise” economic life at a sub-national level. But how is it possible to put this into practice?

The first equalisation policy is in fact the allocation of powers. Then, the greater the regions’ responsibilities (in terms of finances) and the greater the disparities among them, the greater the need for some sort of equalisation in the strict sense of the word.

But what kind of disparities need to be equalised? Once technical questions are dealt with, solutions differ from one federation to another.

Table 1

Country	Canada	Switzerland	Australia
Revenue disparities reduced	Extensively	Moderately	Extensively
Expenditure disparities reduced	None	Moderately	Extensively

Disparities between regions can be reduced by transfers between governments, which can take two forms. Firstly, a formal equalisation program; secondly, specific transfers based on some sort of measures of need or revenues capacities.

Given that the measurement of disparities on the expenditure side appear to be much more complex than on the revenue side, another consideration may be a country's preference for relatively simple fiscal arrangements, especially if this were to ensure greater transparency and accountability.

This table shows that among six federations, there are five different patterns of equalisation. And even if United States seems not to have anything in its "row", equalisation does exist there.

Table 2

Country	Equalisation		Who equalises?		
	Formal equalisation program	Entrenched in Constitution	Federal to sub-national governments	Sub-national governments to federal	Among sub-national governments

	program		governments	to federal	governments
Australia	X		X		
Belgium	X		X		
Canada	X	X	X		
Germany	X	X	X		X
Switzerland	X	X	X	X	
United States					

8. How much to equalise?

This is another basic technical question whose answer shows that there is no unanimity among federations. Differences are due to the fact that the answer depends on two factors.

First, the extent of regional responsibilities: a federation that is not very decentralised probably needs less equalisation than a highly decentralised one.

Second, the level of disparity between the revenue capacity and expenditure needs of the regions: the more unequal regional public services and tax levels are between regions, the more equalisation is needed.

9. What result?

Experts discuss the merit of financial equalisation, and the fact that it is currently at the heart of delicate political debates shows that at least the regions are convinced of its importance.

In Canada, some experts have argued that equalisation has increased the dependency of some provinces and augmented disparities within the country. But there is no empirical evidence to sustain this argument. In fact fiscal disparities have decreased over the past 20 years. Instead of becoming more dependent, less well-off provinces have become less dependant on equalisation.⁴

Of course, the increase or decrease of economic disparities among the regions sometimes has nothing to do with equalisation, and can be due to factors such as the discovery of oil (in Alberta, Canada) or decline of mining industry (in Lorraine, France). These examples show how the state has to take care of economic fluctuations in order to compensate them.

Nevertheless, given that disparities have decreased in the countries where there are equalisation programmes, it could be argued that the latter do not have the negative economic impacts some experts assign to them.

Table 3

Different contexts	Canada	Switzerland	Australia	Germany
Degree of decentralisation	High	High	Moderate	High

Revenue disparities	Large	Large	Relatively small	Moderate
Expenditure need disparities	Small	Small	Relatively large	Large
Resulting design choices				
Degree of equalisation	Not full	Not full	Full	Not full
Revenue disparities reduced	Extensively	Moderately	Extensively	Extensively
Expenditure disparities reduced	None	Moderately	Extensively	None

10. Are there synthetic elements?

Apart from the idea that equalisation is necessary and useful, the legal description of equalisation policies varies considerably from one country to another, and the different definitions of the concepts in use make it very difficult to draw on national approaches. The federal share of direct government spending is lower in Canada and in Switzerland than in Australia. As a result, synthetic elements are rare.

Politically, financial equalisation is disputed in Germany, less in Switzerland – even if it took many years to achieve the new draft – and not at all in Australia or Canada.

Cost equalisation exists neither in Canada, nor in Germany, where it is considered as a “taboo”. A list of the Länder according to their financial capacities would be almost inconceivable. On the other hand, such a list is published every two years by the Swiss government (RS 613.11).

There are new schemes in Germany and in Switzerland, but not in Australia or in Canada.

11. Complexity of equalisation

All participants have pointed out that in every country only a few experts were able to understand the ins and outs of equalisation. Therefore they did not present figures, but rather concepts. In Canada, even though expenditures needs are not taken into account in the formal equalisation program, there are less than 30 experts in the whole country who know the intricacies of its calculations.

In fact, the complexity of equalisation is linked to its very nature.

Firstly, it requires a state structure that allows sub-national units to enjoy a certain level of financial decentralisation. It means that the state structure itself has to reach a certain level of complexity before discussing equalisation. In a federation, one of the most delicate questions is the allocation of tasks. Financial equalisation has then to integrate into a complicated context.

Secondly, there is a problem of measurement and indicators. Equalisation means a certain harmonisation among fiscal, financial and economic disparities. But can one measure these inequalities? How is it possible to measure property tax? Equalisation requires excellent statistics. This is not so

easy: it requires a lot of administrative work and costs a lot of money. Even more difficult is the measurement of immaterial factors like the satisfaction of citizens.

12. Differences between federations

The great diversity of systems found among federations can be explained only through their history. History alone allows us to understand, for example, why competitive federalism is encouraged in Switzerland, or why equalisation is complete in Australia. No one can say whether the first pattern is better than the second, or vice versa. Equally, only history can explain the details and content of policies in the field of equalisation, which often depend on an undefined distinction between participation and devolution. The same applies when we seek to understand why the market freedom remains the priority in certain countries, while in others the social constraints of the electorate have become more important.

Equalisation is not only mathematics. It responds to the basic values of each federation and of their politicians at the federal and sub-national level.

Accordingly, one should not claim to provide an accurate and rational interpretation of situations that are frequently the result of a long process which politicians and administrators have learnt to work with.

13. Competitive federalism versus cooperative federalism

Linked to this issue is the concept of cooperative federalism versus competitive federalism.

On the one hand, great importance can be attached to cooperation at all levels and to the governmental processes that deal with it. This is called cooperative federalism. It helps to reduce conflicts and improve coordination, but over-intricate coordination mechanisms drive to the “joint decision trap”, which eventually reduces autonomy and room for manoeuvre at both levels of government. In Germany, the intricacy of the whole system has resulted in a certain level of inefficiency (Arndt, 2002).

On the other hand, supporters of competitive federalism argue that competition among state levels (of course within the constitutional framework, in particular, the principle of federal faithfulness) is as fruitful as competition between firms. It brings better goods and services to the citizens. Argentina for instance is trying to develop a system based on the Canadian model, considered to be better than the Australian one, because it demands fiscal responsibility from sub-national units. For these experts, cooperative federalism is a kind of collusion, aiding governments instead of citizens. But one has to take into account the fact that an excess of competitive federalism can lead to inter-governmental conflicts, and that fears and angers are destructive in a federation.

As usual, a good balance between these two principles has to be reached, and this should also be the goal of equalisation.

14. Revenue equalisation versus cost equalisation stricto sensu

Participants hardly dealt with technical questions. The point was made that it is less complicated to equalise revenue than expenditure. That is why Canada

forces on revenue equalisation. Moreover, vertical transfers are less disputed than horizontal ones.

But let us examine an example of cost equalisation. This happens in a U-form production situation (\blacktriangledown N \blacktriangledown), with productivity increasing – according to the number of users – in the left part of the pattern, up to an “optimal” point N where production costs are maximised, and then decreasing in the right part of the pattern. Typical examples are natural monopolies like water supply or cleaning. If a regional collectivity has to deliver this service, but is too small to reach the optimal point where the number of users allows for the lowest cost, there are two ways to overcome the difficulty.

The first one is for the collectivity to cooperate with its neighbours. This is a “management variable”: the collectivity can decide for itself.

But such cooperation may be impossible, perhaps for geographical reasons. This is a “situation variable”: the collectivity cannot decide for itself. In such cases, compensation of the costs can be necessary in order to approach the optimal point allowing for the delivery of the service at a same net cost as other collectivities. The level of government that decides the rule should bear the financial consequences: the result is usually vertical equalisation.

15. Conclusion – more questions than answers

A democratic system simply cannot allow people to feel neglected with regard to public service access. Over time, equalisation strengthens the financial capacity of the member states. The gap between richer and less well-off provinces has decreased over the years.

The work session showed that there were two points upon which it has been possible to reach a consensus among participants.

The first is that financial equalisation has good results and is its own justification.

The second is that it is so complicated that only a few experts are able to deal with it. This complexity explains clearly why discussions hardly touched upon the technical issues that the work session title evoked. On the contrary, readers have first of all dealt with principles of equalisation.

As a result, people looking for definitive answers to their questions will have been disappointed. As it is often the case with such a complicated system like federalism, there is no one solution.

Nevertheless, the scientific evidence of this fact has its importance. At a time of globalisation and (dis)information, people tend to have a Manichean view of the world. They seek simple answers to complex questions.

In St Gallen the most reliable experts have proved that there is no evidence. The best solution can only be the one which reflects and takes into account in the most scrupulous way the deepest needs and desires of a country.

Equalisation is a necessity, perhaps even an ethical one. But it is not then possible to say whether cost equalisation or revenue equalisation is the best solution. Its implementation depends on too many factors. Moreover, Switzerland, Germany, Australia and Canada represent “classical” federal cases, when compared with emerging federations or other political systems.

The final point follows from the varying national conditions of equalisation that have been dealt with above. It is difficult to transfer elements from a model in one country to a model in another country. Because of historical and cultural traditions, the same conclusion pertains to the transferability of entire equalisation systems. The lessons to be learnt from others deal mostly with the type of considerations involved when entering the equalisation process, procedures used by others in solving problems, and with the elements that have to be dealt with in constructing equalisation systems. When borrowing ideas and solutions from other countries, one should always be attentive to what type of federal system the ideas and solutions are taken from. Federations differ from each other and the interdependencies between components within the systems may work differently.

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¹ < <http://www.parlament.ch/Internet98/f/dossiers/nfa/nfa.htm>>

² An indication of the complexity of the topic is the fact that experts disagree about current horizontal equalisation in Switzerland. Some pretend that there is none, and others explain that there is a technical explanation. In fact there is horizontal equalisation in the cantons, limited to the assignment of revenue. Cantons have accepted that the federal government can raise taxes, on the condition that it gives back 30% of federal direct taxes with formula of taxation. So despite the fact it is apparently vertical, in reality analysis proves it is horizontal.

³ For more detail on the system see Standard & Poor's report: "Increasing German Länder Bond Issuance Focuses Attention on Credit Quality", published on RatingsDirect, Standard & Poor's Web-based credit analysis system, 2 July 2001.

⁴ The evolution of the provincial per capita real Gross Domestic Product (GDP) also shows that less-well-off provinces are catching up with the richer provinces.