EMERGING ISSUES IN FISCAL FEDERALISM

UNITY IN DIVERSITY
LEARNING FROM EACH OTHER

Volume 1 : *Building on and Accommodating Diversities*

Volume 3 : *Interaction in Federal Systems*

Volume 4 : *Local Government in Federal Systems*

Volume 5 : *Policy Issues in Federalism: International Perspectives*

UNITY IN DIVERSITY
LEARNING FROM EACH OTHER

VOLUME 2

Emerging Issues in Fiscal Federalism

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Preface

Rupak Chattopadhyay

This volume is one of five books that cover the proceedings of the 4th International Conference on Federalism. This conference, entitled *Unity in Diversity: Learning from Each Other,* was held in New Delhi between 5 and 7 November 2007, and coincided with the Diamond Jubilee of India's independence in 1947. This was the fourth in a series of major international conferences organized in partnership between host governments and the Forum of Federations. The earlier conferences were held in Canada in 1999, Switzerland in 2002, and Belgium in 2005.

The Forum of Federations was established by the Government of Canada as the secretariat for the 1st International Conference on Federalism held at Mont Tremblant in October 1999. This event provided the first opportunity for experts and practitioners from around the world to ponder the relevance of *Federalism in an Age of Globalization*. Following the Mont Tremblant conference, the Swiss government invited the second conference to be held in Switzerland. A joint initiative by the federal and cantonal authorities, the 2nd International Conference was held in August 2002 at St. Gallen under the title *Federalism in a Changing World: Learning from Each Other*. At the conclusion of the Swiss event, the Belgian prime minister invited the next conference to Brussels. This third conference was held in March 2005 in Brussels under the title *Federalism: Turning Diversity into Harmony, Sharing Best Practices*. The conference was timed to coincide with a series of events aiming to celebrate the 175th anniversary of Belgium's independence, and the 25th anniversary of federalism in the country.

India announced its intention to host the 4th International Conference on Federalism at the conference in Brussels. The Inter-State Council Secretariat (ISCS), Government of India, was identified as the nodal agency to organize the 2007 conference in India, and the Forum of Federations as the permanent secretariat to the International Conferences on Federalism was invited to cooperate with the ISCS. The objective of the 4th International Conference on Federalism was to promote dialogue on the renewal and development of federalism and greater cooperation among practitioners in pursuit of better governance.

The 4th International Conference on Federalism was a two-and-a-half-day event based around four broad themes and twelve subthemes. Each theme was developed by a panel of Indian and international experts. Thematic papers were peer reviewed at a pre-conference held from 21 to 23 February 2007, before being published as background reading for the conference. These papers were not presented at the conference but were made available to practitioners sufficiently in advance to serve as input for informed discussions. These papers influenced the selection of issues and case studies for discussions at the conference work sessions. The rationale and relevance of the themes selected is discussed in the introductory essay by the co-editors of the post-conference publications, Ronald Watts and John Kincaid. The pieces published as part of this series include the revised background papers—revised in the light of discussions at the conference—and analytical summaries of the proceedings from the work sessions. The analytical summaries represent the authors' analysis of discussions at the work sessions that they participated in. Each volume is organized by theme—*Building on and Accommodating Diversities, Emerging Issues in Fiscal Federalism, Interaction in Federal Systems,* and *Local Government in Federal Systems.*

The organization and structure of the 4th International Conference was inspired by the example of International Conference in St. Gallen. The triennial conferences provide a unique forum where practitioners of federalism, academics, and members of NGOs are able to interact and learn from one another. The thematic work sessions are the core events of these conferences. Unlike intergovernmental conferences, senior officials and ministers present did not present existing government positions from prepared texts. Rather, senior practitioners were expected to participate actively in the interactive work sessions, where colleagues from around the world were exposed to diverse points of view and new insights arising from the dialogue. Such a format allowed for maximum participation, while providing an opportunity for peers to draw inspiration from each others' experiences. The work sessions fed their conclusions to theme sessions on each day of the conference. The working days of the conference were capped by plenary sessions where participating heads of state and senior ministers were invited to share their observations on issues of federalism.

The integration of young professionals into the program of the main conference provided an additional international facet. Fifty young professionals from India and other countries were paired up to produce policy-relevant pieces on the conference themes and present their perspectives at the work sessions. The Forum intends to publish a selection of these papers in due course.

Because these conferences are designed to address the needs of all who share an interest in the practice of federalism, these volumes are meant to be accessible even to "non-experts". The volumes are meant to provide surveys of the themes and subthemes. However, each volume contains a select bibliography of suggested readings for anyone interested in pursuing any of the topics in greater depth.

The publication of these volumes constitutes the final step in a process that first began three years ago and would not have been possible without the support of a great many people. The conference would not have been possible without the support and generosity of the Government of India, particularly the Prime Minister's Office and the Ministry of Home Affairs. The Honourable Prithviraj Chavan, Minister of State, Prime Minister's Office, at the initiative of Prime Minister Manmohan Singh, invited the Forum of Federations to partner with the Indian Government in organizing the 4th International Conference on Federalism in New Delhi. The Honourable Shivraj V. Patil, the Home Minister of India, served as host and took great personal interest in ensuring the success of the conference.

Credit is due to the staff of the Inter-State Council Secretariat, the Forum's partner and co-organizer, who, against all odds, successfully organized the largest International Conference on Federalism to date with 1300 participants from more than 100 countries. The Forum could not have hoped for a better partner. In particular, we offer our thanks to Amitabha Pande and S. Lakshminarayanan, who, as Chairs of the Organizing Committee, oversaw management of the whole process. Thanks are also due to the Additional Secretaries, past and present—Ravi Dhingra, S.D. Sharma, Atul Gupta, and Veena Upadhyaya for their diligence and support. On the administrative side, Deputy Secretaries Sudhir Kumar and Amaresh Singh were instrumental in keeping the organizational machinery running and in good order. Raoul Blindenbacher, then Vice President of the Forum, based on his experience of St. Gallen, contributed immensely to the development of the conference design. The Young Professionals Programme was ably coordinated by Assefa Fiseha, Andrea Iff, Paul Morton, and Rekha Saxena. Arif Ali Khan, in addition to the many other hats he wore during the conference, and Libby Johnston helped with the copy-editing of the analytical summaries. Rod MacDonnell deserves special thanks for managing the entire publications process.

Following the tradition of past conferences, we had initially planned on producing a single volume post-conference publication. Significantly, it was George Anderson who first suggested a series of more accessible publications by theme, an idea embraced enthusiastically by Amitabha Pande and the Inter-State Council. Last but not the least, gratitude is due to both the authors of the papers and all those who actively participated in the conference, without whose inputs these volumes would have been difficult to produce.

Introduction

Ronald L. Watts
John Kincaid

The overall theme of the 4th International Conference on Federalism held in New Delhi, 5-7 November 2007, was "Unity in Diversity: Learning from Each Other". Internationally, this topic was a highly relevant focus because in the contemporary world, federalism as a political idea has become increasingly important as a way of peacefully reconciling unity and diversity within political systems. Diversity is seen here primarily as qualitative collective characteristics based on language, religion, ethnicity, nationality, culture, and race rather than gender, class, status, occupation, and the like (although the latter are certainly not unimportant). Use of the word "in" purposely signifies that unity can be grounded in diversity, that diversity can give rise to unity, that unity need not dissolve diversity into homogeneity, and that there is no necessary contradiction between unity and diversity. Indirectly, the title also signifies the diversity of federal systems in today's world and the need for citizens and public officials in those systems, as well as in emergent and would-be federations, to learn from each other in both practical and theoretical ways.

Federalism has grown in importance, in part because modern developments in transportation, social communications, technology, industrial organization, globalization and knowledge-based societies have all contributed to simultaneous needs for both larger and smaller political units. Thus, there have developed two powerful, thoroughly interdependent, yet distinct and often actually opposed motives for federating. One is the desire to build dynamic, efficient, and modern nation states (e.g. India and the United States) or supernational political systems (e.g. the European Union) for economic progress, for security, and for influence in the world arena. The other is the desire to express distinctive identities through smaller, directly accountable self-governing political units able to give expression to historical, social, linguistic or cultural diversity.

In such a context, federal solutions have had an increasingly widespread appeal. They enable a combination of (a) shared governance in a large political unit for certain common purposes, and (b) autonomous self-governance for the various diverse groups in smaller constituent units of government directly and democratically responsible to their own electorates. By combining elements of shared rule in larger units and self-rule in smaller regional units, federal political systems provide the closest institutional approximation to the complex multicultural and multidimensional economic, social and political reality of the contemporary world.

As a result, there are in the world today some two dozen countries that are federal in their character, claim to be federal, or exhibit the characteristics typical of federations. Although federal institutions are not applicable to all situations, nearly 40 per cent of the world's population encompassing a total of some 510 federated political communities (e.g. cantons, provinces, or states) now live in countries that can be considered or claim to be federations, many of which are multicultural or even multinational in their composition. Furthermore, a number of countries such as Belgium, Ethiopia, Italy, South Africa, and Spain, among others, appear to be forging new and innovative variants of traditional federal forms.

Another notable contemporary trend in response to changing world conditions has been the evolving character of the existing and older federations. Many are undertaking reforms and modifications of institutional arrangements and processes in order to adapt to these new conditions. It is these developments that led to the formation of the International Forum of Federations in 1998 as a way of facilitating the exchange of experience among practitioners, politicians, civil servants and academics in federations. A key feature of the operation of the Forum of Federations has been the holding of large triennial international conferences on federalism. The one held in New Delhi in November 2007 was the fourth.

Indeed, it was particularly appropriate that the 4th International Conference on federalism provided an opportunity for participants from other federations, as well as many other countries, to learn from the experience of the Indian Union in uniting its rich diversity of 1.1 billion people within an embracing unity. Among federations, the magnitude of India's diversity and its achievement of an encompassing unity stand out, although partition into the Dominion of India and the Dominion of Pakistan, along with some population exchanges, were required at the time of independence in 1947, and certain intergroup conflicts have persisted since independence. There are more linguistic variations in India than in any other federation on the globe. But also there is an enormous range of other forms of diversity. Four of the world's major religions—Hinduism, Buddhism, Jainism and Sikhism—originated on the Indian subcontinent, and Judaism, Zoroastrianism, Christianity, and Islam arrived there long ago. Indeed, Pandit Jawaharlal Nehru's *Discovery of India* (1946) described in lyrical terms the diversity of India from north to south and east to west. Hence, the appropriateness of the holding of the 4th International Conference in India.

Within the general focus of reconciling unity and diversity, the 4th International Conference was based on four broad themes; within each of these, there were three subthemes. These themes and subthemes were developed by a panel made half of Indian and half of international experts. The four theme and the twelve subtheme papers were prepared by expert scholars and were distributed in advance as background reading for the participants in the conference. These papers provided a framework for identifying specific cases and issues that were considered and discussed at the working sessions of the conference.

The four broad themes identified for the 4th International Conference on Federalism were: (1) building on and accommodating diversities, (2) emerging issues in fiscal federalism, (3) interaction within federal systems, and (4) local governments and metropolitan regions in federal systems.

The first theme, *Building on and Accommodating Diversities*, was chosen as the lead-off theme because of the widespread use of federalism throughout the world to accommodate diversities and the variety of arrangements that have been developed for doing this in different federations (e.g. Belgium, India, Nigeria, and Switzerland). The theme paper draws attention to the extent to which diversity is not to be viewed simply as a problem but as an asset to be built upon in the process of nation-building. This paper also makes the very important point that diversity can enrich a polity. Subtheme paper "Nation Building and Diversity" deals with the various forms of diversity that have to be accommodated in the process of nation-building. Nation-building is a necessity when the social milieu is diverse, and the various constituent groups need both identity and voice within the nation state rather than marginalization or homogenization. Subtheme paper "Autonomy and Diversity" relates to the use of autonomy by the constituent orders of government to accommodate the distinctive interests of diverse groups. The paper attempts to elucidate the concept of autonomy, suggest which groups can legitimately and realistically claim institutional autonomy, and examine the pros and cons of various territorial and personal accommodations of diversity. Subtheme paper "Managing Conflicts of Diversity", deals with the various ways in which conflict among diverse groups has been moderated in federations, including lessons for mature federations drawn from the experience and innovations of newer federations. The author emphasizes that there are various good and effective conflict-management devices even while there are no universally applicable best practices. The preceding four papers constitute Volume I of four published volumes of the conference papers.

The second broad theme was *Emerging Issues in Fiscal Federalism.* This theme was considered to be of particular importance because the financial arrangements within a federation have significant impact on its operation. These arrangements can be especially salient and volatile in federations characterized by high levels of diversity wherein various groups are highly sensitive to who pays what and who gets what out of any given system of fiscal federalism. Here too, three subthemes were identified. The theme paper examines the appropriate allocation of revenue and expenditure responsibilities, an important issue in all federations. The authors attempt to base the analysis on neutral principles derived from empirical research in political economy. Subtheme paper "Assignment Systems in Federations" examines the problems of establishing a harmonized VAT (value added tax)—which is a very widely used tax internationally—in a federal system, especially because of the difficulty of designing a destination-based subnational VAT. Subtheme paper "Managing Fiscal Conflicts" includes lessons from the experience in different federations. Fiscal conflicts, which are a regular feature of federal systems, can arise intergovernmentally between the national, regional, and/or local governments or interjurisdictionally between constituent governments or between local governments themselves. The existence of viable and long-lasting federations (e.g. Australia, Canada, Germany, Switzerland, and the United States) clearly indicates that such conflicts can be managed pacifically, but the existence of societal diversity and cultural cleavages within a federation can certainly make conflict management challenging. Subtheme paper "Fiscal Federalism and Regional Equity" includes appropriate corrective objectives and methods, especially in light of the mismatches between the resource-raising capacities and expenditure responsibilities of the various constituent governments of a federation. Issues associated with such mismatches can be heightened in federations characterized by diversity because various groups are desirous of remaining within various territorial units rather than being mobile across territorial jurisdictions. The preceding four papers make up Volume II of four published volumes of the conference papers.

The third overall theme was *Interaction in Federal Systems*. Given the unavoidability of overlaps in the responsibilities of governments within a federation, as well as the existence of culturally diverse constituent political communities in most federations, intergovernmental interaction has been an important element in all federations. The authors chose the term "interaction" in order to emphasize the breadth of the topic and the blurring that has occurred between government institutions and the many private and non-profit organizations in the market and in civil society that engage governments. Three subthemes were selected for this discussion, too. Subtheme paper "Anticipating and Managing Tension and Conflicts" examines judicial, legislative, and executive approaches to managing conflicts that go beyond those associated with fiscal federalism. The author focuses particularly on financial equity across constituent units, threats of terrorism, and the ownership and taxation of natural resources. Subtheme paper "Techniques, Structures, and Processes" examines principally relations between federal or national governments and their constituent units. The author looks at both intra-state and inter-state interactions and seeks to uncover common features and converging trends of intergovernmental relations across federal countries. Subtheme paper "Accountability and Transparency" focuses on problems of corruption and on the importance of ensuring accountability and transparency in intergovernmental interactions. The preceding four papers constitute Volume III of four published volumes of the conference papers.

The fourth theme, *Local Government in Federal Systems*, was not a focus in any of the three previous international conferences. In all federations in recent years, there has been a growing awareness of the importance of local governments and also metropolitan regions. The fourth theme overview paper emphasizes local government's closeness to civil society and its role in enabling disadvantaged groups, including women, to participate in governance. The authors also look at the differential constitutional arrangements for local governments in federal countries and highlight the complex challenges of governing megacities. The three subthemes include the following. Subtheme "Enhancement of Democracy through Empowerment of Disadvantaged Groups" focuses on enhancing democracy through the empowerment of disadvantaged groups and civil society in local government arenas. The author argues that there is a need to establish inclusive local democratic institutions by strengthening civil-society organizations locally, empowering women and disadvantaged groups, making local decision-making more participatory, and making participatory decision-making itself more inclusive. Subtheme papers "The Functioning of Local Governments and their Relationship with Upper Levels of Government" and "The Functioning of Local Government in

Federal Systems: Perspectives from India" focuses primarily on local government in India and critically examines a number of issues involving India's local self-governments, including the utility of using the term "local self-government" as opposed simply to "local government". Subtheme paper "Governance of Megacities in Federal Orders" examines the challenges and options for governing metropolitan regions and megacities, namely, cities of more than 10 million inhabitants. Given the growth of the number of megacities around the world, the importance of these regions as drivers of the economy and their position and relation to other governments and to states within federal systems make them somewhat anomalous in relation to traditional federal structures. According to the United Nations, 2007 was the first year in human history that the world's urban population exceeded the rural population, a trend which indicates the importance of including an examination of the role of megacities within federations. The preceding four papers make up Volume IV of four published volumes of the conference papers.

These four sets of significant issues in contemporary federations are of interest to those working in all federations, old and new. Each set is related to the overall theme of the conference, the reconciling of diversity and unity. The theme and subtheme papers, revised to take account of discussions at the conference, and the analytical summaries of the workshop discussions, are now published in the form of four post-conference volumes, one for each theme. These issues discussed at the conference involve problems common to many federations. There is, therefore, a genuine value to those working in each federation, whether old or new, in learning from the experience of federations elsewhere. Of course, each federation reflects the particular circumstances and conditions that produce it; therefore, there is no pure ideal model of federalism that is applicable everywhere. Nevertheless, there are useful lessons to be learned from the discussions of the themes that served as the key foci for the 4th International Conference on Federalism.

THEME AND SUBTHEME PAPERS

Theme Paper

Emerging Issues in Fiscal Federalism

Anwar Shah
Indira Rajaraman
Fernando Rezende

Abstract

This paper is intended to serve as a primer for the theme of fiscal federalism—design of fiscal constitutions for countries where government functions are shared among multiple orders of government. Principles and practices in allocation of spending, taxing and regulatory responsibilities are presented followed by a discussion of current issues in practice. An overview of the principles and practices of intergovernmental transfers is presented. A synthesis of tools and mechanisms for dealing with fiscal conflicts and overcoming regional fiscal disparity is elaborated. Finally, underlying reasons for the growing popularity of federal model of governance are explored.

1. Introduction

Fiscal federalism is concerned with the design of fiscal constitutions when decision-making is among various orders of governments. The design of fiscal constitutions entails the division of powers for taxing, spending and regulatory functions as well as fiscal arrangements that accompany such arrangements. This paper presents an overview of principles and practices in fiscal federalism and highlights emerging challenges and responses to these challenges by federal countries.

The rest of the paper is organized as follows. Section 2 is concerned with the allocation of responsibilities. It provides an overview of expenditure assignment principles and practices followed by tax assignment principles and practices. Section 3 provides an introductory overview of intergovernmental finance and distils lessons from practice of intergovernmental transfers and institutional arrangements for fiscal relations. Section 4 deals with resolving fiscal conflicts. Section 5 highlights mechanisms for achieving regional equity in federal countries. A final section reflects on the reasons behind the growing popularity of the federal model of governance.

2. Allocation of Responsibilities

The "assignment problem", or the allocation of expenditure and tax functions to various levels of governments, is the most fundamental issue in a federation. It is therefore the first fiscal subtheme we have identified for consideration. The literature on fiscal federalism argues that finance should follow function. Assigning responsibility for spending must, therefore, precede assigning responsibility for taxation, because tax assignment is generally guided by spending requirements at different levels and cannot be determined in advance. It may be desirable to decentralize taxation at the same time as decentralizing spending, so that subnational governments will not have to rely exclusively on grants from higher levels of government. If subnational governments are not responsible for raising at least some level of their revenues, they may have too little incentive to provide local public services in a cost-effective way. If subnational governments are assigned more revenues than their spending requires, they may have an incentive to reduce taxes or increase public sector wages.

2.1 *Expenditure Assignments Principles*

The fiscal federalism literature provides broad guidance in delineating expenditure responsibilities among member units in a federation. The basic principles enunciated by this literature are relevant even for unitary states where subnational governments are simply extensions of higher level governments. In such cases, by following these principles, the central government's agents face just the right incentives for efficient and equitable delivery of public services. These principles are discussed below and qualifications where appropriate for unitary governments are stated.

2.1.1 *Efficient Provision of Public Services*

Public services are provided most efficiently "by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision" (Oates, 1972, p. 55). Nevertheless, some degree of central control or compensatory grants may be warranted in the provision of services when there are spatial externalities or economies of scale.

2.1.2 *Fiscal Efficiency*

Decentralized decision-making in a federation results in differential net fiscal benefits (imputed benefits from public services minus tax burden) being realized by citizens depending on the fiscal capacities of their place of residence. It is argued that such differential net benefits (NFBs) would encourage people to move to a resource rich area, although appropriate economic opportunities may not exist. It is argued that the national government should have a role in correcting such a "fiscal inefficiency" (Boadway and Shah, 1993; Boadway, Roberts, Shah, 1994).

2.1.3 *Regional (Horizontal) Equity*

Differential net fiscal benefits across various jurisdictions also lead to unequal treatment of citizens with identical private incomes depending on their place of residence. This is because their after-tax income inclusive of NFB would be different depending on their residence. This calls for a role by the national government in dealing with these fiscal inequities.

2.1.4 *Redistributive Role of the Public Sector*

While the central government may assume a dominant role in pursuit of vertical equity, involvement of subnational governments in implementing specific programs can be tailored to meet individual jurisdictions' circumstances (Boadway, 1992).

2.1.5 *Provision of Quasi-Private Goods*

Modern governments provide many services that by virtue of their technologies are essentially private goods, for example, health, education, and social insurance. Public provision of these private services is justified on grounds of equity. Since benefits accrue mainly to residents of separate jurisdictions, such services would be better provided by subnational governments. A central government's involvement is nevertheless justified to ensure horizontal and minimum standards of service in all jurisdictions—such standards for most services encourage the free flow of goods and services in the nation as a whole.

2.1.6 *Preservation of Internal Common Market*

As suggested by Boadway (1992), constitutional guarantees for free domestic flow of goods and services may be the best alternative to assigning regulatory responsibilities solely to the central government.

2.1.7 *Economic Stabilization*

It is customary to argue that the federal government should be responsible for stabilization policies because such policies cannot be carried out effectively by a local jurisdiction. Local pursuit of such fiscal policies leads to much of the gains being lost to outside jurisdictions. A monetary policy has little scope for being carried out at a local level. These guidelines for a centralized fiscal policy have, however, only limited relevance for a country with a decentralized constitution. Decentralized countries overcome these limitations by having an independent central bank with a mandate for price stability and through institutional arrangements for fiscal policy consultation and coordination.

2.1.8 *Spending Power*

In a federation, there is always some degree of conflict among priorities established by various orders of government. One way to induce lower order governments to follow priorities established by the higher order government is for the higher order government to use its powers of the purse, the so-called spending power. Both the national and state governments could legitimately pursue such policies.

Besides having exclusive authority to carry out monetary policy and provide public services that are national in scope, the central government has a role in correcting fiscal inefficiencies and regional inequities arising from differential fiscal capacities of various jurisdictions. It has also a redistributive role, exercised through a tax and transfer system or through the joint provision of such public services as education and health, which are "transfers in kind" (Boadway, 1992). The central government may also provide compensatory grants to cover the spillovers from provincial-level services.

Both the central and provincial governments could provide matching transfers to influence lower level priorities to further their own objectives. All other services are best provided by local governments, with central and provincial governments defining minimum standards. Table 1 presents a representative assignment of major public services based on theoretical considerations discussed earlier. The table shows that a significant number of major services would be suitable for concurrent assignment to two or more orders of government. For such services, it is important to specify clearly and precisely the roles of various levels of government to avoid duplication and confusion and to ensure accountability to electorate. Such precise specification is critical for infrastructure and social services in most developing countries.

2.2 *Roles and Responsibilities of Local Governments*

The fiscal federalism approach treats local government as a subordinate tier in a multi-tiered system and outlines principles for defining the roles and responsibilities of orders of government. Hence, one sees that in most federations, as in Canada and the United States (*dual federalism*), local governments are extensions of the state governments. In a few isolated instances, as in Brazil

Table 1. Representative Assignment of Expenditure Responsibilities

Function	*Policy, standards, and oversight*	*Provision and administration*	*Production and distribution*	*Comments*
Interregional and international conflicts resolution	U	U	N, P	Benefits and costs international in scope
External Trade	U	U, N, S	P	Benefits and costs international in scope
Telecommunications	U, N	P	P	Has national and global dimensions
Financial transactions	U, N	P	P	Has national and global dimensions
Environment	U, N, S, L	U, N, S, L	N, S, L, P	Externalities of global, national, state, and local scope
Foreign direct investment	N, L	L	P	Local infrastructure critical
Defence	N	N	N, P	Benefits and costs national in scope
Foreign Affairs	N	N	N	Benefits and costs national in scope
Monetary policy, currency, and banking	U, ICB	ICB	ICB, P	Independence from all levels essential; some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility

Table 1—*continued*

Function	*Policy, standards, and oversight*	*Provision and administration*	*Production and distribution*	*Comments*
Immigration	U, N	N	N	U because of forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law, a national concern
Industrial policy	N	N	P	Intended to prevent "beggar thy neighbour" policies
Regulation	N	N, S, L	N, S, L, P	Internal common market
Fiscal Policy	N	N, S, L	N, S, L, P	Coordination possible
Natural Resources	N	N, S, L	N, S, L, P	Promotes regional equity and internal common market
Education, health, and social welfare	N, S, L	S, L	S, L, P	Transfers in kind
Highways	N, S, L	……	S, L, P	Benefits and costs vary in scope
Parks and recreation	N, S, L	N, S, L	N, S, L. P	Benefits and costs vary in scope
Police	S, L	S, L	S, L	Primarily local benefits
Water, sewer, refuse and fire protection	L	L	L, P	Primarily local benefits

Note: **U** = supranational responsibility, **ICB** = independent central bank, **N** = national government, **S** = state or provincial government, **L** = local government, **P** = nongovernmental sectors or civil society.
Source: Shah (1994, 2004, 2007) and Boadway and Shah (forthcoming).

(*cooperative federalism*), they are equal partners with higher-level governments, and in an exceptional case, Switzerland, they are the main source of sovereignty and have greater constitutional significance than the federal government. Thus, depending on the constitutional and legal status of local governments, state governments in federal countries assume varying degrees of oversight of the provision of local public services. That is why one sees an insignificant role for local governments in Australia but an expansive role in Brazil and Switzerland.

The fiscal federalism literature, however, does provide a normative framework for assignment of responsibilities to local governments. The assignment of public services to local governments or to metropolitan or regional governments can be based on considerations such as economies of scale, economies of scope (appropriate bundling of local public services to improve efficiency through information and coordination economies and enhanced accountability through voter participation and cost recovery) and cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and budgetary choices about the composition of spending (Table 2). The particular level of government to which a service is assigned determines the public or private production of the service in accordance with consi-derations of efficiency and equity. Large metropolitan areas with populations in excess of one million could be considered for subdivision into a first tier of municipal governments of smaller size responsible for neighbourhood-type services and a second tier of metropolitan-wide government providing area-wide services. The first-tier governments could be directly elected, and elected mayors of these governments could form the metropolitan council at the second tier. Two-tier structures for metropolitan governance have been practiced in Melbourne, Australia; Vancouver, Canada; Allegheny county, Pennsylvania, United States; and Stockholm, Sweden.

In mature federations, special-purpose agencies or bodies deliver a wide range of metropolitan and regional public services, including education, health, planning, recreation, and environmental protection. Such bodies can include education and library boards; transit and police commissions; and utilities providing water, gas, and electricity. These agencies deal with public services whose delivery areas transcend political jurisdictions and are better financed by loans, user charges, and earmarked benefit taxes, such as a supplementary mill rate on a property tax base to finance a local school board. If kept to a minimum, such agencies help fully exploit economies of scale in the delivery of services where political boundaries are not consistent with service areas. A proliferation of these agencies can undermine accountability and budgetary flexibility at local levels. Accountability and responsiveness to voters are weakened if members of special-purpose bodies are appointed rather than elected. Budgetary flexibility is diminished if a majority of local expenditures fall outside the control of local councils.

2.3 *Current Issues in Expenditure Assignment*

The information revolution and globalization are posing special challenges to constitutional assignment within countries. The information revolution, by letting the sun shine on government operations, empowers citizens to demand greater accountability from their governments. Globalization and the information revolution represent a gradual shift to supranational regimes and local governance. In adapting to this world, there is a growing tension among various orders of governments in federal systems to reposition their roles in order to retain relevance. The federal and provincial governments in mature federations are continuously redefining their roles with the federal government attempting to take over some provincial functions while it looses its control in its traditional areas of responsibility to supranational regimes. Similarly, provincial governments seek greater involvement in local functions. In new federations, decentralization of expenditure responsibilities is being followed by regulatory oversight and controls by higher level governments. Further, unfunded mandates to local governments represent a major source of tension. While the globalization and information revolution calls for local governments to perform a wider role in local governance, assumption of such role is hampered by constitutional and legal provisions in most federal countries and is further constrained by strategic behaviours of federal and provincial governments.

Table 2. Assignment of local public services to municipal and regional/metropolitan governments

Public service	*Allocation criteria for provision*						*Allocation criteria for public vs. private production*			
	Economies of scale	*Economies of scope*	*Benefit cost spillout*	*Political proxi-mity*	*Consumer sover-eignty*	*Economic evalua-tion of sectoral choices*	*Compo-site*	*Effici-ency*	*Equity*	*Composite*
Fire fighting	L	L	L	L	L	M	L	P	G	P
Police protection	L	L	L	L	L	M	L	P	G	G
Refuse collection	L	L	L	L	L	M	L	P	P	P
Neighbourhood parks	L	L	L	L	L	M	L	P	G	G
Street maintenance	L	L	L	L	L	M	L	P	P	P
Traffic management	L	M	L	L	L	M	L	P	P	P
Local transit service	L	M	L	L	L	M	L	P	P	P
Local libraries	L	L	L	L	L	M	L	G	G	G
Primary education	L	L	M	M	L	M	M	P	G	P, G
Secondary education	L	L	M	M	L	M	M	P	G	P, G
Public transport	M	M	M	L, M	M	M	M	P, G	G	P, G
Water supply	M	M	M	L, M	M	M	M	P	G	P, G

Table 2—*continued*

Public service	*Allocation criteria for provision*						*Allocation criteria for public vs. private production*			
	Economies of scale	*Economies of scope*	*Benefit cost spillout*	*Political proxi-mity*	*Consumer sover-eignty*	*Economic evalua-tion of sectoral choices*	*Compo-site*	*Effici-ency*	*Equity*	*Composite*
Sewage disposal	M	M	M	M	M	M	M	P, G	P, G	P, G
Refuse disposal	M	M	M	M	M	M	M	P	P	P
Public health	M	M	M	M	M	M	M	G	G	G
Hospitals	M	M	M	M	M	M	M	P, G	G	P, G
Electric power	M	M	M	M	M	M	M	P	P	P
Air and water pollution	M	M	M	M	M	M	M	G	G	G
Special police	M	M	M	M	M	M	M	G	G	G
Regional parks	M	M	M	L, M	M	M	M	G	G	G
Regional planning	M	M	M	L, M	M	M	M	G	G	G

Note: **L** is local government, **M** is regional/metropolitan government; **G** is public sector, **P** is nongovernmental sector.
Source: Shah (2007).

2.4 *Tax Assignment Principles*

The division of revenue sources among federal and subnational governments constitutes the tax assignment problem. Once expenditure assignment has been agreed on, tax assignment and design of transfers become critical elements in matching expenditure needs with revenue means at various levels of government. Tax assignment can be undertaken independently of expenditure assignment—a common practice in developing countries. The advantages of centralized tax administration and decentralized provision of public services become apparent, however, when tax assignment reflects anticipated spending. Such arrangements prevent overdependence of lower levels of government on intergovernmental transfers, which can otherwise distort local spending priorities. Where theoretical guidance on tax assignment is unclear, expenditure assignment can provide a powerful argument for assigning tax responsibility to the government with the greatest need for more money. Efficiency and equity arguments have to be tempered by administrative considerations, and the exact assignment depends upon informed judgement. We can, however, outline the economic principles that come into play in deciding which taxes to assign to what order of government.

Four general principles require consideration in assigning taxing powers to various governments. First, the *economic efficiency* criterion dictates that taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the central government. Subnational assignment of taxes on mobile factors may facilitate the use of socially wasteful "beggar thy neighbour" policies to attract resources to their own areas by regional and local governments. In a globalized world, even the central assignment of taxes on mobile capital may not be very effective in the presence of tax havens and the difficulty of tracing and attributing incomes from virtual transactions to various physical spaces. Second, *national equity* considerations warrant that progressive redistributive taxes should be assigned to the central government, which limits the possibility of regional and local governments following perverse redistribution policies using both taxes and transfers to attract high-income people and repel low-income ones. Central assignment of progressive redistributive taxes, however, leaves open the possibility of supplementary, flat-rate, local charges on residence-based national income taxes. Third, the *administrative feasibility* criterion (lowering compliance and administration costs) suggests that taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. This criterion minimizes administrative costs as well as the potential for tax evasion. For example, property, land and betterment taxes are good candidates for local assignment because local governments are in a better position to assess the market values of such assets. Fourth, the *fiscal need* or *revenue adequacy* criterion suggests that to ensure accountability, revenue means (the ability to raise revenues from own sources) should be matched as closely as possible with expenditure needs. The literature also argues that long-lived assets should primarily be financed by raising debt, so as to ensure equitable burden sharing across generations (Inman, 2005). Furthermore, such large and lumpy investments typically cannot be financed by current revenues and reserves alone.

These four principles suggest that user charges are suitable for use by all orders of government, but the case for decentralizing taxing powers is not as compelling as that for decentralizing public service delivery. This is because lower-level taxes can introduce inefficiencies in the allocation of resources across the federation and cause inequities among people in different jurisdictions. In addition, collection and compliance costs can increase significantly. These problems are more severe for some taxes than others, so the selection of which taxes to decentralize must be made with care, balancing the need to achieve fiscal and political accountability at the lower levels of government against the disadvantages of having a fragmented tax system. Table 3 illustrates a representative assignment of taxing powers. The trade-off between increased account-ability and increased economic costs from decentralizing taxing responsibilities can be mitigated by fiscal arrangements that permit joint occupation and harmonization of taxes to overcome fragmentation and by fiscal equalization transfers that will reduce the fiscal inefficiencies and inequities that arise from different fiscal capacities across regional and local governments.

Table 3. A Representative Assignment of Taxing Powers

Type of tax	*Determination of*		*Collection and administration*	*Comments*
	Base	*Rate*		
Customs	N	N	N, P	International trade taxes
Corporate income	N, U	N, U	N, U	Mobile factor, stabilization tool
Resource taxes Resource rent (profits, income) tax	N	N	N	Highly unequally distributed tax bases
Royalties, fees, charges, severance taxes, production, output, and property taxes	S, L	S, L	S, L, P	Benefit taxes/charges for state-local services
Conservation charges	S, L	S, L	S, L, P	To preserve local environment
Personal income	N	N, S, L	N	Redistributive, mobile factor; stabilization tool
Wealth taxes (taxes on capital, wealth), Wealth transfers, inheritances, and bequests	N,	N, S	N	Redistributive
Payroll	N, S	N, S	N, S	Benefit charge, e.g. social security coverage
Multistage sales taxes (value-aided tax) [VAT])	N	N	N	Border tax adjustments possible under federal assignment; potential stabilization tool
Single-state sales taxes (manufacturer, wholesale, retail)				
Option A	S	S, L	S, L	Higher compliance cost
Option B	N	S	N	Harmonized, lower compliance cost
"Sin taxes"Excises on alcohol and tobacco	N, S	N, S	N, S, P	Health care a shared responsibility

Table 3—*continued*

Type of tax	*Determination of*		*Collection and administration*	*Comments*
	Base	*Rate*		
Betting, gambling	S, L	S, L	S, L, P	State and local responsibility
Lotteries	S, L	S, L	S, L, P	State and local responsibility
Race tracks	S, L	S, L	S, L, P	State and local responsibility
Taxation of "bad" Carbon	N, U	N, U	N, U	To combat global/national pollution
BTU Taxes	N, S, L	N, S, L	N, S, L, P	Pollution impact may be national, regional or local
Motor fuels	N, S, L	N, S, L	N, S, L, P	Tolls on federal/provincial/local roads
Effluent charges	N, S, L	N, S, L	N, S, L, P	To deal with interstate intermunicipal or local taxes
Congestion tolls	N, S, L	N, S, L	N, S, L, P	Tolls on federal/provincial/local roads
Parking fees	L	L	L, P	To control local congestion
Motor vehicles: Registration, transfer taxes and annual fees	S	S	S	State responsibility
Driver's kitchen fees	S	S	S	State responsibility
Business taxes	S	S	S	Primarily local benefits
Excises	S, L	S, L	S, L	Residence-based taxes
Property	S	L	L	Completely immobile factor, benefit tax
Land	S	L	L	Completely immobile factor, benefit tax
Frontage, betterment	S, L	L	L	Cost recovery
Poll	N, S, L	N, S, L	N, S, L	Payment for services
User charges	N, S, L	N, S, L	N, S, L, P	Payment for services received

Note: **U** is supranational agency, **N** is national/federal, **S** is state or province, **L** is municipal or local and **P** is private.
Source: Shah (2007) and Boadway and Shah (forthcoming).

2.5 *Current Issues in Tax Assignment Practice*

The coordination of sales taxes, the assignment of resources taxation and local revenue autonomy remain sources of major conflict in federal countries. The coordination of sales taxes where all orders of government are involved in some form of sales taxation remains an area of major conflict with no easy compromises. While conceptually such issues can be resolved amicably, in practice, these have proven intractable politically. Resource taxation is another area of conflict in federal countries due to uneven geographical concentration of resources. For local taxes, revenue autonomy in setting tax bases remains an elusive issue in many federal countries.

3. Instruments of Intergovernmental Finance

Instruments of intergovernmental finance have an important bearing on efficiency, equity and accountability in federal systems. These are discussed below.

3.1 *Tax Base and Revenue Sharing Mechanisms*

Tax base and revenue sharing mechanisms are customarily used to address fiscal imbalances or mismatched revenue means and expenditure needs arising from the constitutional assignment of taxes and expenditures to different levels of governments. Tax base sharing means that two or more levels of government levy rates on a common base. Tax base determination usually rests with the higher-level government with lower orders of government levying supplementary rates on the same base. Tax collection is by one level of government, generally the central government in market economies and the local government in centrally planned economies, with proceeds shared downward or upward depending on revenue yields. Tax base sharing is quite common in mature federations and almost nonexistent in newer federations in developing countries.

A second method of addressing vertical fiscal imbalances is revenue sharing, whereby one level of government has unconditional access to a specified share of revenues collected by another level. Revenue sharing agreements typically specify how revenues are to be shared among federal and lower level governments, with complex criteria for allocation and for the eligibility and use of funds. Such limitations run counter to the underlying rationale of unconditionality. Revenue sharing mechanisms are quite common in developing countries. They often address multiple objectives, such as bridging fiscal gaps, promoting fiscal equalization and regional development, and stimulating tax effort at lower levels.

3.2 *Intergovernmental Transfers*

Intergovernmental transfers or grants can be broadly classified into two categories: general-purpose (unconditional) and specific-purpose (conditional or earmarked) transfers.

3.2.1 *General-Purpose Transfers*

General-purpose transfers are provided as general budget support, with no strings attached. These transfers are typically mandated by law, but occasionally they may be of an ad hoc or discretionary nature. Such transfers are intended to preserve local autonomy and enhance interjurisdictional equity. General-purpose transfers are termed bloc transfers when they are used to provide broad support in a general area of subnational expenditures (such as education) while allowing recipients discretion in allocating the funds among specific uses. General-purpose transfers simply augment the recipient's resources. Since the grant can be spent on any combination of public goods or services or used to provide tax relief to residents, general non-matching assistance does not affect relative prices. Formula-based general-purpose transfers are very common.

3.2.2 *Specific-Purpose Transfers*

Specific-purpose, or conditional, transfers are intended to provide incentives for governments to undertake specific programs or activities. These grants may be regular or mandatory in nature or discretionary or ad hoc. Conditional transfers typically specify the type of expenditures that can be financed (input-based conditionality). These may be capital expenditures, operating expenditures, or both. Conditional transfers may also require attainment of certain results in service delivery (output-based conditionality). Input-based conditionality is often intrusive and unproductive, whereas output-based conditionality can advance grantors' objectives while preserving local autonomy.

Conditional non-matching transfers provide a given level of funds without local matching, as long the funds are spent for a particular purpose. Conditional non-matching grants are best suited for subsidizing activities considered high priority by a higher-level government but low priority by local governments.

Conditional transfers may incorporate matching, provisions—requiring grant recipients to finance a specified percentage of expenditures using their own resources. Matching requirements can be either open-ended, meaning that the grantor matches whatever levels of resources the recipient provides, or closed-ended, meaning that the grantor matches recipient funds only up to a pre-specified limit.

Matching requirements encourage greater scrutiny and local ownership of grant-financed expenditures; closed-ended matching is helpful in ensuring that the grantor has some control over the costs of the transfer program. Matching requirements, however, represent a greater burden for a recipient jurisdiction with limited fiscal capacity. In view of this, it may be desirable to set matching rates in inverse proportion to the per capita fiscal capacity of the jurisdiction in order to allow poorer jurisdictions to participate in grant-financed programs.

Conditional open-ended matching grants are the most suitable vehicles to induce lower-level governments to increase spending on the assisted function. If the objective is simply to enhance the welfare of local residents, general-purpose non-matching transfers are preferable, as they preserve local autonomy. To ensure accountability for results, conditional non-matching output-based transfers are preferable to other types of transfers. Output-based transfers respect local autonomy and budgetary flexibility while providing incentives and accountability mechanisms to improve service delivery performance.

3.2.3 Designing Fiscal Transfers

The design of fiscal transfers is critical to ensuring the efficiency and equity of local service provision and the fiscal health of subnational governments (for a comprehensive treatment of the economic rationale of intergovernmental fiscal transfers, see various chapters in Boadway and Shah, 2007). A few simple considerations can be helpful in designing these transfers.

3.2.4 *Guidelines for Grant Design*

1. *Clarity in grant objectives*. Grant objectives should be clearly and precisely specified in order to guide grant design.
2. *Autonomy*. Subnational governments should have complete independence and flexibility in setting priorities. They should not be constrained by the categorical structure of programmes and uncertainty associated with decision-making at the centre. Tax-base sharing—allowing subnational governments to introduce their own tax rates on central bases, formula-based revenue sharing, or bloc grants—is consistent with this objective.
3. *Revenue adequacy*. Subnational governments should have adequate revenues to discharge designated responsibilities.
4. *Responsiveness*. The grant programme should be flexible enough to accommodate unforeseen changes in the fiscal situation of the recipients.
5. *Equity (fairness)*. Allocated funds should vary directly with fiscal need factors and inversely with the tax capacity of each jurisdiction.
6. *Predictability*. The grant mechanism should ensure predictability of subnational governments' shares by publishing five-year projections of funding availability. The grant formula should specify ceilings and floors for yearly fluctuations. Any major change in the formula should be accompanied by hold-harmless or grandfathering provisions.
7. *Transparency*. Both the formula and the allocations should be disseminated widely, in order to achieve as broad a consensus as possible on the objectives and operation of the programme.
8. *Efficiency.* The grant design should be neutral with respect to subnational governments' choices of resource allocation to different sectors or types of activity.

9. *Simplicity.* Grant allocation should be based on objective factors over which individual units have little control. The formula should be easy to understand, in order not to reward grantsmanship.
10. *Incentive.* The design should provide incentives for sound fiscal management and discourage inefficient practices. Specific transfers to finance subnational government deficits should not be made.
11. *Reach.* All grant-financed programmes create winners and losers. Consideration must be given to identifying beneficiaries and those who will be adversely affected to determine the overall usefulness and sustainability of the programme.
12. *Safeguarding of grantor's objectives.* Grantor's objectives are best safeguarded by having grant conditions specify the results to be achieved (output-based grants) and by giving the recipient flexibility in the use of funds.
13. *Affordability.* The grant programme must recognize donors' budget constraints. This suggests that matching programmes should be closed ended.
14. *Singular focus.* Each grant programme should focus on a single objective.
15. *Accountability for results.* The grantor must be accountable for the design and operation of the programme. The recipient must be accountable to the grantor and its citizens for financial integrity and results—that is, improvements in service delivery performance. Citizens' voice and exit options in grant design can help advance bottom-up accountability objectives.

Some of these criteria may be in conflict with others. Grantors may therefore have to assign priorities to various factors in comparing design alternatives (Boadway et al., 1994b; Canada 2006; Shah, 2007, Boadway and Shah, forthcoming).

As noted earlier, for enhancing government accountability to voters, it is desirable to match revenue means (the ability to raise revenues from own sources) as closely as possible with expenditure needs at all levels of government. However, higher-level governments must be allowed greater access to revenues than needed to fulfil their own direct service responsibilities, so that they are able to use their spending power through fiscal transfers to fulfil national and regional efficiency and equity objectives.

Broad objectives for national fiscal transfers can be identified. Each of these objectives may apply to varying degrees in different countries; each calls for a specific design of fiscal transfers. Lack of attention in design to specific objectives leads to negative perceptions of these grants. The six broad objectives are:

1. Bridging Vertical Fiscal Gaps
2. Bridging the Fiscal Disparities through Fiscal Equalization Transfers
3. Setting National Minimum Standards
4. Compensating for Benefit Spillovers
5. Influencing Local Priorities
6. Dealing with Infrastructure Deficiencies and Creating Macroeconomic Stability in Depressed Regions

3.3 *Lessons from International Practices in Intergovernmental Fiscal Transfers*

Review of international practices yields a set of practices to avoid and a set of practices to emulate. A number of important lessons also emerge (Table 4).

3.4 *Current Issues in Intergovernmental Finance*

Vertical fiscal gaps, i.e. mismatch in revenue means and expenditure needs and revenue autonomy at subnational orders remains an area of concern. This is particularly so 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-local levels in Australia, Germany, India, Malaysia, Nigeria, Russia, Spain, and South Africa among others. 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 reform of conditional transfers is of concern to subnational governments in most federal countries due to their ad hoc nature and in view of their distortionary impacts on subnational priorities and policies. Equalization transfers also invite controversy due either to the complexity of the formulae or the lack of consensus on the standard of equalization.

3.4.1 *Institutional Arrangements for Fiscal Relations*

Who should be responsible for designing the system of federal-state-local fiscal relations? There are various alternatives (see Shah, 2006 for an evaluation framework and comparative reflections on alternate institutional arrangements). The first and most commonly used practice is for the federal government to decide on it alone. The most obvious one is to make the federal government solely responsible, on the grounds that it is responsible for the national objectives that are to be delivered through the fiscal arrangements. In many countries, this is the norm and one or more central government agencies assume exclusive responsibility for the design and allocation of fiscal transfers. A potential problem with this approach is the natural tendency of the federal government to be overly involved with state decision-making and not to allow the full benefits of decentralization to occur. This biases the system toward a centralized outcome, despite the fact that the grants are intended to facilitate decentralized decision-making. To some extent, this problem can be overcome by imposing constitutional restrictions on the ability of the federal government to override state and local decisions. In India the federal government is solely responsible for Planning Commission transfers and centrally sponsored schemes. These transfers have strong input conditionality with the potential to undermine state and local autonomy. The 1988 Brazilian constitution provides strong safeguards against federal intrusion by enshrining the transfers' formula factors in the constitution. These safeguards represent an extreme step, as they undermine the flexibility of fiscal arrangements to respond to changing economic circumstances.

Alternatively, a separate body could be involved in the design and ongoing reform and enforcement of fiscal arrangements. This could be an impartial body or a body made up of both federal and

Table 4. Principles and Better Practices in Grant Design

Grant objective	*Grant design*	*Examples of better practices*	*Examples of practices to avoid*
Bridge fiscal gap	Reassignment of responsibilities, tax abatement, tax-base sharing	Tax abatement and tax-base sharing (Canada)	Deficit grants, wage grants (China), tax by tax sharing (China, India)
Reduce regional fiscal disparities	General non matching fiscal capacity equalization transfers	Fiscal equalization with explicit standard that determines total pool as well as allocation (Canada, Denmark, and Germany)	General revenue sharing with multiple factors (Brazil and India); fiscal equalization with a fixed pool (Australia, China)
Compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spill-out of benefits	Grant for teaching hospitals (South Africa)	Closed-ended matching grants
Set national minimum standards	Conditional non-matching output-based bloc transfers with conditions on standards of service and access Conditional capital grants with matching rate that varies inversely with local fiscal capacity	Road maintenance and primary education grants (Indonesia before 2000) Education transfers (Brazil, Chile, Colombia) Health transfers (Brazil, Canada)	Conditional transfers with conditions on spending alone (most countries), pork barrel transfers (USA, e.g. $200 million earmark in 2006 for a "bridge to nowhere" in Alaska), ad hoc grants

Table 4—*continued*

Grant objective	*Grant design*	*Examples of better practices*	*Examples of practices to avoid*
		Capital grant for school construction (Indonesia before 2000), highway construction matching grants to states (United States)	Capital grants with no matching and no future upkeep requirements
Influence local priorities in areas of high national but low local priority	Open-ended matching transfers (preferably with matching rate varying inversely with fiscal capacity)	Matching transfers for social assistance (Canada before 2004)	Ad hoc grants
Provide stabilization and overcome infrastructure deficiencies	Capital grants, provided maintenance possible	Capital grants with matching rates that vary inversely with local fiscal capacity	Stabilization grants with no future upkeep requirements

Source: Shah (2007).

state representatives. It could have true decision-making authority or be purely advisory. Whatever body is responsible, to be effective, it needs to be able to coordinate decision-making by the two levels of government. Three commonly practiced options are: (1) an independent grants commission; (2) an intergovernmental forum; and (3) an intergovernmental-cum-civil-society forum.

Some countries set up a quasi-independent body, such as a grants commission, to design and reform the fiscal system. Such commissions can have a permanent presence, as in Australia or South Africa, or they can be brought into existence periodically to make recommendations for the next five years, as in India. India has also instituted independent grants commissions at the state level as advisory bodies for state-local fiscal transfers. These commissions have proven ineffective in some countries, largely because many of their recommendations have been ignored by the government and not implemented, as in South Africa. In other cases the federal government may have accepted and implemented the commission's recommendations but have been ineffective in reforming the system due to self-imposed constraints, as in India. In some cases these commissions become too rigorous and academic in their approaches, contributing to the creation of an overly complex system of intergovernmental transfers. This has been the case with the Commonwealth Grants Commission in Australia.

A few countries use intergovernmental forums, executive federalism or federal-provincial committees to negotiate the terms of the system, as Canada and Germany do. In Germany this system is enhanced by having state governments represented in the Bundesrat, the upper house of the parliament. This system allows for explicit political input from the jurisdictions involved and attempts to develop a common consensus. Typically such forums opt for simplicity in design to make the system transparent and politically acceptable.

Finally, a variant of the above is to use an intergovernmental cum legislative cum civil society committee with equal representation from all constituent units, chaired by the federal government to negotiate changes in existing federal-provincial fiscal arrangements. The Finance Commission in Pakistan is an example of this model, which is constituted periodically to determine allocations for the next five years. Pakistan also follows the same approach by having province level finance commissions for designing and allocating provincial-local fiscal transfers. This approach has the advantage that all stakeholders—donors, recipients, civil society, and experts-are represented on the commission. Such an approach keeps the system simple and transparent. An important disadvantage of this approach, however, is that due to the unanimity rule, such bodies may be permanently deadlocked, as has recently been witnessed at the federal level in Pakistan.

4. Resolving Fiscal Conflicts

A second subtheme of the conference relating to issues in fiscal federalism was that of resolving fiscal conflicts. Fiscal conflicts in federal countries usually arise from (a) conflicting interests in the division of fiscal resources especially in countries with a concentration of natural resources in a few regions; (b) lack of clarity and coordination of roles in fields of shared rule; (c) fiscal transfers that appear to pass the buck and buttress citizens' negative perceptions that they simply represent the "magical art of passing money from one government to another and seeing it vanish in thin air"; (d) "beggar thy neighbour policies" under decentralized decision-making; and (e) economic divisions within the nation that foster a sense of alienation in lagging regions.

One continuing source of tension is vertical fiscal gaps, or the mismatch between revenue means and expenditure needs at lower orders of government. Vertical fiscal gaps and revenue autonomy of subnational orders of government remain areas of concern in federal countries where the centralization of taxation powers is greater than necessary to meet federal objectives. This leads to undue central control over subnational policies and can even undermine bottom-up accountability.

Various options have been tried by federal countries to resolve fiscal conflicts. One is having clarity in roles and responsibilities and institutional mechanisms for coordination, especially in the exercise of shared rule. Another is asymmetric federalism arising from uniform principles to achieve amicable and sustainable fiscal compacts and outcomes. Yet another is ensuring that finance follows functions and that the division of the fiscal pie is fair and transparent, especially in the sharing of fiscal dividends from natural resources through transparent compacts that compensate resource rich regions for costs of infrastructure services and environmental degradation associated with natural resources exploitation. Inter-regional conflicts associated with attempts to shift the burden of local taxes on non-residents and a race towards bottom can be limited by having proper assignment of taxes and harmonization of taxes on inter-state trade. Macro fiscal conflicts resulting in fiscal indiscipline can be avoided through legislated fiscal rules. Output or performance based grants with conditions on standards and access to public services but having flexible choices in designing programmes and in spending allocations can also help foster results based accountability and help restore the trust of the people in government.

5. Federalism and Regional Equity

Ensuring regional equity within federal nations was the third subtheme of fiscal federalism for this conference.

Large regional disparities represent serious threats in federal states as the inability of the federation to deal with such inequities creates potential for disunity and, in extreme cases, for disintegration. It is heartening, however, to note that federal countries generally do better in restraining regional inequalities in order to avoid the greater political risk caused by widening regional disparities. Regional fiscal equity is often addressed in federal nations (a) by overcoming the fragmentation of an internal common market through removal of barriers to trade and factor mobility; and (b) by creating a level playing field for poorer jurisdictions with fiscal equalization and national minimum standards grants in order to afford them opportunities for integrating their economies with the rest of the country. Such grants work as the glue that holds the federation together by enabling poorer jurisdictions to provide reasonably comparable levels of public services at reasonably comparable levels of taxation, and foster mobility of factors of production (land, labour and capital) and mobility of goods, as well as help enhance a common economic union.

6. Why Fiscal Federalism? Some Conclusions

Federal fiscal constitutions have been recommended for large and diverse countries as they create incentives for multiple orders of government to provide services competitively, efficiently, equitably, and responsibly to their own residents. This is accomplished while respecting diversity in local identities and preferences. Federal fiscal arrangements pay special attention to regional economic divisions in order to ensure level playing field to strengthen the economic union. This explains why federal countries generally do better than unitary countries on all aspects of public governance—citizen participation, political freedom, political stability, rule of law, efficient and equitable service delivery, human development, fiscal and economic management, curtailing corruption and equitable and inclusive governance.

In conclusion, federal countries have shown a remarkable ability to adapt to meet emerging challenges in fiscal federalism. While 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 a never ending quest for the right balance and of excellence in responsive, responsible, equitable and accountable governance.

Subtheme Paper

Assignment Systems in Federations

Mahesh C. Purohit

Abstract

VAT has been introduced in a large number of countries. However, it is no coincidence that it has not been possible to introduce a fully harmonized VAT in any of the federations. The key difference in introducing VAT in a unitary form of government and in a federal country lies in designing a "destination based" subnational VAT. Therefore, the important issue that needs to be addressed in designing a subnational VAT relates to treatment of inter-state trade. To understand the problems of introducing a harmonized VAT in a federation, this paper presents case studies of the structure of VAT in a few select federal countries, such as Brazil, Canada and India. It illustrates the case of the European Union (EU), drawing upon the harmonized features of VAT in its Member States.

1. Introduction

While VAT has been introduced in more than 141 countries, it is probably no accident that a single comprehensive VAT at the national or subnational level has not been adopted in any of the federations. Each one of the federations has different forms: either a federal form of VAT or a system of dual VAT or state VAT.

With a view to analysing the problems in introducing a single comprehensive VAT in federations, this paper presents some case studies of sales tax and VAT in federal countries and trade blocks, viz., central and state VATS of Brazil, central VAT and provincial sales taxes or VAT of Canada, dual VAT in India, and state-VATs of the EU. These studies illustrate the design of sales tax/VAT adopted by both the national and the subnational governments and offer some insight into the problems.

2. Brazil

Brazil is one of the oldest federations having a comprehensive division of tax powers between different tiers of governments. The overall system of taxes on commodities and services is characterized by a variety of taxes. Besides taxes on income and property, it includes VAT at the federal level as well as at the state level. In addition, it has some cascade type taxes at the municipal level.

2.1 *Federal VAT*

Brazil's system of VAT at the federal level is known as IPI (*Imposto sobre productos industrializados*). It is confined to the manufacturing sector only. It is levied on the value added by the industrial manufacturing sector. That is, the tax is levied on raw materials, intermediary products, packaging materials and finished goods with set-off for the tax paid at the earlier stage of transactions. Set-off is, however, not available on output exempted from IPI. Agricultural and mineral products are also excluded from the scope of IPI, i.e. no credit is available whether used as input or as output. Capital goods, in general, are outside the creditable base but the tax on machinery and equipment produced in Brazil forming part of fixed asserts and used solely in the industrial process is eligible for credit. As in most other countries, exports are zero-rated.

Imports are subjected to IPI but the products exempted from import duty are automatically exempt from IPI. Also, importation of specified machinery and equipment is exempt. Other exemptions under IPI include: (1) output of firms established in Manaus Free Zone—the ZFM (*Zona Franca de Manaus*) and approved by the proper authority, (2) a large number of notified products or projects, and (3) some specified inputs. The structure of IPI indicates multiplicity of rates with considerable variations across commodities. In general, there are nine rate categories ranging from 4 to 333 per cent. More than half the revenue of IPI is generated from a few commodities. These include vehicles (16.2 per cent), tobacco products (13.2 per cent), beverages (10.1 per cent), chemical products (8.1 per cent), and the products of metal and mechanical industry (7.0 per cent).

2.2 *State VAT*

The system of VAT at the state level is known as ICMS (*Imposto sobre operacoes relatives a circulacao de Mercadorias e services*). It replaced the sales/turnover taxes which prevailed in the sixties. It is levied on the sale of goods at all stages of the production and distribution process including the retail trade, agriculture and cattle raising sectors.

Unlike the multiplicity of rates under IPI, there are only five rate categories under ICMS, viz., 7 per cent on rice, beans, bread, salt, meat and food items; 8.8 per cent on capital goods; 12 per cent on the supply of electricity; 18 per cent standard rate (applicable to most other items); and 25 per cent for luxury consumption items, such as liquor, cigarettes, tobacco, electronic goods, video games, sports, communications, gas and alcohol.

Services are outside the scope of the Brazilian ICMS. Also, a large number of capital goods produced in Brazil are excluded. In addition, there are many exemptions for notified items. These include fertilizers and pesticides, goods for agricultural production, and specified products such as imports of intermediate goods, and the sale of agricultural equipment in the north-eastern states. Exports are zero-rated.

2.3 *Harmonization of Inter-state Transactions*

Brazil has adopted an "origin" principle for taxation on inter-state transactions. Accordingly, ICMS is levied on inter-state transactions by the exporting state. However, the tax levied by the exporting state varies according to destination. While the general rate of tax on inter-state transactions is 12 per cent, the rate is 7 per cent for goods sent from south-eastern states to the less developed north-eastern or central-western states.

To neutralize the impact of tax on these transactions, the importing state gives set-off for the tax. In effect, by having a higher rate of 12 per cent on exports from the south-eastern states (other than to the north-eastern and central-western states) and the lower rate of 7 per cent on imports into that region and allowing rebate of both these taxes, the ICMS redistributes tax revenue between the states. The rate of tax on inter-state transactions is prescribed by the National Public Finance Council (CONFAZ). In addition, the CONFAZ grants exemptions to some notified products such as vegetables, eggs and domestic fish. Exemptions also include the sale of agricultural equipment to the north-eastern states and agricultural exports. Sales to the ZFM area are zero-rated.

The features of Brazilian VATs described above indicate that there exists a system of a dual VAT: the IPI—a federal VAT on the manufacturing sector—and the ICMS—a state VAT on agriculture and industry. The federal VAT is primarily a tax on selected commodities and restricted to the manufacturing sector with a plethora of exemptions. It is also beset with problems, such as non-neutrality. Besides, there is a tendency on the part of entrepreneurs to undervalue their output to reduce the tax liability. In addition, exemption from IPI is given to machinery produced in the country as against non-exempt imported machinery, which creates distortions in the system. No attempt has been made to harmonize IPI and ICMS; both taxes are independent of each other. In addition to IPI and ICMS on goods, the local taxes on services in general levied by local authorities on a gross sales basis are not integrated with the taxes on goods. The main source of revenue is, however, the state VAT (ICMS).

3. Canada

Canada is another federal country that has implemented a comprehensive VAT at the federal level, known as the goods and services tax (GST). At the level of provinces, there are different forms of sales taxes. Efforts have been made to harmonize these taxes at the federal and provincial levels.

3.1 *Federal VAT*

At the federal level in Canada, a comprehensive VAT, known as the Goods and Services Tax (GST) has been in force since 1991. It covers almost all goods and services at all stages of production-distribution process. The tax is levied at the rate of 6 per cent (changed recently to 5 per cent) on sale price, allowing input tax credit for all purchases in the course of business. Thus, the total amount of tax on goods and services is equal to the final selling price multiplied by the nominal rate of the GST.

While having comprehensive coverage, GST provides for some exemptions and rebates for specified goods and services. Sales made by small dealers with an annual taxable turnover of less than $30,000 (Canadian) and occasional sales by private individuals (such as the private sale of a used car) are exempt. Residential rents (other than temporary accommodation), majority of the health and dental services, domestic financial services (such as interest on loans, charges for accounts, credit card fees and commission on transactions in stocks or other securities), day care services, and education services are also exempt. The resale of old houses is exempt but sales of new homes are fully or partially taxable.

As in most countries, exports are zero-rated. Some other items that fall in this category include basic groceries (excluding snack foods, non-food beverages, prepared foods and restaurant meals), prescription drugs, medical devices, and international flights. All purchases made by provincial and territory governments are zero-rated either through mutual agreement or through treaties. Zero-rated items also include most agricultural and fish products. Sales by farmers are zero-rated. These include seeds and fertilizers bought in large quantities. Individuals and organizations having diplomatic immunity also fall in the category of those eligible to buy goods under zero-rating.

Visitors to Canada making purchases for taking goods out of the country are given full refund of GST, provided the amount paid exceeds a certain threshold. They can also claim refund of tax payable on accommodation. There is no rebate for tax on restaurant meals, gasoline, alcoholic beverages, tobacco and services purchased while in Canada.

Some specified institutions such as municipalities, academic institutions (including universities), schools and hospitals (known as MASH sector) that do not engage in sales but provide services, pay GST on their purchases. Such institutions, however, receive a partial rebate on taxes paid by them. Municipalities receive a rebate of 57.14 per cent of the tax paid while universities and public colleges receive 66 per cent rebate. The rebate for schools is 68 per cent and for public hospitals 83 per cent. Government registered charities and non-profit organizations are also entitled to a 50 per cent rebate of all taxes paid on their purchases. The rebate is provided directly to these institutions when they file a specific rebate application at the Canada Customs and Revenue Agency which verifies the amount and sends the rebate amount directly to them.

3.2 *Provincial Sales Tax/Vat*

In addition to the imposition of GST by federal government, all provinces except Alberta levy a provincial tax on the sale of tangible personal property. The different forms of sales tax in the provinces are as follows: first, a retail sales tax, known as provincial sales tax (PST), is levied by five provinces, viz., British Columbia, Ontario, Manitoba, Prince Edward Island, and Saskatchewan. The PST levied by these five governments differs considerably in terms of coverage and varies between 7 and 10 per cent. Second, Quebec levies VAT at the provincial level. It applies zero-rating of QST on inter-provincial sales and exports. Third, harmonized sales tax (HST) is levied in four provinces, viz., Newfoundland, Nova Scotia, Prince Edward Island, and New Brunswick. The HST is a VAT imposed by the federal government and composed of the 6 per cent GST and the 8 per cent provincial tax, and applies to the same base of goods and services that are taxable under GST.

In the Canadian system, there is no effective tax on inter-provincial transactions. In the provinces that have a retail sales tax, the tax is not imposed on inter-provincial transactions. In the other provinces, such transactions are zero-rated under VAT.

The coverage of GST as well as HST is comprehensive. Both the forms cover most goods and services. However, the provinces levying provincial sales tax (PST) provide for some exemptions that have been notified by the concerned provinces. Most provinces exempt prepared meals as well as a few specified consumer and producers' goods.

Most services are exempt under PST. However, over the years, many provinces have taxed services such as car repairs, hotel/motel accommodation, etc. Insurance premiums are taxable in Quebec and Newfoundland, where there are different rates for different schemes. Telephone and other communication services also fall in the category of taxable services. Similarly, computer software, labour services, laundry and dry-cleaning are taxable in most provinces. Many provinces provide for separate sales tax on specified goods and services such as alcoholic beverages, restaurant meals and telephone services.

3.3 *Federal Efforts at Harmonization*

The federal government attempted to harmonize these taxes. With the dialogue extending for over six years, it was only in April 1996 that the federal government entered into an agreement with four provinces (viz., Newfoundland, Nova Scotia, Prince Edward Island, and New Brunswick) to introduce a harmonized sales tax (HST), which is a combination of the GST and the provincial sales tax being levied in each of these provinces. HST became effective from 1 April 1997 and now is being levied at the rate of 13 per cent (GST 5 per cent and provincial VAT at 8 per cent).

The HST is legislated and administered by the federal government. The provinces receive their share (8 per cent) from the federal government. The share is allocated primarily on the basis of consumption although some other variables also get into the distribution-formula. In addition, the provinces receive adjustment assistance to compensate for the loss of revenue due to reduction in the tax rate. The grant of \$961 million was payable over a period of four years. To enlarge the scope of harmonization, the federal government is attempting to persuade the other provinces to enter into the system of HST.

Quebec levies a VAT known as Quebec Sales Tax (QST). It collects GST as well as the QST (which has been converted into a value added tax at the provincial level). However, Quebec remits the yield of GST to the federal government after deducting the charges for collection.

The model of dual taxation, i.e. GST (the federal VAT) levied by the federal government and the provincial retail sales tax (PST) imposed by the provinces is followed in Ontario, Manitoba, British Columbia, and Prince Edward Island. Prince Edward levies PST on the GST inclusive base and Ontario, Manitoba, Saskatchewan and British Columbia impose PST on the price exclusive of GST.

None of the provinces levy tax on inter-state sales. Their retail sales tax/VAT jurisdiction is confined to sales within their own borders. For example, if the Ontario vendor delivered the products to a vendor in Quebec, he would not charge Ontario tax. However, if Quebec buyer actually took delivery of the goods in Ontario, he would have to pay the tax. Thus, a sale delivered outside the province is free of provincial sales tax/VAT of the province of origin.

4. European Union

The VAT structure of the European Union (EU) could also be considered an illustration of VAT under a federal system, wherein VAT is levied by all the member states (MSs). The EU has ensured that the domestic trade taxes levied by the member states would be rational by insisting that any country which wishes to be part of the Union should adopt a VAT and must refrain from levying any effective tax on intra-Community transactions. Prior to the abolition of internal fiscal frontiers within the Union (1 January 1993), this object was achieved by zero-rating exports of goods from the member state of origin and taxing their importation in the member states of destination. As from the abolition of fiscal internal frontiers, the concept of zero-rated exports of goods was replaced by zero-rated intra-Community supplies of goods and the concept of taxed importation of goods was replaced by taxed intra-Community acquisitions of goods. From 1 January 1993, the concept of zero-rated export was restricted to the movement of goods from one member state to non-EU countries, and the concept of taxed importation of goods was restricted to imports into the EU from non-EU countries.

Coverage of VAT in the EU includes both goods and services. The basis of assessment was substantially harmonized through the implementation of the Sixth Directive. Further, a degree of rate harmonization was achieved by the Union stipulating that there shall be a minimum standard rate of 15 per cent, with one or two reduced rates on a few specified items, with a minimum of 5 per cent following the removal of border controls. The standard rate ranges from 15 to 25 per cent. The Finance and Economic Ministers of the Member States reached agreement to this effect in 1992.

Thus the EU has succeeded in preserving the common market with a harmonized VAT. In order to achieve this, it proposed two systems. The first relates to the origin principle, that requires a clearing house mechanism, and the second relates to the traditional destination principle.

4.1 *Origin Principle*

The European Commission's initial idea of harmonizing VAT in the EU was based on the origin principle necessitating the establishment of a clearing house. The Commission's idea was that supplies of goods transported from one member state to another would be taxed in the member state from which the goods were supplied (member state of origin) and the customer in the member state of destination would be entitled to a tax credit. To make the system work, the exporting state would remit the VAT collected on exports to the administration of the importing state. Only net balances would have to be settled, through a mechanism of a central clearing house. It was thought that each member state would calculate its total VAT sales and purchases for intra-Community trade for the month by aggregating all VAT charged and claimed by registered traders on sales and purchases to EU member states. The net position would be calculated vis-à-vis the EU and not against each individual state. So each country would create a monthly statement showing its total VAT input and output figures for intra-Community trade. The statement would establish a claim or payment. Under this system, clearing would be a perpetually on-going process.

While the benefits of the clearing house mechanism were clearly recognized, the members of the EU anticipated problems relating to the accuracy of likely claims involving large flows of money. The Commission proposed to tackle this through the mechanism of standardized audit trails, improved control and cooperation between member states. Subsequently, the Commission proposed clearing on the basis of estimates of consumption in member states.

However, considering the different levels of commitment towards making the clearing house work, the member states were not ready politically or administratively to implement the system of the clearing house mechanism.

4.2 *Destination Principle*

The EU subsequently adopted a transitional regime to deal with the treatment of intra-Community transactions in goods. In conjunction with this, a VAT information exchange system (VIES) was set up to monitor intra-Community trade of goods. Under the "transitional regime" the taxable event in cross-border transactions takes place in the country of destination. For example, a manufacturing firm producing finished goods, located say in France, "imports" raw material worth EUR 500 from the United Kingdom where this transaction is subject to 17.5 per cent VAT. When the transaction involves the movement of goods from United Kingdom to France, the transaction is taxed at the zero rate in the United Kingdom provided the sale is made to a registered trader in France. With a view to ensuring that non-registered traders do not benefit from this zero rate, the registration number of the French customer would have to be mentioned on the invoice of the UK supplier. Thus, the supplier who sends goods to other EU countries will need to obtain the VAT registration number of its foreign customer and quote it with its own VAR number on the sales invoice.

Consequently, the "exports" to France would effectively be free of UK tax, but the French customer has to account for French VAT on the intra-Community acquisition (19.6 per cent of EUR 500). The French customer pays the same amount of VAT on goods purchased from suppliers in other member states as he would have to pay to French suppliers.

In addition when the UK supplier dispatches goods, there is no paperwork to present to customs officials because for VAT purposes fiscal frontiers have been abolished. Apart from spot checks for drugs, anti-terrorism measures, etc., there would be no delays in the transportation of goods from one member state to another.

Similarly, the French dealer is not required to clear the goods into France; neither is the French dealer required to pay French VAT to French customs officials at the time the goods enter the country. When the goods arrive at the dealer's premises in France, the French dealer accounts for French "acquisition" VAT on his VAT return. If the French dealer has acquired these goods for resale, that dealer is entitled to deduct the acquisition VAT on the same VAT return. The same procedure applies in reverse if the goods are moving from France to the United Kingdom. In this regime, taxation of intra-Community transactions in goods takes place in the consuming state.

This scheme was originally scheduled to apply only from 1993 through 1996. However, there has been no consensus among the member states about changing to the new regime. Hence, the transitional regime still continues.

5. India

India has adopted a system of dual VAT: central VAT (CenVat) at the federal level, and state VAT at the state level. In addition to the central VAT, which is the basic excise duties, some other taxes are also levied. These include Special Excise Duty on a few items at the rate of 8 per cent, which is levied over and above CenVAT (basic excise duty); Additional duties of excise on textile and textile articles; additional duties of excise (as goods of special importance) on sugar, tobacco products and textile articles; and cess at varying rates under different enactments.

5.1 *Federal VAT*

The central government levies VAT (known as CenVAT) on all goods manufactured, payable at the time of clearance of such goods from the manufacturing unit (factory). The general rate of CenVAT is 16 per cent. A few commodities are subject to 8 or 16 per cent special excise. There are some total or partial exemptions, which are general as well conditional in nature. Set-off is given for the tax paid. For capital goods, however, only 50 per cent of the duty paid on the goods can be availed of in a financial year; the remaining credit can be claimed in the next financial year, provided the goods are still in use (except for spares and components, refractories, moulds and dies). A manufacturer who manufactures only tax-exempt final products is not allowed to take this credit. However, a manufacturer producing both dutiable and exempted final products in the same factory is eligible to avail of its benefits. This is subject to certain conditions, viz., maintenance of separate records in respect of inputs used to manufacture exempted products, or payment of 8 per cent of the total price (excluding taxes) of the exempted final products or on reversal of the credit availed in the case of a few specified items. Similarly, credit can be availed on capital goods, if not used exclusively for the manufacture of exempted final products. The coverage of CenVAT, however, does not encompass light diesel oil, high-speed diesel and motor spirit (gasoline), as also matches.

5.2 *State VAT*

The most important of state taxes is state VAT. All states except Uttar Pradesh now levy VAT on the sale of goods on all transactions. Uttar Pradesh levies a first-point sales tax. The system of state VAT in all the states and sales tax in Uttar Pradesh follows a two-rate structure: 4 per cent and a standard rate of 12.5 per cent with some exceptions. Gold, silver, precious and semi-precious stones have a VAT rate of 1 per cent and liquor has a higher rate of 20 per cent. On essential commodities (such as branded bread, bulk drugs, writing paper); goods considered important in inter-state trade (such as iron & steel, hide & skins); industrial and agricultural basic inputs (such as printing ink, coir, beedi leaves, fibres, seeds); and capital goods a 4 per cent VAT is applicable. Commodities exempted from tax include natural and unprocessed products (generally in the unorganized sector such as betel leaves, earthen pots, etc.); items which are legally barred from taxation on sale (such as newspapers, national flag, etc.); and items which have social implications (such as books, periodicals, slates, slate-pencils, etc.). The coverage of VAT, however, does not encompass petrol and petroleum products.

6. International Experience in Harmonizing Taxation of Inter-state Trade

Taking into account the different models of VAT prevailing in federations, this section presents international experiences and also academic proposals in relation to harmonization of taxation of inter-state transactions.

6.1 *Canadian Models*

Canada presents some interesting models of subnational VAT as well as a "joint-tax" administered by the federal government. Especially, there are three different models of harmonization of subnational VAT: Quebec levies a VAT (known as Quebec Sales Tax—QST); four of the provinces (viz., Newfoundland, Nova Scotia, Prince Edward Island, and new Brunswick) levy a harmonized sales tax (HST)—a combination of federal GST and provincial VAT; and rest of the provinces levy a retail sales tax. HST is legislated and administered by the federal government. The provinces receive their share (8 per cent) from the federal government. The share is calculated on the basis of a formula, which is based mainly on consumption, although some other variables are also taken into consideration. While the federal government collects HST comprising both the taxes (GST + provincial VAT), Quebec collects GST as well as the QST (which has been converted into a value added tax at the provincial level). However, Quebec remits the yield of the GST to the federal government after deducting the charges for collection. None of the provinces levy tax on inter-provincial sales. Their retail sales tax/VAT jurisdiction is confined to sales within their own borders. Four provinces having HST are treated as one block, where all inter-provincial transactions are also treated as intra-provincial transactions. As regards transactions taking place between an HST province and provinces outside the HST system, they are zero-rated under the provincial component of HST. Distribution of the net collections between the HST provinces is on the basis of consumption statistics, ensuring the destination principle. Quebec, which levies a provincial VAT, know as QST, applies zero-rating on inter-provincial sales and exports. Thus, the Canadian federation has succeeded in fashioning a system where inter-provincial transactions are not taxed.

6.2 *Harmonization in EU*

The EU levies VAT at the "state" level. It has attempted harmonization of VAT and abolition of fiscal frontiers with effect from 1 January 1993. Under the "transitional regime" the taxable event in cross-border transactions was changed from the country of origin to the country of destination. Accordingly, all movement of goods to member states are zero-rated and taxed in the country where the goods are consumed. However, to ensure that the transactions take place between registered dealers, a system of VIES has been operational. In this scheme, the importing manufacturing firm uses inputs as if they are just bought in that country. In addition, when the supplier of an exporting member state dispatches the goods, there is no paper work to present to the customs officials at the frontier. Apart from spot checks for drugs, anti-terrorism measures, etc., there would be no delays at the frontier. Similarly, the importing dealer is not required to pay VAT at the time goods enter into the country. When the goods arrive at the business premises, the importing dealer will account for "acquisition" VAT on the VAT return. When the dealer sells goods further, the dealer would recover the "acquisition" VAT from the purchaser.

6.3 *Brazilian Model*

The overall system of state VAT in the Brazilian federation, known as ICMS is levied on interregional as well as intra-regional sales.

The former transaction is taxed by the exporting state. While the general rate of tax on interregional transaction is 12 per cent, the differential interregional rate is 7 per cent for goods sent from south-east to the north-east or north-west regions. That is, the rate of tax on inter-state transactions varies according to destination. In effect, by having a higher rate of 12 per cent on exports from the south-east subnational governments and lower rate of 7 per cent on imports into that region and allowing rebate of both these taxes, the ICMS redistributes tax revenue among the regions.

To neutralize the impact of tax on these transactions, the importing state gives a set-off for the tax. The National Public Finance Council (CONFAZ) prescribes the rate of tax on interregional transactions. In addition, the CONFAZ grants exemptions to some notified products sold to the north-east, and to agricultural exports.

6.4 *The Little Boat Model*

Apart from the above-mentioned models of taxation of inter-state transactions prevalent in different federations, Varsano (2000) has proposed a new model based on dual VAT. It is a destination-based consumption type of dual VAT without zero-rating of inter-state exports, called the "little boat model". In the terminology of a riverboat, it suggests that tax levied by the state of origin from where goods are exported may not cross the border (say, a river, as many a time it happens to be). To avoid double taxation in the next transaction and to make the system destination-based, it assumes a dual VAT: a federal VAT levied in all the provinces and a state VAT levied in each province. It further asserts that for the purpose of the federal part, the state borders are irrelevant because it is levied all over the country. But the tax jurisdiction of state VAT ends when the commodity moves out of the state. Hence, the exporters and importers, who are federal taxpayers, transport the state tax across the border embodied in the federal tax. That is, the federal government collects both the state VAT and the federal VAT and provides the corresponding credit to the importer. The result is that the subnational VAT reaches the other bank of the river free from previous tax collections and ready to follow its course as a tax of the state of destination.

This simple procedure is able to take care automatically and practically at no cost of transactions between registered dealers subject to the normal tax regime, which is the bulk of inter-state trade. In the case where the importer is an identifiable household (distance selling)—a non-registered trader, or a small registered trader not assessed according to value added—a different scheme must be used. The state tax is also paid to the national government—but separately, so that total tax collection of this kind may be known, which shares the proceeds to the states in proportion to their respective own VAT revenues.

The "little boat model" requires that registered traders distinguish four components of their total sales: (i) intra-state sales, including those to unidentifiable residents of other jurisdictions (cross-border shopping), to which the federal and the state rates apply; (ii) inter-state sales to registered taxpayers, except small traders subject to special simplified tax regimes, in which case the state tax is zero-rated and the federal tax is assessed at a rate equal to the sum of the federal and the state rates; (iii) inter-state sales to unregistered traders, small traders excepted from the previous case, and identifiable households domiciled in other jurisdictions (distance-selling), to which the federal and the state rates are applied, but the state tax is paid to the national government (explicit CVAT); and (iv) exports to other countries, which are zero-rated.

No special rules are necessary regarding purchases: taxes paid to the national government are credited against federal liabilities; and those paid to the subnational units against state dues. Note that, by contrast with current arrangements, no tax that had been collected by a state is credited against another.

At the end of each VAT assessment period, each registered trader is liable for three pieces of information on tax: (i) the net state tax liability (difference between its state liabilities, except the explicit CVAT, and state credits); (ii) the net federal tax liability (difference between its federal liabilities and credits); and (iii) the explicit CVAT paid to the national government, which distributes the proceeds to the states.

6.5 *The Indian Model*

Taxation of inter-state trade in the Indian state VAT is origin based. Currently, the inter-state tax is levied at the rate of 3 per cent (against 12.5 per cent on intrastate transactions) when sale takes place between the registered dealers of different subnational governments having support of a C Form issued by the importing State. In the absence of a C Form the transaction is treated as a sale made to an unregistered dealer in another subnational government and the tax rate applicable for the commodity in the exporting state is levied. The effort has also been made to have verification of the information about the C Form and the status of the registered dealer through the TINXSYS (Tax Exchange Information System).

In spite of the low rate of CST (central sales tax) on registered dealers, the levy of CST on the basis of "origin" goes against the principle of a unified market. It conflicts with the principle of inter-jurisdictional equity. Available information indicates that a major portion of revenue from the CST goes to high-income (or industrially developed) subnational governments. CST on inputs levied at earlier stage cascades and results in higher prices. The producing subnational governments use this measure to "export" their tax to the consumers in other subnational governments. Such a tax also encourages consumers to buy locally produced goods at the expense of the national economy. The consuming subnational governments surrender a considerable degree of autonomy in exercising their power to levy high rates of VAT. This is because the rate of CST besides the rate of VAT of the importing state, which is levied in addition to the CST, becomes excessive for the consumers of the importing state. Also, the incidence of CST on exports (for dealers entering in to export transactions) cannot be reliably quantified, much less relieved under such a system. Hence, the existing CST encumbers exports. In view of the adverse economic implications of the origin based CST, it has now been decided that the CST will be tapered off gradually. It has already been reduced from 4 per cent to 3 per cent this year.

Further, as already announced by the central government, it is expected that it will be further reduced to 2 per cent next year, to 1 per cent the following year and to zero per cent by 1 April 2010.

Notwithstanding the effort of the central government in reducing the rate of CST to zero per cent, the treatment of inter-state taxation by the constituent units of federations discussed above indicates that, except for India, all other federations take care to ensure that there is no effective taxation of inter-state sales so that there is no cascading and escalation of costs. The principle of destination is fulfilled and there is no barrier to interregional trade.

From the experience of different federal structures discussed above, three alternative solutions to the problem of inter-state taxation can be considered: the first is zero-rating of inter-state sales, the second is some kind of clearing house mechanism as envisaged by the EU and the third is the destination based pre-paid VAT, to be discussed below.

One advantage of the clearing-house mechanism is that the rate of taxes for all transactions, intra-state as well as inter-state, will be the same for any given state. Thus, there will be no need to differentiate between inter-state transactions and other transactions. As such the possibility of evasion is much reduced (if the rates of taxes in the different states are close to one another, the advantage of exporting goods to unregistered entities will also be reduced considerably). The major characteristic of the clearing-house mechanism concerns the fact that effectively the tax collected by the exporting states would have to be transferred to the importing states. In order to do this, the exporting states would have to transfer, month by month, the amounts of tax they have collected on inter-state transactions to the national pool and the national pool will have to distribute these amounts to all the states according to their respective imports. If the rates of tax vary among the states, this job would require elaborate account keeping because the national pool office will have to keep records of commodity exports to each of the states. The job would be made somewhat simpler if inter-state transactions are differentiated and taxed with one single rate. In such a case only total state export and import figures would have to be recorded. This itself would be a stupendous job. This may not be possible in many countries, given the present state of information coverage and state computerization. Besides the importing state will have to give a set off as soon as the import takes place and will get it back only after a delay of a month or so. It is also important that the states exporting goods must fulfil their commitment to transfer the tax amounts promptly to the national pool.

One way of handling this is to adopt the EU system and to have an information exchange system. In addition, the states could introduce the powerful instrument of what is known as "prepaid VAT". This is a destination-based system with no effective tax burden on inter-state transactions. In this system, when dealer "A" imports commodities, say in Delhi (importing state) from dealer B in Maharashtra (exporting state), "A" (Delhi dealer) will immediately pay Delhi VAT on its imports, and instantaneously claim a set-off from VAT liability. Hence, it will not cause any additional burden on Dealer A—the importing dealer. As a next step, "A" will transmit the proof of this payment (e.g. a copy of the tax deposit receipt or authenticate challan form showing payment of tax, that could be prescribed by state VAT procedures) to the dealer "B" in Maharashtra (exporting state). On receipt of this document, "B" can claim a set-off of the input taxes already paid under the Maharashtra VAT. That is, the exports would be zero-rated in Maharashtra. With this modus operandi of the operations of "prepaid VAT", the importing dealer "A" would instantaneously claim a set-off from the tax payable to the government on the sales. There would neither be any cascading of the tax paid by the importer nor would there be any additional cost to the dealer. This will be a national tax and will not stick to the price of the commodity. It will, therefore have no price effect. In the spirit of the VAT, which is a self-complied tax, "prepaid VAT" will also be self-regulatory. The state administration would not be required to have check-posts or any other mechanism to control such payments. The dealer in the importing state (who is a taxable person for VAT purposes) would have a strong incentive to pre-pay the tax, which would instantaneously be creditable against his output tax in the state of destination. Unregistered dealers or consumers would have the choice of paying the local tax or the destination tax. On similar lines, the dealer in the exporting state would have an interest in obtaining the proof of payment needed for claiming a refund of input tax, failing which he would be required to pay state VAT on his turnover. The whole mechanism would be guided by the self-interest of both the parties.

7. Conclusion

As in most federations, India also faces the problem of harmonizing tax on inter-state trade in the context of introducing the VAT. The examples of Canada and the EU suggest that there should not be tax on the basis of "origin". The case study of Brazil suggests that if the tax is levied on the basis of "origin" the set-off needs to be given in the importing state, which in addition to making the tax destination-based, serves as an "equalizing mechanism" in a federal structure. The other models available in the tax literature suggest that the central and state VATs could corroborate each other in carrying the tax of the originating state to the destination state. However, under the Indian system of CenVAT, the power to tax extends to the manufacturing sector only. Hence, the coordination of CenVAT and state VAT for carrying the tax burden to the exporting state is not feasible. However, the model of pre-paid destination VAT seems to be useful. Thus, India should have a common market by repealing the CST Act and replacing it by a "prepaid VAT". This would enable India to have rational procedures and facilitate removal of check-post. It would also help Indian taxpayers to reduce the costs of doing business and be competitive internationally.

Subtheme Paper

Managing Fiscal Conflicts

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Abstract

Fiscal conflicts are a permanent feature of multi-level governments. They arise both at the vertical level between layers of government, and horizontally among governments of the same level. Such conflicts are best avoided *a priori* through clear tax and revenue assignment rules, and transparency within all fiscal arrangements, including equalization payments in particular. Equalization grants are useful as conflict-resolving devices, but their power should not be overestimated. Where underlying political conflicts loom large, such grants could create fiscal dependency and encourage hold-ups by regional governments. This entails inefficiencies and is likely to sharpen fiscal conflicts over time. But matters are complex where populations living on a given territory, or being confronted with different governments, are not homogeneous. This is true wherever there are ethnic, linguistic, religious, or other cleavages that entail fiscal rivalries between different factions of the population. Some of these complexities are addressed in this paper since federal systems of government are often thought to mitigate such conflicts. An avenue to explore is quid pro quo microtransfers that compensate for interregional public service provisions or are used to co-finance infrastructure developments. Where the financial transfer matches the economic value of the service provided, intergovernmental transfers can avoid fiscal conflicts altogether. But obviously their power ends where fiscal conflicts are just the expression of deep-rooted political conflicts.

1. Introduction

The allocation of funds within a federal or decentralized system of government is crucial for both political stability and economic development of a country. True, there will always be rivalry among public administrations for the limited public resources, which has to be resolved both vertically between tiers of government, and horizontally among jurisdictions at the same level of government. But whether this leads to temporary or lasting fiscal conflicts within a multi-tiered government must be seen from two very different aspects: (i) an allocation system that is improperly defined or deemed to be unfair; or (ii) underlying political conflicts that transcend into a fight over fiscal resources. Underlying political conflicts are typical of ethno-federal systems.

Obviously the first type of problems could be addressed by revising the fiscal allocation machinery in accordance with principles of efficiency and equity, although equity or fairness standards are always based on value judgements which could reflect political disagreement. The second type of questions is more difficult to tackle because it requires resolving the underlying political problems first. Occasionally, but not always, political conflicts can be resolved by restructuring intergovernmental fiscal relations or fiscal cooperation, which may even lead to a reorganization of the state (i.e. a new constitution). But this is just a variant of the problem set (i), which means that it could perhaps be addressed rationally. Where political conflicts go beyond economic reasoning, however, in particular those arising within ethno-federal systems, conflict resolution are more a matter of diplomacy than of political science or economics.

Aspects of institutionalized intergovernmental cooperation to resolve such macro-fiscal conflicts are also addressed in this paper.

1.1 *What Does a Properly Defined and Fair System of Intergovernmental Finance Mean?*

It is interesting to note that young federations have tended to resolve fiscal conflicts *a priori* by clear tax assignment rules. Ideally every public authority controls the fiscal resources on its territory as to tax policy, tax administration, and the appropriation of the proceeds from taxation. In these instances taxation by each jurisdiction is said to follow the origin principle. This procedure is expected to avoid horizontal fiscal conflicts in particular. Vertical fiscal conflicts are more difficult to resolve through tax assignment since territories will overlap for the different layers of government. Formally the highest level of government could always claim the right to tax within the territory of the whole nation. But this is often contested by regional governments. This type of fiscal conflict is a mere reflection of vertical tax competition between layers of government. It can only be resolved politically because there is no economic rule that would tell us how much to spend at every layer of government that have different spending responsibilities. It amounts to solving the "butter or canons" dilemma, or education *versus* defence, which is essentially political in nature.

It is obvious that the assignment of *exclusive* rights to exploit certain tax bases between layers of government is itself conflict-prone. Such vertical fiscal conflicts can be easier resolved for taxes with a truly encompassing territorial incidence (such as customs duties), duties relating to property rights (royalties), revenue instruments with a regulatory functions (the sugar levies in the European Union), or taxes that generate little revenue (passport fees). Such revenue sources are typically handed over to national or supranational governments in conjunction with their outlay responsibilities. Expanding the realm of national taxation beyond these types of instruments is usually more difficult, but it could be rationalized based on economic arguments. One such argument is fiscal neutrality for interregional commerce, which finds its reflection in the Australian constitution for instance. This country assigns the taxes on trade (or in a broader sense: indirect taxes) to the Commonwealth to avoid regional price distortions and the discrimination of trade. Although the United States constitution also aims at a level-playing field for internal trade (the inter-state commerce clause), it has never adopted a uniform sales tax system for instance, let alone the assignment of such taxes to the federal level. Consequently, the outcome of vertical fiscal conflicts may often be *compe-*

titive tax assignment to different layers of government, and even rival taxation of the same sources.

Tax competition is however not confined to vertical fiscal relations alone. Jurisdictions within a borderless single market of a nation cannot employ *any* tax regime at their discretion, and their potential to define tax bases and vary tax rates is severely restricted by tax arbitrage. For instance, the two entities of Bosnia and Herzegovina were initially operating two different sales tax regimes—one based on retail sales, the other on wholesalers/importers. Obviously this encourages imports through the entity employing retail sales taxes, and final sales in the other entity taxing only wholesalers and importers. In this way internal transactions go wholly sales tax free. Of course this system duality had to be abandoned and sales tax systems harmonized to avoid market distortions.

Similarly, the European Union has harmonized the base of VAT among its member states to generate a level-playing field for intra-European commerce, but it accepts the employment of different tax rates in different countries. This is possible where the destination principle is used, which applies for most inter-state transactions within the European Union despite a borderless single market.

The destination principle has a double meaning: transactions, in particular for final consumption, are taxed with the rate prevailing in the destination country; and the proceeds from VAT are allocated to the budget of the administration of that same country. It resolves fiscal conflicts to the extent that it preserves the tax sovereignty of member states, including the appropriation of tax revenue, but not fully. Although tax systems might be identical or similar, the tax policy of the individual jurisdiction is usually constrained within a single economic space. This applies even for a VAT based on the destination principles. The only exceptions are perhaps residence-based taxes or taxes on immobile assets such as the property tax. But fiscal conflicts may emerge even for taxes with a local incidence, i.e. tax arbitrage will always work against high-taxing jurisdictions. They risk foregoing economic activities or losing production factors to low-taxing regions over time.

Even though exclusive or competitive tax assignment may preclude fiscal conflicts *a priori*, it cannot avoid fiscal conflicts altogether.

- Eventually the development of expenditure responsibilities at different layers of government may evolve at a different pace from that of tax revenue. This leads to vertical fiscal imbalances. Such effects are particularly prevalent during war periods when the central government has to draw more heavily on fiscal resources. Vertical fiscal conflicts may become particularly acute in the case of exclusive tax assignment. In the case of competitive taxation the total tax burden is likely to increase if fiscal policies are not properly coordinated, which converts vertical fiscal rivalries into conflicts with taxpayers. Moreover, competitive tax assignment tends to render the tax system highly complex (creating a "tax jungle"), which could also obstruct economic activities through higher compliance costs for the taxpayer.
- Among different jurisdictions at the same level of government, the origin principle of taxation will usually produce regional inequities. This results from the fact that economic resources and activities are unevenly distributed among regions. Regional inequities could lead to unbalanced economic growth within the nation, and this could provoke regional political conflicts. Therefore, resolving a fiscal conflict among entities through taxation according to the origin principle may have short-run benefits, since it postpones fiscal conflicts, but it may build up political tensions that could become disruptive eventually if deemed to be unfair or inequitable.

1.2 *What Can be Achieved through Intergovernmental Fiscal Transfers?*

Vertical fiscal conflicts are usually addressed by either grants or tax sharing. Federations have often used grants or per-capita contributions by the states to finance the federal government initially. This is true for the United States (that introduced a capitation, later converted into the income tax), the German Reich (that used *Matrikularbeiträge*, upward-oriented grants from the states), and more recently Bosnia and Herzegovina (that still sponsors the state budget through grants from the entities). The same applies to the European Union, which finances its budget mainly through transfers from its members. In these instances, the national or supranational government remains "at the mercy" of its constituent jurisdictions, which is one strategy for controlling fiscal conflict. But all these attempts have failed over the longer run through centripetal forces with an expanding budget of the central government.

In unitary countries most taxes are run by the national government, and public resources flow top-town. It allows imposing vertical fiscal balance by decree or national legislation. Moreover, vertical transfers could also be geared toward equalizing regional inequities through asymmetric allocation. In fact it appears that unitary states may be more successful in reducing regional income disparities than federations. Whether a unitary system will achieve national cohesion, political accountability, or economic efficiency through regional and local self-government, is yet another question. It is likely to depend on the degree of national homogeneity and the integration of national minorities.

Tax (or revenue) sharing is a more recent phenomenon. It is alien to countries, such as the United States, preferring clear tax assignment rules for resolving vertical fiscal conflicts. But most federal and decentralized governments use revenue sharing to correct vertical fiscal imbalances. Obviously it requires a high degree of political consensus among territorial governments, and the participation of benefiting tiers of government in adopting the corresponding legislation. In federal countries, tax sharing rules are typically subject to approval by the second chamber of parliament that represents the constituent states, provinces, cantons, or other regional governments.

It is important to note that tax shares can be adjusted to accommodate for varying expenditure responsibilities at different layers of government. This avoids vertical fiscal imbalances, but it cannot correct regional fiscal inequities where tax sharing is based on the origin principle. Regional governments with a high tax potential will obtain larger resources per capita than those with an underdeveloped tax potential. For this reason some countries have adopted different sharing proportions for lower tiers of government in accordance with the degree of economic development, but this cannot replace a specific equalization scheme. A high share of a poor tax base will still produce poor public revenue. Other countries employ tax or revenue sharing to form a fund, which is then allocated horizontally among regional governments according to a formula. This vertical-fiscal-balancing-*cum*-equalization strategy is prominent in a number of countries including Australia, Brazil, Germany, and Scandinavian countries. It attempts to resolve vertical and horizontal fiscal conflicts at the same time. Again the strategy requires some grade of consensus-democracy, as equalization is not likely to emerge in societies with internal political conflict potentials.

There are two possible exceptions however: (1) subnational governments could be "bribed in" through equalization grants; and (2) intergovernmental transfers may reflect a quid pro quo for exchanging services among public authorities.

1.2.1 *Equalization Grants*

A prominent historical example for a successful bribing-in through equalization grants is Western Australia, which had threatened to leave the Commonwealth in the early days of the federation. In fact secession threats may be an effective tactical device for poorer regions to maximize their resource flows from the central government. Where grants dependency is high however (for instance for the Autonomous Region of Muslim Mindanao in the Philippines), such threats may not always be credible, unless there is an option to connect with potential foreign donor governments that are politically closer to the region than its own national government.

This is why grants from outside should be monitored with care. They could create political dependencies and systematically undermine national cohesion where ethnic, religious, or other affiliations of a region with a foreign country are strong. In this case—the bribing-in through equalization grants by a national government may become costly and even excessive where the national government is exploited by a hold-up position of the benefiting regional authority. It may also be economically counterproductive since it fosters fiscal passivity and a reluctance to exploit their own regional tax base. And it encourages the strategic abuse of cooperating governments and moral hazard behaviour of local politicians and officials in the conflict-region.

The corollary for the fiscally better-off regional governments is fiscal autonomy. Where regions are economically self-sufficient, a possible secession threat is indeed more credible and perhaps likely. Even where the option of secession is remote, fiscal conflicts with richer regions tend to produce political concessions allowing the defiant region to exploit its tax base more fully through asymmetrical tax assignment and sharing rules, or through greater autonomy in tax policy and tax administration. Examples of such arrangements abound: the province of Quebec in Canada; the province of Aceh in Indonesia; the Basque country and Navarre in Spain; and perhaps Scotland in the United Kingdom. So asymmetrical fiscal arrangements are often the manifestation of pending fiscal conflicts within a nation.

1.2.2 *Quid Pro Quo Transfers*

Some intergovernmental transfers are paid on a quid pro quo basis where one public agency provides particular services on legal, bureaucratic or contractual grounds as requested by another (funds-providing) agency. Such "microtransfers" are generally for current services. They also enable compensation vertical and horizontal spillovers between and among jurisdictions through co-financing, including joint investment projects.

In all instances, such transfers between layers of government, or among public agencies, can enhance social welfare from an efficiency point of view. It results from the fact that each level of government or public agency, from its own perspective, would tend to supply insufficient amounts of the public service because it will disregard spillover effects that accrue to other levels of government or to other public agencies. Contractual arrangements, including co-financing provisions, are needed to achieve an optimal outcome for the federation as a whole.

The appropriate instrument for compensating spillovers in a quid pro quo-like fashion is matching grants. Ideally each agency would contribute a share of programme financing that corresponds to the relative benefit of its citizens from the public programme to be financed. Matching transfers entail a change in relative prices and hence exhibit a substitution effect in addition to providing extra funds. This will interfere with the recipient government's policy and alter its priority settings. Where microtransfers exist, they are often effected on the basis of fixed legal or bureaucratic rules, not on negotiated contractual arrangements, which could be a source of embedded inefficiencies. There are, however, positive examples of contract-based microtransfers for specific programmes among jurisdictions, for instance among cantons in Switzerland.

Quid pro quo transfers are common in many countries, but the extreme example is perhaps found in the United States where the federal government uses a host of so-called categorical grants to compensate for vertical spillovers, to signal federal policy principles, and to impose its own priorities onto the states. A specialization of grants allows the "targeting" of programmes by Congress. During the 1990s, these transfer arrangements had become more and more specific, often imposing federal policy priorities onto state and local governments, which were resented as violating the 10th Amendment. However the Supreme Court affirmed these grants as being in line with the constitution because entering into such transfer arrangements was based on a contract, and was hence "voluntary".

"Voluntary" is indeed the key word for this type of grant: because the transfer corresponds to the value of a reciprocal service, fiscal conflicts should normally be avoided if effected at *market prices*. One must not overemphasize this aspect, however, as intergovernmental microtransfers are still relatively rare, and there might be some degree of coercion through monopoly power or national regulations. In these instances, fiscal conflicts are again the expression of underlying political or economic conflicts.

The bribing-in through equalization grants or reliance on voluntary intergovernmental payments is however not always successful in avoiding fiscal conflicts. Where political antagonisms are too strong, deep-rooted conflicts cannot be resolved through fiscal policy alone. It would be naïve to expect the present conflicts, for instance in Iraq or Palestine, to be the expression of fiscal misalignment alone which could be resolved by reassigning taxes, appropriate tax sharing rules, or intergovernmental transfers.

2. How to Solve Fiscal Conflicts Resulting from Underlying Political Conflicts?

It is often argued that federalism or regional fiscal autonomy is a panacea for resolving political conflicts and preserving national cohesion. At least, it would forestall secession and potential civil war. In this vein the conflicts in Bosnia and Herzegovina and Iraq were thought to be contained through adopting federal constitutions. A federal design was also conceived in the Annan Plan for a united Cyprus to settle a long-lasting conflict, but failed to materialize when it was rejected by one of the parties in a referendum.

True, decentralization of government in its various forms can prevent or contain political conflicts, including those arising from linguistic, ethnic, or religious tension. The Swiss confederation is an example of a nation that has successfully integrated both religious and linguistic diversity. However, tax competition both vertical and horizontal between cantons remains a recurrent fiscal conflict even in Switzerland. It calls for intergovernmental cooperation or institutionalized cooperative federalism, which Switzerland has developed over time. Canada is another example of a successful, although precarious, balance between linguistically diverse provinces within a federal regime. And the fiscal machinery and intergovernmental relations in Canada provide rich material for illustrating fiscal conflict resolution in a federation. It is interesting to note that both examples, Switzerland and Canada, lean toward competitive solutions of fiscal conflicts.

The war in Bosnia and Herzegovina was successfully brought to an end through the Dayton Agreement, which basically adopted a federal constitution (with a second-layer federation within the federation). Initially fiscal conflicts were contained through fiscal "segmentation" in this country. This meant the adoption of an extreme version of the origin principle, where there are practically no fiscal spillovers among jurisdictions at the national, the cantonal, and municipal levels. This type of "conflict resolution" is not sustainable, however, because it jeopardizes economic development and balanced growth, and it sharpens existing regional economic and social inequities over time, which is likely to result in re-emerging political tensions.

The studies on federalism as a conflict prevention device are inconclusive though. There are important positive examples, but there are also a number of prominent cases where federalism has failed: the former Soviet Union, Yugoslavia, Czechoslovakia, and more recently Serbia and Montenegro. However, it might be questioned whether failure in these latter cases was related to federalism or rather to the collapse of communism and its consequences. Yet a decisive ingredient was likely to have been vertical fiscal conflicts between the federation and its constituent republics, oblasts, or autonomous regions.

In fact, the former socialist federations used to assign taxing powers to *subnational* jurisdictions. In particular company profit taxes, the main revenue source of communist regimes, were administered and collected by regional authorities and shared with the central government through upward-oriented grants. When regional politicians experienced a loss of political control by the federal government and a waning party discipline, they began to boycott the central government by retaining these public revenue collections, all the more if they were in disagreement with political developments or uncertain about the future. This fiscal boycott weakened the central power further through potential insolvency, which could only be overcome through inflationary money creation. In Yugoslavia this conflict was further exacerbated by ethnic tensions that were ignited by nationalist politician seeking to maximize their sphere of political influence in a shaky multi-centered power environment, by relying on traditional party command that was still functioning partially.

Although federalism may have power to contain pending political conflicts, there is no guarantee that it functions properly by strengthening the rule of law and enhancing the economic and social welfare of people. Where underlying political antagonisms are strong, federalism does not necessarily terminate violent communal or ethnic conflicts as the experiences of Ethiopia, India, Indonesia, Iraq, Nigeria, Somalia, or Sudan demonstrate. Moreover, where the devolution of power to regional governments has the effect of legitimizing the rule of local warlords and *caudillos*, federalism could even be a counterproductive device. “Without a strong central legal authority and the legitimate means to coerce the lawless, the seemingly noble institutions of local autonomy may simply provide protection for the corrupt" (Bermeo, 2005, p. 8).

It is interesting to note that ethno-federalism is typically associated with conflicts and violence only if the federal constituency involves a "core region", i.e. "a region with an outright majority of the population or a population that exceeds the size of the second largest region by 20% or more" (Hale, 2004, p. 169). In his study of 28 ethno-federal states, Hale finds that those that lack a core region are comparably resistant to conflict, secessionism, and downfall. Not a single one of them collapsed between 1945 and 1999. It is also the reason why the Russian Federation is reasonably robust while the Soviet Union was not (Hale, 2005).

Conversely, federations with a core region are just as likely to collapse or survive. But it is interesting that every federal state that has broken down has also had a core region (Czechoslovakia, Mali Federation, Nigerian First Republic, Pakistan, and Yugoslavia). It is therefore hazardous to expect a federal constitution to form a pre-emptive conflict resolution device among entities involving a core region—except by dictatorship or restraint from abroad. A downfall is not excluded when the internal or external pressure is taken away. And it might explain the difficulties in forming federations for countries such as Cyprus, Iraq, Somalia, or Sri Lanka.

Fiscal conflicts resulting from political quarrels are simply *conflict derivatives* that can only be resolved by addressing the very underlying causes. It is noteworthy, however, that fiscal arrangements could help to mitigate such conflicts and even contribute to preserving national cohesion and unity. Two different themes are worth discussing in this context: (i) resolving fiscal conflicts on resource taxation; and (ii) addressing ethno-national conflicts through "personal federalism".

2.1 *Fiscal Conflicts over Resource Taxation*

The geographical distribution of natural resources such as petroleum, minerals, timber, water, and so on, is usually highly unequal among regions of a nation state. It raises the fundamental question which government possesses the ownership rights of these resources and can therefore exploit their fiscal dividend. This represents just a special case of vertical fiscal competition within a federation.

The question has found different answers within different constitutional environments: Canada and the United States assign the right to exploit the fiscal dividend of natural resources to its provinces and states. Colombia, a decentralized unitary state, does likewise. Others countries assign these rights to the central government exclusively (the former Soviet Union and Mexico) or partially (Canada for its territories and off-shore deposits). Again others are engaged in sharing arrangements between the central and regional governments (China, Nigeria, and the Philippines). Sometimes the fiscal dividend from natural resources goes into a special National Heritage Fund, which invests them to secure the future of the country or a region. And finally the ownership rights could be assigned to "the people" as in the case of the recent constitution of Iraq.

Assigning clear ownership rights to tiers of government does not avoid fiscal conflicts however. Obviously the existence of important natural resources is prone to stir political conflict over the sharing of national wealth even where legal entitlements are properly defined. The issue may stir secessionist tendencies in particular in the resource-rich regions, and therefore a fiscal compromise is needed to contain such political pressures.

In Canada, for instance, the constitution assigns the property rights of natural resources to the provinces, but only within their boundaries. This was considered to discriminate against the maritime Eastern provinces where natural resources exist offshore. These resources lie outside the provincial borders and are therefore constitutionally owned by the federal government. In the mid-1980s, the federal government signed offshore oil and gas deals with Newfoundland and Labrador and with Nova Scotia, which asserted the federal government's ownership of offshore natural resources, but the provinces were allowed to tax offshore oil production in the same way other provinces (such as Alberta) tax their "onshore" natural resources. Fiscal conflicts of this type may be difficult, but they are usually resolved through peaceful agreements in mature democracies. But they can strain intergovernmental fiscal relations considerably in factional democracies or autocracies. In Nigeria—with 99.6 per cent of its export income from oil being the world's most oil-dependent country (Ross, 2003)—"the central government has nearly complete control over how revenues are disbursed. Even constitutional promises to states—such as the provision in the 1999 constitution that at least 13 per cent of the revenue from national resources would be returned to those states producing it—carry little weight" (Srinivasan and Wallack, 2003, p. 12). Consequently, fiscal conflicts continue to loom in that country. The continuing tensions in Aceh and West Papua bear testimony to the acrimony with which lingering regional conflicts over natural resources can be fought.

Where national ownership, national constitutional rights, or national political control predominate there is likely to be state monopoly power—often represented by a national petroleum company that controls everything from exploration to marketing of natural resources. Where rent-seeking autocrats or oligarchs exercise this monopoly power, it tends to promote a combination of economic and political challenges known as the "resource curse". These challenges, and the fiscal conflicts that go with them, are not easily overcome. Resolving such fiscal conflicts is not easy, but perhaps a more rational approach may resolve them, if possible through rationalizing the system of natural resource taxation, creating different types of fiscal revenue from natural resources, and stratifying them by layer of government.

Whether natural resource taxation follows a rational approach or not, it is always possible to differentiate various charges related to their exploitation. Oil-producing countries have developed a host of public charges such as royalties, concessions, resource rentals, geological fees, subsoil user fees, depletion (severance) taxes, production taxes, production sharing agreements, land rentals, land use payments, land taxes, pollution charges and environmental taxes, transportation taxes, including on pipelines, excise taxes (for oil consumption) and oil export duties. Some fiscal dividends such as royalties accrue unambiguously to the owner of the resources (nation or province), but others—such as production taxes, environmental charges, levies for specific infrastructure, duties on services related to storage and transportation, and taxes on the distribution of resources—could also fall to regional or local governments. A clearly structured system of resource taxation and its stratification by layer of government could help to elucidate multiple fiscal competencies and therefore contain fiscal conflicts enduringly.

Yet even though fiscal revenue from natural resources may be clearly structured, and its assignment be stratified by layer of governments, it gives rise to yet another type of fiscal conflict. It results from the antagonism between two fundamental principles: ownership rights and equalization. This is best illustrated by reference to the Canadian Maritime Provinces. Even though these provinces now possess the right to tax offshore natural resources, its revenue is counted as increased tax potential in calculations for the national equalization scheme. In other words, equalization grants to the provinces are cut to the extent that revenue from natural resources is considered to constitute the province's "own revenue". Hence, the national government "claw back" of the fiscal dividend by reduced grants entitlements equalization. It is argued that "full equalization amounts to confiscation of the property rights of provinces and essentially negates the provincial ownership of resources" (Boadway, 2004, p. 9). This is in fact a serious dilemma that could prolong fiscal conflict, at a different echelon of argument even after their settlement through clear allocation rules.

This type of fiscal conflict can only be solved politically, although it could be facilitated by fiscal segmentation. Some elements of the fiscal dividend relating to natural resources could be counted as own revenue for equalization purposes in order to establish a fair system for intergovernmental fiscal relations. Other elements would remain uncounted maintaining the fiscal incentives or accounting for related costs and administrative effort. It could also be simplified by including the increased tax potential of regional governments only partially in the equalization formula.

3. Addressing Ethno-National Conflicts through Personal Federalism

As noted in the beginning, federalism is predominantly a territorial concept. "Territory has become such a crucial element in the formation and organization of states that it is hard to imagine the exercise of state power without reference to its exclusive rights over a particular territory" (Jans, 2000, p. 215). Territorial notions are potential identity-builders for ethnicities, but often ethno-national groups face competing claims over the territory from other groups—if only emotionally. This can transcend into a violent political conflict or even war. The unfortunate events on the territories of the former Yugoslavia bear vivid testimony to such conflicts in recent times. Afghanistan, the Caucasus, Dafur, Iraq, and Sri Lanka are other examples of territorial disputes that have turned into blind violence.

Territorial concepts of federalism can only function properly if there is some degree of economic and social homogeneity within a federation's constituent parts, and perhaps some regional balance by avoiding "core regions" (see Hale, 2004). This can, of course, be achieved at times by drawing corresponding boundaries. Ethiopia has attempted to define the territories of its provinces by ethnic groups "on the drawing board". But there are also devastating incidents of human rights violations from efforts to achieve ethnic homogeneity in the case of rival claims to territories: ethnic cleansing (Bosnia and Herzegovina, Croatia) and mass murder (Burundi, Dafur, Rwanda). The cause of such violence is ethno-nationalism. "Ethno-national groups seek to rule themselves and not to be ruled by others" (Jans, 2000, p. 216). The conflict is driven by an ideology seeking to establish congruence between state borders and the settlement space by an ethno-national group. This can become fatal where there are rival claims for the territory. Fiscal conflicts might play a role in such a context, but they are clearly ancillary in nature.

There are a number of institutional techniques to prevent such latent conflicts. These techniques are based on power sharing and the protection of minority rights. It includes a federal design of the state, which is usually attractive to ethno-national groups seeking self-rule. Yet such a solution retains a territorial assignment of political powers. Nevertheless federations offer greater room for political representation and participation of minority groups than unitary states, but their usefulness is limited to those instances where minorities are regionally concentrated.

Where such ethno-national groups are regionally dispersed and mixed, and where there are juxtaposed competing claims for a territory, conventional forms of federalism possess no power to resolve the conflict, and they could even become counterproductive. They must accentuate the conflict where other groups will experience control of a regional government by one group as a direct loss.

An alternative concept could be "personal federalism" or extraterritorial federalism. It implies that there is a direct link between state powers and a population group irrespective of its territorial distribution. "The limits of governmental jurisdiction are determined by group membership, not by territorial borders" (Jans, 2000, p. 219). And "[p]ersonal systems use voluntary ethnonational membership to determine the limits of governmental jurisdictions" (idem, p. 220) irrespective of territory, whereas conventional federalism includes forced membership of all residents of a territory without regard to their ethno-national affiliation. The advantage of personal federalism is a high degree of self-rule for the groups without assigning exclusive control over land.

Belgium, and within it particularly the capital city of Brussels, is a prominent example that combines territorial concepts of federalism with personal federalism. Certain state functions requiring a territorial base (such as infrastructure development, urban planning, economic policy, transport, natural resources, environmental policies and communal public services) remain assigned to the provinces and municipalities. Yet each group administers other policies that are key identifiers for ethnic groups such as education, culture, language, religion, media, etc., separately over the whole territory. In Belgium these policies are administered by so-called "community governments". They are partly territorial, partly extraterritorial. The Flemish community consists of the inhabitants of the Flemish region (of Wallonia) following a territorial concept, but also of the Flemish-speaking inhabitants of Brussels, which follows a personal concept. Similarly, the French community consists of the inhabitants of Wallonia following a territorial concept but also the French—speaking inhabitants of Brussels. The German community is identical to the German-language area using a territorial concept.

The three community governments have jurisdiction over policies relating to the ethno-national characteristics of their members such as language, culture, education, welfare, etc. They possess their own parliaments whose members are elected exclusively by their ethno-national groupings. The parliaments of the communities elect their own government members and exercise political control over this government. Community income is provided by tax shares allocated by the federal government, radio and television licensing, federal government grant assistance, and a variety of income from such sources as the sale of publications, museum entrance fees, tuition fees, gifts and bequests, proceeds from educational heritage sales, and even borrowing. Consequently, there is full fiscal autonomy of these personalized community governments.

The Belgian institutional provisions, together with some minority-protection rules for territorial governments, created the conditions under which both Flemish and Francophones could accept the sharing of a territory "which they initially considered as their sole birthright" (idem, p. 225). The Belgian case also illustrates that even the most intractable conflicts can be resolved peacefully through personal federalism. Furthermore, fiscal conflicts are avoided totally as the communities have their own revenue sources, which they can use for providing public services exclusively to their ethno-national group.

Apart from Belgium, personal federalism is untried, however, and the international community has shied away from adopting it to resolve other ethno-national conflicts such as in Georgia-Abkhazia, Africa, the Balkans, Chechnya, India, and Indonesia. Ultimately, people living on one territory will have to learn how to deal with each other, which requires interpersonal mechanisms of conflict resolution. Institutionalizing an ethno-national division of a country by creating personalized community governments does, however, risk eternalizing societal segmentation and fostering forms of segregation. What may work in practice in Belgium, a member of the European Union with its borderless internal market and robust traditions of a rule of law, may fail to produce similar results in other countries where tribal affiliations or clan thinking are still prominent. Personal federalism could, however, possibly function as a temporary conflict resolution device even in those countries, especially where other options have failed to achieve success.

4. How to Address Macro-Fiscal Conflicts?

It is obvious that intergovernmental coordination is essential for achieving effective service delivery and macroeconomic stability and sustainability. This has become a major issue in federal countries where the provinces or states have won significant financial independence from the national government. Where there is little or no coordination of tax and budget policies in a multi-government environment, the outcome may well be macro-fiscal conflicts and even fiscal crisis. The recent crisis in Brazil (1999) and Argentina (2001) can be directly associated with the lack of macroeconomic policy coordination.

Macroeconomic policy conflicts have, of course, different facets such as insufficient domestic flexibility (in particular in the labour market), unsustainable monetary policies, contradictory exchange rate policies, balance-of-payment disequilibria, and speculative capital movements. But lacking fiscal discipline at both national and subnational levels of government also plays an essential part. In Brazil and Argentina it entailed fiscal conflicts between the nation and its constituent jurisdictions which were part of the causes leading to macroeconomic instability.

In Brazil the crisis was triggered by the insolvency of a large state, Minas Gerais, which declared a moratorium on its debts to the federal government, causing a plunge in the stock market, a rush of capital out of the country, and a massive devaluation of the Brazilian currency. In Argentina, much of the fiscal problems reflected a lack of discipline at the provincial level, exacerbated by unfunded transfers of responsibilities from the federal government. The prolonged weakness of the public finances had an impact on Argentina's consolidated public debt burden. Moreover much of the debt had to be serviced in foreign currency, which was made more and more difficult by Argentina's low export-to-GDP ratio. In addition, the fixed exchange rate regime under the convertibility plan had reduced the degrees of freedom for fiscal deficits and debt. External debt had already climbed to 50 per cent of GDP in 2000, but with the collapse of the currency board, the exchange rate plummeted, and the consolidated government debt skyrocketed. At the end of 2001 Argentina's debt-to-GDP ratio stood at 130 per cent.

The experience of these Latin American and of other countries clearly underlines the need to avoid fiscal conflicts through macroeconomic policy coordination particularly in federal or decentralized countries.

The coordination of government policies in a multi-tier government framework requires clear policy objectives, an appropriate design of policy rules, institutions and coordination processes, and the development of suitable management tools for implementation, monitoring, and control. Management techniques and coordination instruments (such as a medium-term budget framework, for instance) are not addressed here, but some institutional concepts and coordination processes need to be related to decentralization.

It is useful to be reminded of some EU truisms relating to macro control of the public sector such as the importance of a stable institutional environment or the no-bail-out clause for the central bank. Other sources of macro instability in a decentralized government framework such as the lack of own resources and inadequate design of intergovernmental fiscal relations are also important. All such aspects could interfere with a coordinated approach to achieving macro-fiscal stability, and it could disrupt the effective delivery of public services at lower tiers of government.

As to the operational aspects of fiscal policy coordination, there is need for general policy guidelines (framework legislation) to be set by national governments to direct policy making of all budget units while respecting the constitutional rights and obligations and other political constraints. These guidelines could take the form of fiscal responsibility legislation, including the harmonization of the budgetary framework, accounting rules, consolidation of budgets, and reporting and enforcement regulations. And there must be institutions and policy rules to determine and approve a common macroeconomic outlook on a recurrent basis to guide the revenue projections and the preparation of budgets of all budget units within a consolidated framework. This should allow the effective monitoring and control of public sector deficits and of vertical and horizontal fiscal imbalances within the public sector and identifying of individual budget risks that could jeopardize the achievement of fiscal discipline and macroeconomic stability.

Three important mechanisms appear to be of particular relevance for intergovernmental coordination in a multi-tier system: (1) institutional constraints and prudential rules; (2) fiscal responsibility legislation; and (3) internal stability pacts.

4.1 *Institutional Constraints and Prudential Rules*

In many countries, particularly unitary ones, there are legal or administrative restrictions on subnational government borrowing to avoid fiscal conflicts. However, such restrictions cannot be imposed on the constituent states of a federal or decentralized state because these possess either sovereignty or autonomy as to their budget policies. But institutional constraints are often imposed on the municipal sector even in federal countries.

These institutional restrictions may take different forms: either subnational governments are required to seek permission for each borrowing act (especially for loans in foreign currency, including those from multilateral organizations, and for bond issues); or (more often) they are free to borrow within certain quantitative limits, or for specific purposes, but need permission to exceed those limits.

Permissions can be defined by law or by discretion of the senior government. They could also be general and uniform for the local government sector as a whole, or be differentiated by types of local governments (regions, cities, municipalities), and by size of jurisdiction. Some countries have developed regulations governing municipal debt workout or bankruptcy procedures, rules on the kind of assets that can or cannot be used as collateral for loans and bonds, and prudential regulations concerning the types of public investment local governments can make (e.g. Hungary). Debt workout procedures have also been used in federal countries *ex post* in the case of state or provincial insolvency, where subnational public assets were swapped, or legal transfers withheld in exchange for a bailout by the federal government (e.g. Argentina, Brazil). In nearly all countries there are regulations concerning the reporting on cash holdings, borrowing, and guarantees given to third parties.

The use of institutional limits has a number of drawbacks however.

- First and foremost they insinuate a false sense of security that could encourage leniency by capital suppliers and drive some local governments into unsustainable debt. Subnational creditworthiness varies substantially and has little to do with these institutional limits.
- Second, these institutional limits have to be enforced to be effective. In practice this is difficult to achieve as is demonstrated by a number of cases where they have in fact been violated without sanctions. Often the reporting requirements are inadequate or the administrative capacity to comply with them is lacking.

Restrictions on subnational debt linked to the consolidated budget deficit are particularly problematical because they penalize the parsimonious and reward the squanderer. Although the Stability and Growth Pact of the European Union imposes an overall constraint on the consolidated budget, an "internal stability pact" must be able to differentiate among different budget authorities according to the degree of indebtedness and risk.

4.2 *Fiscal Responsibility Legislation*

Potentially the most comprehensive institutional device for strengthening fiscal sustainability in the context of fiscal decentralization is a Fiscal Responsibility Law (FRL). The FRL concept was pioneered by New Zealand and has found worldwide acknowledgement. Several Latin American countries, and also India, have now adopted such legislation with the aim of promoting enhanced fiscal policies. Brazil's FRL, for instance, provides a general framework for budgetary planning, execution, and reporting applicable to all levels of government.

There are four main general aspects that characterize a FRL:

- Numerical targets (or limits) on fiscal indicators, e.g. rules such as requirements for overall balance or current balance, or limits on the overall deficit, primary expenditure, change in debt stocks, public sector wage bill, and so forth.
- Fiscal transparency requirements, e.g. requirements for comprehensive timely, frequent, and detailed reporting on budget execution of a well-defined medium-term macroeconomic budget framework, including the underlying macroeconomic assumptions, all of which are essential for showing the current budget in the context of a sustainable perspective; and information of tax expenditures and potential fiscal risks as part of the annual budget exercise; a special annual report on compliance with the law may also form part of the FRL.
- A small number of escape clauses to be invoked in a discretionary manner in the event of an unforeseen exogenous shock, e.g. national catastrophes or periods of negative economic growth.
- Enforcement mechanisms (usually through the audit office or the legislature) to enhance compliance, along with a system of sanctions and penalties for violations of the FRL.

To be successful, the implementation of a FRL needs to go hand-in-hand with strengthening macro-fiscal analysis, institutional and managerial capacities of subnational governments and municipalities, corroboration of the judicial system and fiscal control institutions, and sound financial management systems at all levels of government. This would represent a major challenge for many emerging and developing countries, but also for the industrialized world.

Although FRL, by which existing legislation is brought together to a consistent whole and streamlined toward achieving accountability, public sector efficiency and macroeconomic stability, may still be an interesting option for most countries over the longer run, it is often too ambitious to be considered in the short run. The alternative could be an internal stability pact.

4.3 *Internal Stability Pacts*

The EU Stability Pact provides that the public deficit of a member state may not exceed 3 per cent of its GDP and consolidated public debt may not exceed 60 per cent of GDP. Public deficit or surplus is defined as the net borrowing or net lending of the general government (defined to include the central government, local governments and social security funds) in accordance with the European System of Integrated Economic Accounts, and it encompasses all public expenditures including infrastructure financings. Although these criteria are indicative, their consistent negation and violation may trigger an excess debt procedure by which a member state government may face sanctions in the form of fines.

Although non-EU countries are not compelled to comply with these rules, they must consider establishing macroeconomic benchmarks for their consolidated general governments as a whole to avoid major fiscal conflicts at the macro level. This raises the problem of how to coordinate autonomous public budgets in a decentralized setting, and how to enforce these global limits for all governments. The EU experience could be helpful for the discussion in this regard.

There are basically two different strategies for an "internal stability pact" found in EU countries:

- Consensual agreements and formalized cooperation (e.g. Austria, Germany, Belgium, and Denmark), and
- Fiscal rules and administrative controls (e.g. France, Greece, Italy, Spain, Sweden, and United Kingdom)

It is no coincidence that the former type of arrangements is found primarily in federations, while the second is more typical for unitary states.

Consensual agreements are difficult to reach. They require institutionalized forms of cooperation. The Financial Planning Council (Finanzplanungsrat) represents such an institution in Germany, for instance. It coordinates the budgets of the federal and state governments through indicative planning. Australia in 1927 established a Loan council to coordinate public borrowing of the Commonwealth and its member states. Initially the Commonwealth government was the sole public borrower, which severely limited the borrowing powers of the states by requesting them to borrow through the Commonwealth.

But consensual agreements to contain public sector deficits and borrowing are not enough. There must also be enforcement mechanisms and these are usually deficient in federations because they are confronted with sovereign rights or subnational autonomy. Australia failed to impose such sanctions, and current arrangements seek to emphasize transparency of public sector finances through financial market scrutiny of proposed borrowing to restrict borrowing to prudent levels. In the European Union, enforcement of the budget criteria has been extremely difficult politically and there have been flagrant violations by important member states.

While fiscal responsibility legislation may not be feasible in the short run for most countries, because it would require the consolidation of existing legislation, intergovernmental budget coordination is an absolute obligation. Some decentralized countries have in fact started to introduce regulations that require coordinated budgets, but these measures are still insufficient and ineffective. However fiscal rules and administrative controls are needed and they should be designed in a way to minimize their impact on effective regional and local service delivery. Although enforcement might be a problem for some time, it creates an environment that is propitious for mutual consultation and cooperation. Fiscal rules and administrative controls as the basis of an internal stability pact are likely to be more appropriate for most countries.

5. Conclusion

Fiscal conflicts are a permanent feature of multi-level governments. They arise both at the vertical level between layers of government, and horizontally among governments of the same level. Such conflicts are best avoided *a priori* through clear tax and revenue assignment rules, and transparency within all fiscal arrangements, including equalization payments in particular. Equalization grants are useful as conflict-resolving devices, but their power should not be overestimated. Where underlying political conflicts loom large, such grants could create fiscal dependency and encourage blockage by regional governments. This entails inefficiencies and is likely to sharpen fiscal conflicts over time.

An avenue to explore is quid pro quo microtransfers that compensate for interregional public service provisions or are used to co-finance infrastructure developments. Where the financial transfer matches the economic value of the service provided, intergovernmental transfers can avoid fiscal conflicts altogether. But obviously their power ends where fiscal conflicts are the expression of deep-rooted political conflicts.

It is often argued that federalism could be a conflict prevention device for ethnically or otherwise divided societies. This has to be differentiated and tested within a particular political context. True, there are a number of positive examples where federalism has in fact reduced political tensions by enlarging the political power of ethno-national groups, but it is no guarantee that decentralization strategies are always successful. In some instances, federalism may even provoke ethno-national conflicts.

Fiscal conflicts among ethnically diverse groupings are likely to emerge in the area of natural resource taxation. Such conflicts are particularly difficult to resolve, but there could be rational solutions through restructuring the fiscal systems and stratifying the revenue allocation system. Where the fiscal dividend of natural resources is shared among governments in a clear and transparent way, accounting for related services (such as transportation) and costs (including the environment), a stratified system of revenue sharing is likely to resolve fiscal conflicts more permanently.

So-called personal federalism has the potential to resolve fiscal conflicts arising from ethno-national diversity. An example is the case of Belgium, but whether this approach is feasible in other circumstances where a firm rule of law is lacking remains uncertain.

Finally, there are important macro-fiscal conflicts that may arise from a lack of fiscal discipline, excessive public borrowing, and moral hazard. Such conflicts can only be resolved through institutionalized forms of intergovernmental fiscal cooperation.

Subtheme Paper

Fiscal Federalism and Regional Equity

Renuka Viswanathan

Abstract

Federalism is a political construct, but fiscal federalism seeks to derive principles that can be applied for optimal allocation of functions among different levels of government. The issue of regional equity can in one sense be treated as a direct offshoot of the tension between political and fiscal federalism. But even if a federation sticks closely to the form book and achieves a near-optimal situation of distribution of fiscal competencies, issues relating to regional equity will surface. The resultant mismatch between resource raising capacity and expenditure responsibilities calls for equalizing fund transfers which create their own perverse incentives and distortions.

In terms of vertical fiscal imbalance, regional equity requires non-discriminatory treatment of subnational units, while sharing tax proceeds or making general purpose grants and enforcement of equitable rules in overlapping areas of taxation and spending within the competitive federalism model. In terms of horizontal imbalance among constituent states, the dilemma while making general and specific purpose grants relates to whether equalization should be done among regions or among individuals.

These issues have been considered in this paper within the three overall approaches to fiscal federalism that have evolved over time: cooperative federalism, competitive federalism and "market-preserving" federalism. Vertical fiscal imbalance is

inevitable even in federations that closely adhere to the theoretical ideal and it raises difficult questions concerned with symmetrical treatment of regions; some of them have been discussed with reference to specific situations in existing federations. Degrees of disparity vary among federating units also in approaches to horizontal equalization. The objective of individual equity conflicts with that of regional equity and these are closely related to concepts concerning the degree of freedom that should be exercised by subnational units to respond to local preferences. This issue has also been discussed while examining equalization mechanisms in some federations.

1. Political Federalism and Fiscal Federalism

Federations are set up when, in K.C. Wheare's terminology, many states seek unity without unification, by sharing legislative and executive powers through a constitutional contract enforced by an independent judiciary. Fiscal federalism, however, refers to the theory which lays down how the three budgetary functions of allocation, redistribution and stabilization should be performed by different government levels within a country for optimal, efficient economic performance and growth. Principles of fiscal federalism will apply even when there are no formal federal structures; they can also be drawn upon to draft fresh federal constitutions.

2. Equity Concerns: Vertical Fiscal Imbalance

Fiscal federalism has, over the years, moved from concepts of co-operative and competitive federalism to the notion of "market preserving" federalism, under which there are positive and negative incentives for good economic performance. The notion of equity in fiscal federal theory is generally couched in the language of vertical and horizontal imbalances. Vertical fiscal imbalance arises when assignments of fiscal competences are made between federal and subnational governments looking at their comparative advantage in performing budgetary functions. It is measured as the ratio of transfers to states' total revenue, but whether tax shares should be excluded if they are independently determined entitlements is debatable. (In Australia, the federal GST is voted by the Commonwealth Parliament after it is approved by the states and proceeds accrue to them, and in India tax shares are determined by a constitutional body, the Finance Commission.) The extent of vertical fiscal imbalance varies widely among federations: in 2000-1, federal transfers accounted for 46 per cent of state revenues in India, 45 per cent in Australia, 44 per cent in Germany, 30 per cent in Brazil and USA, 25 per cent in Switzerland and 20 per cent in Canada.

Vertical fiscal imbalance can be minimized by allocating direct taxes like income and corporate tax and taxes on external trade like import and export duties to the federal government and motor vehicles tax, taxes on property transactions and piggyback taxes on income to provincial governments, and taxes on immovable property to local communities. Commodity taxes like sales tax and selective excises were once considered suitable for provincial governments. Global experience with value added taxation indicates, however, that centralized levy and administration and sharing of tax proceeds among fiscal jurisdictions help to preserve the common national market and avoid ticklish issues related to taxation of inter-state trade. But a centralized VAT would substantially dilute fiscal responsibility at the state level. Rate harmonization among states is achievable through consensus as well as competition as is happening in India and Brazil. Borrowing powers can be shared by different levels of government, but there may be need for interjurisdictional coordination and management for external as well as internal public debt obligations.

On the expenditure side, redistribution and stabilization functions in the classical Musgravian mould are best performed by the federal government and the allocative function shared largely between national and provincial governments. Defence, foreign affairs, inter-state trade and commerce and similar countrywide responsibilities should fall within the federal list of legislative powers.

Nevertheless, there will continue to be vertical fiscal imbalance when major revenue raising competences remain with higher order governments and major expenditure responsibilities with subnational governments. In operating federations, there are further anomalies and compromises as theory is not fully reflected in practical politics. Creative solutions developed under different federal situations generate perverse fiscal incentives and distort expected policy outcomes. But experience has also made federations move closer to the ideal situation through a process of judicial interpretation, legislation and negotiation to promote economic efficiency.

The Australian Commonwealth has converted a transitory wartime arrangement to centralize income taxes into permanent transfer of powers by the states to the federal government by linking centralized levy with grant entitlement. When the goods and service tax (based on the principle of value addition) was introduced by the Commonwealth government in 1999, it was voted as a federal tax although rates have to be approved by the states and tax proceeds accrue to them. State taxes on wealth (like death duties) have withered away in Australia and courts have deprived the states of sumptuary excises.

Canada and Switzerland, however, continue to remain highly decentralized from the fiscal point of view. Movement of the fiscal system towards greater economic efficiency in Canada has taken place without dilution of its federal character. Joint occupancy by the federal and provincial governments of the fields of personal and corporate income taxation and commodity taxation has been leavened by tax collection agreements which enable the federal Canada Revenue Agency to collect many of these taxes for most provinces. In the case of Switzerland, Articles 128 to 134 of the 1999 constitution, which allocate tax sovereignty among different government levels, vest the power to levy indirect taxes (VAT and special consumption taxes) with the cantons. In respect of direct taxes, however, two Swiss federal laws provide for harmonized definition of the tax base and common lists and definitions of possible deductions (though not their amounts), while federal jurisprudence prohibits double taxation and unjustified tax rebates. At the cantonal level, therefore, the gross tax base and the list of deductions are identical, but the tax rate schedule and the actual amount of deductions are decided by the cantonal Parliament. For the rest, the Swiss practice is one of joint taxation with problems of competition, coordination and harmonization. In India, the power to tax individual incomes derived from agriculture is vested in state governments as also domestic commodity taxes (sales taxes and some excises).

Constitutional distribution of expenditure powers in federations follows the distribution of legislative and administrative powers. These powers may themselves not be assigned together; the federal constitutions of Switzerland, Germany and India assign some fiscal powers by separating the power to levy tax from that of administering it. On the expenditure side too, responsibilities allocated to states like health, education and social security, demand far greater public resources than can be raised by exercising the powers given to them.

3. Regional Equity Concerns for Provinces vis-à-vis the Federal Government

At the federal-subnational interface, regional equity implies equitable fiscal treatment of different regions. In this context, there are at least two obvious issues:

- mechanisms used to correct vertical fiscal imbalance should as far as possible be nondiscriminatory among regions and
- levies raised by different provinces should not obviously discriminate against taxpayers of other regions.

Federal constitutions and agencies set up to regulate intergovernmental transfers take note of both these requirements in most federations. Vertical fiscal imbalance is generally corrected by tax sharing mechanisms for federal levies and general purpose transfers from the federal government to the states. The interests of regional equity (but not necessarily of equity among individuals) are served when criteria applied in such mechanisms strengthen regional governments in a uniform manner without curtailing their discretion and capacity to deploy transferred or shared resources to respond to local preferences. From this viewpoint, tax sharing based on the source of revenue principle would suit the requirements of regional equity. In India, before the tax sharing mechanism was rationalized under the 80th constitutional amendment of 2000, the source principle was applied at different times for sharing the proceeds of some shareable taxes.

This criterion should be applied when the power to levy a tax has been contracted out as an agency function to the federal government by provincial governments, but in India, although the power to levy and collect additional excise duty on textiles, sugar and tobacco was contracted out by the states to the central government as an agency function, the proceeds are shared under the normal Finance Commission formula and not on the origin principle. Most of the Canadian provinces have entered into an agreement with the federal government to levy and collect income tax jointly. Quebec, however, does not participate in this arrangement, collecting its own GST (VAT) as also the federal tax. In Switzerland too, the agency obligation is at the cantonal level for it is they who are legally bound to collect federal income and corporate taxes. In the case of general purpose transfers, which increase the resources of states without reducing their power to deploy them, however, the criteria used are usually aimed at equalizing fiscal capacities. The issues that arise have implications from the point of view of horizontal fiscal imbalance. General purpose grants determined solely on the basis of population may probably be nondiscriminatory from the point of view of individuals, but are not necessarily so from the regional equity viewpoint. The power of the Commonwealth government in Australia in respect of VAT (GST) is not in fact run as an agency function and the distribution of the proceeds is not based on source or even population; it is in line with the horizontal equalization exercise conducted by the Commonwealth Grants Commission.

Asymmetrical treatment of regions can become a live issue when the constitution itself (generally for political and historical reasons) offers special treatment to a specific province or region. This is the case in India, for example, under Article 370 of the constitution which provides a special legislative regime for the State of Jammu and Kashmir to respond to the requirements of its Instrument of Accession to the Indian Republic. The federal Parliament is empowered, therefore, to exercise its legislative powers within the Union List as well as the concurrent list only after consultation with the state government subject to Presidential interpretation and guidance. Similar situations have arisen while federalizing unitary political structures in both Spain and Belgium. There is scope for substantial organizational and power asymmetry among Spanish subnational units called Autonomous Communities. Due to historical arrangements safeguarded by the constitution, two of them—the Basque country and Navarra—even enjoy their own privileged system of financing. In Belgium too, the constitution as well as the Special Majority Law on Institutional Reform have enabled federated entities to exercise different levels of competences. The German speaking community unlike the Flemish (French speaking) community does not exercise power over language policy, nor does it possess "constitutive authority" (the limited right to modify organizational rules imposed by special institutional reform laws). Article 138 also permits the French-speaking community alone to transfer power to the Walloon region (with regard to its powers in the unilingual French language region) and to the French-speaking community commission (with regard to its powers in Brussels) without special majority law. Article 139 allows the Walloon region to transfer certain regional responsibilities to the German-speaking community to exercise them in the German-speaking region. These asymmetries have refocused Belgian federalism around "community federalism" in the north and "regional federalism" in the south and allowed the capital region of Brussels to retain its distinct status. Increasingly, such arrangements will become inevitable to hold together federations consisting of provinces with differing needs for integration and amalgamation.

From the purely fiscal angle, however, inequitable access of different regions to federal grants can arise as a consequence of negotiated political compromise. An example in this regard is that of the so-called "special category" states in India, a list of 11 eastern, north-eastern and northern states, which share perhaps only one characteristic—they are all "nonviable" smaller states with an international border. Inclusion in this group has entitled such states to concessional access to federal grants for most transfers (general purpose as well as special purpose grants), even though many of them would not qualify for special treatment under normal criteria relating to state domestic product or human development applicable to such transfers. There are murmurs and demands for similar treatment from larger but more backward states but by and large the special treatment has been accepted nationwide as the necessary price of inclusion of these states within the federal compact. Expectedly, however, the policy has created a culture of dependence in these states which is contrary to the canons of autonomy and accountability essential for good fiscal policymaking and efficient administration.

Non-discriminatory treatment by subnational governments of taxpayers and producers of other jurisdictions is a universal formal stipulation in federal constitutions as this is a basic prerequisite for protecting the common national market. The power of the Australian commonwealth under section 90 of the constitution to establish a single uniform tariff policy has permitted it to prevent states from imposing protectionist burdens on inter-state trade and commerce. Similarly, Article 133 of the Swiss constitution forbids taxes in the form of tariff barriers which could impede the free movement of goods between the cantons. Part XIII of the Indian Constitution (specifically Articles 301 to 304) safeguards nationwide freedom of trade and commerce, but the federal Parliament is empowered to impose restrictions in the public interest. Article 303 bars all legislatures from making laws which favour any regional discrimination except to deal with a situation of scarcity in any part of the country. (This provision has indeed been used continuously over the years.) State taxes on goods manufactured in other parts of the country should not discriminate against similar goods manufactured within the state.

The concept of competitive federalism envisages arrangements for fair competition among subnational units. Such rules could determine the principle on which a tax base with inter-state implications is to be apportioned among them, where adjudication responsibilities for disputes lie, etc. These rules may be formulated by the federal government itself in consultation with states but the responsibility of making and enforcing them would rest with the federal government, subject, of course, to judicial interpretation. Since judicial relief is likely to be sought only in rare cases, this gives federal governments substantial influence over state policies. In a highly decentralized federation like Switzerland characterized by overlapping tax powers, it is the Federal Court of Justice, which has done horizontal coordination by focusing on avoidance of double taxation as well as prevention of evasion of progressive taxes by taxpayers with taxable activities across jurisdictions through geographical splitting of the tax base. The manner in which rules are framed and interpreted can even implicitly set uniform standards across the country. Strict interpretation of environmental legislation could raise the bar for all states while low tax rates or lax administration in one state could reduce rates and efficiency in neighbouring areas too and unleash "a race to the bottom".

In practice, therefore, while raising resources, subnational governments attempt to manipulate statutory provisions to favour their own residents. The preferred technique is "tax exportation", which is possible particularly under non-VATable multipoint or first point cascading commodity taxation. Economic distortions resulting from such mechanisms result in suboptimal inefficient decisions regarding the location, structure and scale of production and distribution units for goods and services. Since movement to a more efficient rational system could shift the tax burden to domestic consumers, it is likely to be strongly resisted. The Indian experience with introducing VAT is a good example of how such situations develop. Tax exportation by producer states has been a rampant feature of state level first or multi point sales taxes since the fifties. This has distorted locational and other business decisions and led to the evolution of ingenious (though perhaps desirable) forms of evading cascading state levies by practices like consignment and agency transfers. More than a decade has elapsed since the recommendation to move to a dual destination based VAT was made by the Bagchi committee in 1994. Over years of advocacy and negotiation, the more blatant forms of preferential treatment of local producers through sales tax credits for investment have been reluctantly abandoned by Indian states. When state level VAT was finally introduced in 2005, the initial proposal to restrict it to domestic producers was also diluted. Much still remains to be done to rationalize the taxation of inter-state trade before the "tax exportation" issue is finally settled and some degree of non-discriminatory fiscal treatment is possible among different regions.

4. Regional Equity in the Context of Horizontal Fiscal Imbalance

The second type of imbalance referred to in federal fiscal theory is horizontal imbalance. The concept of horizontal equity developed by Buchanan as well as Boadway and Flatters applies to equity among residents of different subnational jurisdictions within a federation, not regional equity. Taking comprehensive income as the index of well being, it is argued that the income tax levied by federal governments cannot ensure horizontal equity as its base does not take into account the redistributive effect of the fiscal operations of subnational governments. These operations cannot be distributionally neutral except in the unlikely case of benefit taxes. When quasi-public services of such governments are financed by resource rents or source-based taxes as against residence-based taxes, net fiscal benefits will vary. Residents in resource rich high income regions will have higher benefits and their higher public consumption will not be included in determining the tax base of the federal government.

Boadway and Flatters adopt a broad as well as a narrow view of horizontal equity. The former approach stipulates that the fiscal system should be equitable across the country vis-à-vis the actions of all governments and persons equally well off before federal and subnational actions must also be so afterwards. To achieve this, transfers should be made in such a manner that each province is enabled to provide the same level of public services at a given tax rate (as in a unitary state). Under the narrow view, federal fiscal action is only expected to ensure horizontal equity on the basis of distributional effects established after state fiscal action has been taken. When we consider the requirements of regional equity, however, we are concerned primarily with the broader notion of horizontal equity in which the federal government's aim should be to equalize the capacity of states to provide the same level of public services at a given rate and leave it to the states themselves to then determine how to respond to local taxing and spending preferences.

5. Range of Regional Disparities

The range of regional disparities varies among federations. Opportunities for mobility and investment that become available for capital and labour after the federation is established also help to reduce disparities over time. Canada is among the most diverse of federations with most of its population concentrated in two large provinces, although the range of dispersion in per capita income is reduced if natural resource revenues are discounted. Switzerland has 6 cantons out of 26 which have a low per capita income. Poverty in Indian states is largely concentrated in the BIMARU group in north and central India (Bihar, Madhya Pradesh, Rajasthan, and Uttar Pradesh) while states of the south and west are by and large considered to be better off. Although Australia is substantially heterogeneous in area and population, GDP per head is largely homogeneous. Large disparities demand measures to equalize fiscal capacities without impinging on subnational powers, a task which has been tackled in different ways in these federations.

6. Causes of Horizontal Regional Imbalances

A fundamental cause of regional disparity is divergence in natural resource endowments in different provinces. Fiscal federal experience indicates, however, that the determining issue is the possibility of exploiting such resources to augment the budgetary capacity of subnational governments. A case in point is mineral wealth like oil, coal and other deposits on which royalties are raised for the public exchequer. If subnational governments are largely free to levy royalties in mineral rich areas, their budgetary resources often need little supplementation through compulsory levies. Much depends, however, on how the regulatory and fiscal power to control natural resource exploitation is shared by different government levels.

In Canada, section 92 of the original British North America Act of 1867 had vested provinces with the power to manage and sell public land and its forest resources and the additional clause (section 92A) enacted in 1982, providing for taxation of non-renewable natural resources, forestry resources and electrical energy has confirmed their right to levy royalties. As a consequence, discovery of onshore oil reserves in Alberta in 1948 has enabled this province to overtake Ontario and Quebec on the provincial GDP ranking list and shed its dependence on equalization transfers. Such budgetary affluence has substantially reduced the fiscal burden of the citizens of Alberta, as they can now enjoy high levels of public goods with very little income tax liability. Nova Scotia and Newfoundland which continue to receive equalization payments also enjoy significant oil royalties. In Australia too, Western Australia has joined the donor states of New South Wales and Victoria because of its buoyant mining royalty tax base.

A diametrically different situation exists in India where the power to raise royalties from mineral deposits has not been solely vested in state governments. The power to regulate mines and mineral development in the state list of the constitution has been made subject to powers given to the federal government in the Union list to regulate and develop oil fields and mineral oil resources and regulate mines and mineral development (the latter power can be exercised if legally declared to be in the public interest). States can also levy taxes on mineral rights only subject to limitations imposed by central laws relating to mineral development. Federal legislation for developing and regulating mines and minerals has taken over much of the space available for states to realize resources from mineral wealth. Only "minor" minerals (which are defined under the central act) can be regulated and taxed through state rules. Not only are royalty rates for minerals with major revenue potential like petroleum, iron ore and coal determined by the federal legislature, the speed and manner of exploitation of minerals deemed to be critical for industry or defence are also controlled by the central government. Hence, although state governments raise and fully utilize royalty revenues, there are severe limitations on states rich in mineral deposits to determine how they should exploit this wealth to realize revenues in the long and short term. A constant and legitimate grievance of these states is inadequate increase in royalty rates for major minerals and non-adherence to the periodicity prescribed in the law for rate revision, since policies are being applied in a *dirigiste* environment to benefit users and public sector companies. As a consequence, there is no correlation between natural resource endowment and budgetary surplus in India. In fact, some of the best endowed states in terms of exploitable natural resources like Bihar, Orissa (both rich in mineral deposits like coal and iron ore) and Assam (rich in petroleum) are among the least developed parts of the country and continue to be major recipients of largesse from the federal kitty in terms of general and special purpose transfers.

A similar situation exists in the case of regions rich in hydro-electric and forest resources, which demand adequate compensation for the ecological costs of exploitation (submersion of land, denudation, etc.) on behalf of other beneficiary states. The call for greater power to equitably exploit their rich hydro-electric and forest resources is becoming strident in the mountain states of the north (like Himachal Pradesh and Uttarakhand) and north-east, which today run high budget deficits and depend substantially on central grants. Inefficient levies in the form of exportable cesses on electricity generation are being proposed in such states but no clear view has been evolved on this issue by the central electricity regulatory authority where the principal actor is the federal government owned generation company. Current policies demand early review so that affected states do not introduce distorting levies of different kinds to export their budgetary burden to users in developed industrialized states.

The pace and level of exploitation of natural resources at the time of creation of the federation are also responsible for regional imbalances. Fragmented administrative structures in political units existing in pre-independence India have resulted in differential developmental levels in different parts of the country, sometimes cutting across frontiers of reorganized states too. Almost all rivers flowing through the southern state of Tamil Nadu, for example, had been harnessed for irrigation purposes under the British government, while dams are only now being proposed in some of the upper reaches of the same rivers in adjoining states (Karnataka and Kerala). The substantial investment needed for the purpose has prior claim on the limited budgetary resources of these states, particularly when failure to exploit riparian resources could result in permanent loss of the right to use the water. One consequence is that Tamil Nadu has been able to devote public funds to building up a good network of schools and public health institutions much earlier and faster than Karnataka, thereby compounding its original developmental advantage. Such initial conditions have been a source of regional disparity in many federations, but they tend to get adjusted over the years in response to public resource raising and expenditure choices.

Fiscal federal literature presupposes that macroeconomic control remains at the federal level, since freedom to access capital markets and budget mismanagement on the part of subnational governments could jeopardize efforts to stabilize the economy. In reality, however, budgetary commitments of such governments are often too rigid for short term adjustments and some degree of national consensus is desirable on growth targets and strategy. Within limits, subnational governments enjoy considerable leeway to determine their growth path. This is the case even in a formal "planned" economy like that of India. The degree of such divergence will depend on the looseness of the federal compact, but porous fiscal barriers across states and the possibility of "voting with the feet" can help to ensure that investments are made in line with resource endowments to take advantage of large unified markets. Nevertheless, in a developing economy, growth strategies adopted by states might accentuate other kinds of inequities, calling for inducements from the federal government to ensure that minimum entitlement levels are assured for all segments of the population throughout the country through equalization measures like specific purpose grants.

In India, post-independence developmental strategies adopted by the states of Punjab and Kerala were diametrically different, as reflected in the electoral choices of their voters. Kerala moved left and preferred to raise the literacy levels and health status of its population by public funding, social security and advanced labour legislation (which drove private investment away to neighbouring states with laxer regimes). Its per capita income stagnated while it notched up scores equal to those of highly developed nations on other aspects of human development. Punjab on the other hand channeled budgetary resources into irrigation and agricultural growth. It rose to the top in terms of per capita income but literacy and public health statistics continue to be dismaying. Equalization in terms of central incentives has become essential to induce Punjab to devote funds to improving the literacy levels of neglected groups like women and other deprived classes.

Varying capacities to raise revenue from the same sources or differing costs of providing the same services in subnational units can also be a fertile ground for regional imbalances in federations. Taxable capacity is primarily a function of state income and transfers of different kinds can be used to equalize this capacity. In practice, however, other factors also affect the ability of a state to raise revenue and these need to be addressed.

In Australia, the Capital Territory, which is a high income area receives large grants from the Commonwealth Grants Commission because it is disabled from levying payroll and property taxes on employees and property holdings of the Commonwealth government under the constitutional principle of immunity of instrumentalities of governments (section 114). Again, available tax handles may not be effective enough to tap a productive sector and yield revenue. This is the case, for example, in the Indian state of Punjab where agriculture is a major contributor to state income for which even if the state desires, it may be unable to develop an effective mechanism to tax agricultural income. The power to levy income tax in the country is truncated in an unsatisfactory fashion, with taxation of agricultural income left to states and that on non-agricultural income being undertaken by the federal government. Return-based taxation of agricultural income has not proved feasible in most countries except for large commercial farms. India is no exception and plantations run mainly by corporates are the main sources of agricultural income tax. Other options to tap agricultural income are based on standardized, simplified *forfait* (presumptive) methodology for which institutions are badly designed and generally ineffective. Commodity cesses and market fees could siphon off some of the surplus accruing to agriculturists but this is a generally unsatisfactory method. In Punjab, where most of the wheat and rice produced is in fact compulsorily "procured" by government agencies through a cost-plus pricing method for being supplied through government fair price shops under the public distribution system in other regions, indirect taxes on agricultural produce simply get exported. The resultant disconnect between taxation and expenditure is also contrary to all good principles of public finance and this has affected fiscal accountability and responsibility in Punjab.

Administrative capacity could be a limiting factor under some conditions, particularly when new states or provinces are created in existing federations for reasons of administrative convenience or cultural homogeneity or additional subnational units are added to existing federations. The new entities are often at a disadvantage vis-à-vis developed existing states in the federation. Such a situation calls for substantial assistance in terms of funds, training and technical assistance to build up over time a structure of governance that can respond to voters' preferences. This may perhaps be the best justification for asymmetrical assistance extended today to "special category" states in India.

7. Equalization and Horizontal Regional Equity

In fiscal federal theory, horizontal fiscal imbalance should be addressed by equalization transfers (mainly general and specific purpose grants). The former are aimed at offsetting the fiscal disadvantages arising from lower fiscal capacity and the higher unit cost of providing public services in different states. This is achieved by unconditional grants equivalent to the difference between what a state ought to spend to provide specified normative levels of public services and the revenue it can raise at a given standard tax effort. Extension of specific purpose grants to compensate for spillover effects is equivalent to attempts to establish level fiscal conditions necessary for effective competitive federalism. Primarily, however, such grants are extended for good reasons to provide a uniform level of core public goods across the country. To achieve this purpose, grants should be open-ended and at matching rates; ideally, a variety of matching ratios should be available to obtain the desired response from all states. From this point of view, the aim of specific purpose grants is equity among individuals of different states, not just regional equity. This distinction between general and specific purpose grants cannot, however, be drawn in federal countries, since criteria and procedures used for both are often meant to equalize entitlements of individuals as well as regions, as can be seen in the following examples.

Canada has unconditional equalization transfers and in addition some general purpose grants for health and social services. The unconditional equalization grants referred to in section 36 of the Canadian constitution focus primarily on the normative equalization of taxing (or overall resource raising) capacity. They do not attempt to list services for which equalization is to be done and they do not attempt to equalize for differential needs, or the cost of providing public services in the ten provinces. Under the federal equalization programme, until recently equalization grants were based on a formula calculating the average per capita yield from thirty-three tax bases with compensation going to the provinces in which the per capita yield was below the average of the five middle income provinces. In 2007, on the advice of an expert panel, this was changed to include the fiscal capacity of all 10 provinces, but the effect of including wealthy Alberta in the calculations was moderated by reducing the rate of resource revenues inclusion from 100 to 50 per cent. Together these enriched the equalization standard significantly. In addition under the Canada Health and Social Transfer arrangements, there are general purpose grants in support of health and social expenditures in the provinces which also have had an equalizing effect in them. The health transfers are tied to adherence by provinces to the five general principles of the Canada Health Act—public administration, comprehensiveness, universality, portability and accessibility. This transfer has in principle an equal per capita value for all provinces with part of the transfer being a transfer of federal tax points.

Switzerland has no constitutional provisions for equalization, which is done under the 1959 federal law, the agricultural aid policy and assistance to mountain areas. The law aimed at providing minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than in others. Fiscal imbalance was seen in terms of differences in revenue-raising capacities of cantons as well as relative unit costs of providing the defined service level was above the national average. Eventually, however, because of the difficulty in defining needs, average versus minimum provision and relative costs, which induced strategic behaviour in recipient governments, three out of four indicators used in the formula for computing the financial capacity of cantons refer to revenue-raising abilities; the four indicators are per capita national income, the inverse of the tax burden, per capita tax revenues from different sources weighted by indices of tax burden for comparability and an approximation of the cantons' expenditure requirements, taking into account population density and the relative importance of each canton's agricultural surfaces in mountains and in plains. Many items of cantonal expenditure benefit from conditional federal grants, built around a basic rate, which represents the federal interest in minimum standard requirements for cantonal public services (varying according to incentive or some technical criteria like economies of scale, spillovers, congestion costs, etc.) to which an equalization supplement is added, inversely related to the recipient canton's index of financial capacity. There are also equalization components in the three revenue sharing programmes of the federal government for the federal direct tax, the withholding tax and part of federal customs duties on petrol and motor fuel.

The Indian system of intergovernmental transfers operates through multiple channels. Finance commissions appointed on a quinquennial basis under Article 280 of the constitution recommend tax sharing percentages and formulae and provide for equalizing "gap" grants. Budgetary estimates of states are redone to assess their likely revenue gaps and this process is gradually taking on a normative hue. The need to provide basic minimum standards of key public services strongly influences the process of assessing expenditure needs, but "gap" grants are not tied to utilization patterns and reports. The practice of the Finance Commission extending special purpose grants was originally started when the seventh such Commission felt that "non-Plan" ("non-developmental") requirements in regulatory administrative departments of states, which needed upgrading (like police, law courts and general administration) were being overlooked by the central government which focused its specific purpose grants on "Plan" ("developmental") activity. The latest (Twelfth) Finance Commission has gone a step further and extended specific purpose grants to selected states even for developmental sectors like education. Most of the other central government grants to states are made within the national Plan. The Planning Commission makes general purpose grants according to a formula (tied to population, tax effort and need) approved long back by the state Chief Ministers at the National Development Council. But most Plan grants today are specific purpose, meant to ensure minimum levels of performance by states in a large number of sectors. Within these, debate to both increase as well as reduce the centrally sponsored schemes has continued for several decades. State governments plan their own priorities and strategies to meet the needs of their people with the twin objective of accessing the maximum possible level of central largesse with minimum adherence to conditionalities and reporting requirements.

Commonwealth grants to states in Australia are made under section 96 of the constitution, the key player being the Commonwealth Grants Commission (CGC) set up in 1933. Equalization is based on the perception that a state suffers a disability when its revenue capacity or cost of delivering services is worse than the mean for all states due to reasons that are beyond its power such as remoteness, congestion or differential prices of wages or supplies. The aim is thus to make it possible for a state by reasonable effort to function at a standard not appreciably below that of other states, by giving it the capacity to provide the average standard of state public services, assuming that it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources. However, general purpose grants recommended by the Commonwealth Grants Commission have been accused by

Australian commentators of equalizing only the financial capacities of states and not therefore being aligned with indices of individual equity like GDP per capita. Seen from this viewpoint, however, such grants seem to satisfy the requirements of regional equity, since they grants reflect what actually affects the financial capacities of state governments, given the services that states in general provide and the revenues they raise. From a different angle, however, since the grants take into account the equalization effect of all special purpose federal transfers, the latter lose their incentive effect. Hence, while federal priorities and choices are "imposed" on states by CGC transfers, they are still given the freedom to utilize transfers in response to local priorities.

This is indeed the key concern of general purpose grants in all federations: there is no way of ensuring that states utilize them for providing the services which have given rise to their needs assessment, so that requirements of individual equity for which these transfers are made are met. The problem is compounded by the fact that availability of general purpose transfers creates perverse incentives for continuing dependency of state governments on federal assistance, except in the case of transfers which are tapered off over a specific time period during which a recipient state is expected to raise its standards of public services to acceptable levels. To avoid such incentives for states to become or remain inefficient, the CGC tries to weight only costs that governments cannot change, e.g. those deriving from climate or sparseness of population.

The issue of regional equity would, therefore, arise in the context of fiscal federalism only after taxing and spending competences are shared as closely as possible in line with theoretical precepts for efficient and responsive budgetary policy. To enable subnational units to function equitably within a cooperative/competitive federal environment, rules for symmetrical treatment of regions as well as "horizontal coordination" of their overlapping tax statutes need to be laid down by the constitution, statute, jurisprudence or the federal government. States should also be disabled from resorting to discriminatory practices like "tax exportation". Tax revenue raised by the federal government by exercising powers enjoyed by state governments on their behalf must be transferred to states based on the source of revenue principle. General purpose grants should be used for equalizing regional disabilities over which states have little or no control like remoteness, distances, etc., and they should be given without conditions so that state governments can respond to local preferences. When such grants are determined after taking into account special purpose transfers, the driving principle is no longer regional but individual equity. Special purpose grants should, therefore, be superimposed at a later stage if the federation seeks a further degree of equalization at the level of individuals. Nevertheless, in one sense at least transfers extended to correct spillovers could also be viewed as a mechanism to provide a level playing field among competing jurisdictions within a federation.

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ANALYTICAL SUMMARIES OF WORK SESSIONS

Subtheme

Assignment Systems in Federations

Work Session 4: How Effective are Different Forms of Harmonizing VAT and Other Taxes?

Work Session 16: Does Fiscal Responsibility Legislation Undermine Federalism?

Vishwa Nath Alok

1. Harmonizing Value Added Tax and Other Taxes?

Harmonization of VAT and other taxes has been attempted in a large number of federations by subsuming sales tax and other commodity taxes into this. It has involved a grand bargain between the federal and state governments. A number of issues had to be dealt in view of the heterogeneity of states in terms of its income, economic character, population, size, geographical location, etc. Consensual sharing of taxation jurisdiction of states with the federal government without affecting fiscal autonomy had been the key challenge. With the belief that retail sales tax is best suited at the regional level and the VAT is best administered at the federal level, efforts have been made to harmonize it during the transition from sales tax to VAT. On the basis of experiences across federations, some key issues were addressed.

Each country attempted fiscal harmonization in its own fashion and evolved its own model. Broadly, this can be categorized into four:

1. *Federal VAT with Tax Sharing.* The VAT is collected at the federal level and shared with the subnational governments on the basis of a formula. The merits of the model include unification of tax rates across the country and the coverage of all transactions from manufacturing to retail by one level of government. On the flipside subnational governments surrender taxing powers and fiscal decentralization is affected adversely.
2. *Autonomous State VAT.* The federal government vacates the field of commodity taxation for states except some sumptuary items and VAT is exclusively collected and retained by the states. While this system enhances fiscal responsibility on the part of states, it has implications in intergovernmental fiscal transfer mechanism as revenue equalization role of the federal government gets affected.
3. *Dual VAT.* whereby both levels of governments collect the VAT independently on a separate economic base as per the powers defined in the constitution. In this case both tiers retain autonomy in fixing tax rates, exemptions and administrative procedures. However, arrangements for harmonization of state VAT need to be strengthened time to time.
4. *Nationally regulated State VAT.* National government determines rates, exemptions, and procedures of VAT, and states collect and retain the tax. This model ensures automatic harmonization. However, redistributive role of federal finance gets affected and subnational governments lose autonomy to vary rates.

As mentioned by the chairperson and other experts, India has recently adopted a system of dual VAT, at both the Union and state level. Adoption of state level VAT is a result of repeated and candid discussions amongst the states. Harmonization of VAT rates across states for integration was crucial as multiple tax rates were barriers to free movement of goods. While the need for tax harmonization was well recognized, its process and procedures threw up intense debate in terms of putting in place regulatory instruments and mechanisms to ensure uniformity and compatibility. In India, though sales tax has been replaced with VAT, other commodity taxes and levies imposed by the state governments and local governments still affect fiscal harmonization. It is viewed that a common or a central information exchange system might bring in transparency in tax administration. Current consultations for a final negotiation with the states for a point of convergence between the central VAT, service tax and state VAT, to lead to a Goods and Service Tax (GST), could be an important step forward, along with the phasing out of central sales tax (tax on inter-state movement of goods) in the next three years. Currently, the system of taxation of inter-state trade based on the origin principle is being reformed. Alternatives, so far discussed, include (a) zero-rating of inter-state sales, (b) clearing house mechanism, and (c) destination based pre-paid VAT. It is viewed that while subnational jurisdictions could feel loss of fiscal autonomy, they would gain from a common market that would provide hassle free tax administration for individuals and corporate sector to plan and engage in productive economic activity leading to creation of wealth and employment opportunities.

The case of Brazil was also presented. Federal, state and municipal governments in Brazil administer a variety of commodity taxes, i.e. (a) IPI *(Imposto sobre Productos Industrializados)*, a federal VAT on manufacturing, (b) ICMS *(Imposto sobre operacoes Relativas a Circulacao de Mercadorias e Servicos),* a state VAT on consumption covering almost all economic activities related to agriculture, manufacturing and services, and (c) ISS *(Imposto Sobre Servicos),* a tax on the gross receipts of municipalities, based on a variety of industrial, commercial, and professional services that is not included in the ICMS. The state VAT is levied on sales within and outside the state. However, the rate differs on intra-state and inter-state sales subject to floors and ceilings determined by the federal government. Even for inter-state sales, the rate of tax varies according to destination. However, the importing state gives rebate for the tax. The National Public Finance Council (*Conselho de Politica fazendaria*—CONFAZ) comprising representative of all states with 27 councillors plays a crucial role in harmonizing the inter-state tax. The council determines exemptions and rate of ICMS through periodic meetings. Brazilian VAT at two levels poses some technical and administrative problems in its application in different states, in addition to a federal VAT. Various attempts have been made to integrate the IPI and ICMS systems (vertical) with the inter-state transactions (horizontal). But, a hassle free harmonized VAT system in Brazil is yet to be developed and implemented.

The Argentine case was also discussed. The central government collects most of the taxes in Argentina. These taxes are shared with the states through a "co-participacion" (tax-sharing) system. The gross receipts tax is the most important in own source revenues of the provinces. In order to change the gross receipt tax to a retail sales tax, many provinces abolished or reduced the tax on agriculture and some items on manufacturing. All options including central VAT, state VAT, dual VAT and retail sales tax are being examined in Argentina. Inter-state variations in fiscal capacity create challenges in the design of a new system.

The case of EU suggests that EU levies VAT at the state level. The tax system has been based on destination principles through VAT information exchange systems ensuring zero-rating for the transactions between the registered dealers only. The VAT has been harmonized through abolition of fiscal frontiers and zero rating of inter-state transactions. The EU Parliament issues directives from time to time to impose uniformity in structure, organization and procedures of VAT in the European Union.

The debate on how effective different forms of harmonizing VAT and other taxes have been is inconclusive. It reiterated that different contexts require different solutions. Many dimensions including population, size, location, economic pattern, quality of tax administration, the degree of trust, and the existing tax structure of a country play an important role in tax harmonization and determining its effectiveness.

2. Fiscal Responsibility Legislation

Since the beginning of the last decade of the twentieth century, several governments have been intensely exploring the mechanism to shift from discretion based fiscal policy to a rule based fiscal responsibility framework. An increasing number of countries, including federations, introduced fiscal responsibility legislation (FRL). FRL includes elements like numerical fiscal targets, fiscal transparency standards, escape clause in case of exigencies, fiscal policy rules, and enforcement mechanism. The examples of such countries are Argentina, Australia, Brazil, Chile, Columbia, Ecuador, Estonia, India, Indonesia, Mexico, New Zealand, Peru, Russia, South Africa, the United Kingdom, and Venezuela. However, the fiscal targets set under the Treaty of Maastricht in 1992 facilitated the adoption of the Euro.

The adoption of fiscal policy rules emanated from the tendency of the populist governments towards fiscal profligacy to enhance their election prospects. The tendencies became unsustainable over the medium term and jeopardized public service delivery and the safety of the financial system in view of the fact that the banks were the major holders of the public debt. The creditworthiness of the states or the governments themselves were affected when there were huge accumulations of debts, as states' ability to service those debts decreased in the market. Finally, the overall macro economic stability of the central bank was affected.

FRL, if well designed and rightly implemented, is considered as a commitment device. It commits federal, regional and local governments through cooperative framework to follow a certain fiscal discipline and ensure that deficits are within tolerant levels so that the tendency of an individual government to run excessive deficits is minimized. Country examples suggest that it has been more voluntary rather than coercive. So, some states have adopted this legislation whereas others have not. Thus, for a group of the federal and subnational governments it is mutually reinforcing, as every government is part of the bargaining solution framework. To an extent, it protects the common interest that although not every government is part of the framework, there is commitment to bringing down the level of fiscal deficit and reducing borrowing. It is considered the state of fiscal behaviour of both the federal and subnational governments. However, within a common framework, there is a tendency in both governments—the federal and subnational—to take advantage and violate some of these frameworks.

Therefore, it is essential for every government to abide by the same framework.

3. Discussions and Conclusions

Against this backdrop, the Chairman of the session presented the Indian case, among others, in his speech. The Indian Constitution recognizes federalism in its legal, political, administrative and financial aspects. The two tier federal system of the Union and the state governments was extended a decade and a half ago to cover local governments at the district, sub-district, city, town and village levels. Like many other federations, a complex system of financial relations between different levels of government attempt to address existing vertical and horizontal imbalances. The Union Government of India enjoys a greater share of the overall tax revenues while the states bear greater responsibilities for expenditure to meet many basic needs of the people, such as education, health services, water supply, electricity, transport infrastructure and many others. Successive finance commissions guide a system of devolution of tax revenues from the Union to the states. The institution of planning commission and ministries provide development assistance and funds to states for implementing many 'Centrally Sponsored Development Programmes'. The finances of both the Union and the state governments in India were under great stress during the nineties due to a number of reasons including inadequate mobilization of taxes and fast expanding revenue expenditure. The combined fiscal deficit of the Union and the states at one time went up to about 11 per cent of the Gross Domestic Product (GDP). The combined internal debt of the Union and state governments was very high at about 80 per cent of the GDP. The interest payments consumed a substantial part of the tax and non-tax revenues of the Government with revenue deficits becoming very common, which forced the governments to borrow increasingly to meet their revenue expenditure. Consequently, the Government was unable to commit adequate resources to pursue its development goals.

It was in this context that FRL was adopted as one of the first steps in that direction. This was first passed in 2002 by the state of Karnataka followed by Punjab even before the Union Government passed the Fiscal Responsibility and Budget Management Act in 2003. The Act required the Union to eliminate its revenue deficit before 2008. It also imposed restrictions on borrowing from the Central Bank, i.e. the Reserve Bank of India. The Centre is also required to present to Parliament every year a Medium Term Fiscal Policy Statement and a Macroeconomic Framework Statement along with the budget. Further, quarterly reviews of receipts and expenditure are also to be presented by the Finance Minister. Other states, namely, Kerala and Tamil Nadu, also passed it in 2003 and Uttar Pradesh in 2004. The enactment has helped the state in bringing about the required fiscal correction and restricts its fiscal deficit to less than 3 per cent since 2004-5. The Act requires the state to present to the Legislature a rolling Medium Term Fiscal Plan every year and a review of its fiscal situation once in six months. As a consequence of adopting these measures, the state of Karnataka has been able to restrict its revenue expenditure and exercise prudence in its overall financial management. After the adoption of the FRL by the Union, the Twelfth Finance Commission stipulated a scheme of consolidation and partial waiver of the state's debts to the Union Government. The states were required to adopt fiscal responsibility measures to become eligible for this debt restructuring and waiver. Consequently, remaining states have also passed the FRL. However, it is believed that the passage of an Act is no guarantee of its implementation, but most of the states that have bound themselves to fiscal targets have so far achieved them.

Indian experts were of the view that the Fiscal Responsibility Legislation adopted by the Union and the state governments in India has greatly helped in strengthening the federal structure instead of weakening it in any manner. It was emphasized that states which manage their finances prudently can sustain their political autonomy much more effectively than those which have to repeatedly seek the assistance of the Union Government to overcome their financial difficulties. FRL acts as a check against unbridled populism on the part of governments, which indulge in financial profligacy in the hope of improving their electoral prospects. The risk of such populism is very high in cases where elections result in a fractured mandate leading to unstable coalition governments. "The balanced development of all parts of a large country like India also requires financial discipline being observed by the states, so that the profligate financial policies of some states do not result in serious distortions in the efforts needed for the development of different regions", the chairman said, with support from other experts.

An Austrian case was also presented. The salient features of the presentation are as follows: The federal assembly of Austria comprises a federal government, nine states and 2357 municipalities. Austria joined the European Union in 1995 with a fiscal responsibility framework. Under the Austrian Internal Stability Pact, fiscal policy rules were framed, federal fiscal deficit was restricted, and state surplus was made mandatory with balanced municipal budgets. Procedures such as accrual based accounting and frequent government reporting were adopted. There is an independent monitoring and financial sanction that is possible. A high level committee comprising Federal Minister of Finance, nine state finance ministers, and political representatives of rural and urban municipalities coordinate the budgets. It was viewed that in Austria, FRL, although it did not guarantee fiscal discipline, was a formal expression of the political will towards sustainable public finances and could be reconciled with federalism. It is a good instrument to harmonize fiscal behaviour; this point was stressed during the case presentation of Spain.

The case of Brazil was also presented and discussed at length. The genesis of the FRL in Brazil can be traced in three subnational debt crises that happened in 1989, 1993, and 1997. Each time there was an agreement, the agreement specified some ways of limiting the future subnational debt. It reinforced the perception that the federal government would rescue states and bail the subnational debts. However, most debts were rescheduled and not waived. The provinces continued to borrow and the debts kept growing. There was no penalty on the subnational government for having defaulted. So, the federal government was left with all the debts of subnational government. In the 1997, under the new strategy, the states were liable to pay more by way of debt servicing to the centre on the existing debt. There would be deduction in the fiscal transfers from the federal government to the provinces in favour of debt service. Privatization was prescribed to all the state enterprises including all state owned banks. This was considered imperative, as state owned banks were financing provincial debt in Brazil. Therefore, it was an effort as part of the privatization regime to force the states to divest their holdings in state-owned banks. The passage of FRL of 2000 was the culmination.

The Brazilian FRL of 2000 was considered to be a coercive law. It was one law for all level of governments, federal, state, and municipality. It had prescribed the eligibility criteria to borrow and the legal penalties for any default. It had all the in built intermediate targets, caps on the spending, deficits, and debt targets were specified. It prohibited debt refinance operations between governments.

To conclude, the experience in countries at the subnational level with fiscal responsibility legislation so far, while mixed, is fairly positive. Passage of an act is no guarantee of its implementation, but most of the subnational governments, which have bound themselves to fiscal targets, have by and large achieved them. However, in a federal set up considerable care is needed in the design and enforcement of numerical fiscal policy rules. While uniform fiscal policy and procedural rules are possible in a top down approach, these are difficult where considerable fiscal decentralization exists.

Subtheme

Managing Fiscal Conflicts

Work Sessions 5 and 17: Fiscal Equalization and Fiscal Conflicts are like the Chicken or Egg Question: Which Came First?

Jan Werner

1. Introduction

The decentralization of expenditure and public functions is only "one side of the coin" of fiscal federalism. Just as well it has to be settled how this delegation is financed and how independent the subnational and local authorities are in their provision of public goods and services. A reasonable intergovernmental financial system has to consider the following principles[1]: revenue autonomy, subsidiarity and connectivity (local accountability), transparency of the tax system and direct impact of the tax burden (benefit tax link), reference to local circumstances and neutrality of the taxes with regards to the private sector, tax bases, which are not affected by economic fluctuation and are also viable, and simplicity of tax system.

At first glance, these five principles seem to be trying to "square the circle" and even at second glance, it has to be admitted that no federal or unitary country in the world has implemented a public finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of how to finance subnational and local services differs significantly. The respective advantage and disadvantages of each method can best be assessed in a general comparison.

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers. Besides a local property tax, a group of European countries, namely, Switzerland, Belgium, Croatia and the Scandinavian countries—give significant tax autonomy to their local authorities and therefore a local surcharge on the personal income tax is common.

Furthermore, a third possibility to finance local authorities has been chosen by Austria, Germany and Poland, who developed a local tax system with its own revenues as well as tax-sharing. Nevertheless, vertical grants are also needed in the Anglo-Saxon model, the Scandinavian model and the German model. Grants and transfers avoid external effects and spillovers, for example, a local jurisdiction benefits from services of other local authorities without participating in the cost. This situation often exists in the relationship between a metropolitan city and its suburbs. A reasonable solution of this problem is the FOCJ (functional, overlapping, and competing jurisdiction) concept (see Frey/Eichenberger, 1995), but for developing countries the FOCJ concept is not comprehensible. Moreover, the school communities of the Swiss canton of Zurich and the North American special districts are the only successful examples of the FOCJ concept.

Sometimes a country restricts the local accountability, because it substitutes local taxation for vertical grants. These negative scenarios can be found in the Netherlands, Wales, Ireland and Scotland. In the case that local authorities cannot generate sufficient finances from taxes and grants, municipalities will use charges and fees to fill the financial gap. These developments do not only occur in China (see World Bank, 2002) but also in such a rich country as Norway, where "since 1980 user charges have been the fastest growing revenue component of Norwegian local and county governments" (Borge, 2000).

2. Revenue or Cost Equalization

An equalization system can be mainly based on revenue equalization or cost equalization. Well known examples of revenue equalization are the Canadian equalization system between the provinces (see Boadway, 2004 and Bird and Vaillancourt, 2007) and German equalization between the Länder (Werner, 2003 and Spahn and Werner, 2007). In contrast, Australia and Scandinavian countries such as Denmark or Sweden (see Werner/Shah, 2005) base their respective equalization systems on the concept of cost equalization. In the following paragraphs the different ideas of revenue and cost equalization are explained, illustrated by the examples of Germany and Switzerland.

Germany is a federal state with a three-level administrative structure. In addition to the federal government, whose ministries are based both in Germany's capital, Berlin, and in Germany's former capital, Bonn, there are 16 federal states (Bundesländer) and 13,897 municipalities.

In Germany, tax revenues are distributed among the individual regional administrative bodies both according to own assigned revenues and revenue sharing. This, for example, means that the tax receipts from the real property tax are available to the municipalities in full, while they also receive a fixed percentage of the tax receipts from the value added tax (VAT) and the personal income tax (PIT).

The distribution of the most important tax revenues is shown in Table 1.

Germany's fiscal equalization among the federal states is based on Article 107 of the German constitution and consists of several levels. Generally, the horizontal fiscal equalization among the federal states can be classified as; the distribution of corporation tax and personal income tax, the distribution of value added tax, fiscal equalization among the federal states (narrow definition), and the allocation of additional funds by the central government.[2]

Table 1. Tax revenues assignments between the central government, the federal states and the municipalities in 2006

	Central Government (%)	*Federal States* (%)	*Communities (%)*	*Revenues in 2006 (billion)*
Consumption tax*	100			72. 938
Inheritance tax		100		3.763
Property tax			100	10.398
Personal income tax	42.5	42.5	15	152.082
Value added tax	51.4	46.4	2.2	146.688
Corporate income tax	50	50		22.808
Interest rebate	44	44	12	7.633
Trade tax**	14.8	7.7	77.5	38.369

Notes: * Tax on mineral oil, electricity, tobacco, spirits, coffee and sparkling wine.

** The breakdown refers to the 2001 tax year. The municipal share of the "German Unity" fund as well as the municipal share of the reformed fiscal equalization system were added to the central government.

Source: Author.

Generally, the fiscal authorities in the respective federal states are entitled to receive, in full, the tax revenues from the states' own taxes and a share of both the income tax and the value added tax, according to the principle that taxes are collected in the place where they were generated.

The principle of collection of taxes where they are generated runs counter to the law of tax segmentation (Zerlegungsgesetz) and the sharing of income and corporation tax. This is meant to prevent a company with several outlets in different federal states from paying its taxes exclusively in the federal state where its head office is based, while the remaining federal states are not able to take advantage of any tax revenues.

When apportioning the corporation tax, the principle of the business location of the trade tax applies, while the apportioning of the personal income tax between the federal states is based on the principle of the taxpayer's place of residence.

This principle of apportioning the taxes is also applied when determining the percentage that the federal states receive of the value added tax. Article 107, section 1, clause 4 of Germany's constitution stipulates that at least 75 per cent of the generated VAT to which the federal states are entitled has to be distributed among the federal states according to the number of their inhabitants. The remaining 25 per cent is distributed as an additional percentage to the financially weak states. Particularly because of Germany's reunification and the resulting incorporation of the new federal states into the Federal Republic of Germany, this financial redistribution has gained enormous significance.

Under the narrow definition of the fiscal equalization system among the federal states, there are direct horizontal transfer payments between the federal states.

So as to determine the financial strength of every single federal state, one has to calculate the financial strength indicator in the fiscal equalization system. This figure is composed of a state-specific total sum of state taxes as well as 64 per cent of the municipal taxes. Under the fiscal equalization system, the financial requirements of each state are determined on the basis of an equalization indicator. This equalization indicator is calculated by multiplying the number of inhabitants of that state by the average nation-wide per-capita figure of the state and municipal tax revenues. While state tax revenues are considered completely, the municipal taxes are only taken into account at 64 per cent of this collection. Moreover, the inhabitant numbers of the city-states of Hamburg, Bremen and Berlin have been "readjusted", i.e. their inhabitant numbers have been multiplied by the factor 1.35.

If the financial requirements of a federal state are higher than its financial strength, this state will receive equalization funds from the financially stronger states, whose financial strength is higher than their requirements. By means of these equalization funds, the "recipient states" among Germany's federal states are able to increase their financial strength to at least 95 per cent of nation-wide financial strength. At the same time, the financial strength of the "donor states" must not fall below 100 per cent of the average nation-wide financial strength.

On account of the additional funds allocated by the central government, there are vertical grants from the federal government to the federal states. Regarding the central government's allocation of additional funds, a distinction can be made between the allocation of deficit-coverage funds and special requirement funds. The deficit-coverage funds enable the financially weak "recipient states" to reach 99.5 per cent of the average financial strength of the federal states. The allocation of special requirement funds means that for particular reasons, some federal states receive additional funds from the federal budget. Thus, for example around 0.75 billion a year flows to all those federal states with less than four million inhabitants in order to compensate for the disproportionately high political and administrative costs. In addition, there are special allocations of funds for the abolition of special charges relating to Germany's division (Berlin and all new federal states).

In Switzerland all three tiers of government can levy their tax rates independently on the direct taxes, but since 2001 the tax base of the direct taxes as well as the tax year have been completely harmonized. Therefore the tax "jungle" (Duss/Bird, 1979) has now dwindled a bit but it has not yet been fully cut back, especially regarding the PIT and the wealth tax.

On the other hand, all revenues from indirect taxes like the VAT or all excises belong to the central government and only a small tax-sharing between the central government and cantons exists for the stamp taxes and the withholding taxes.[3]

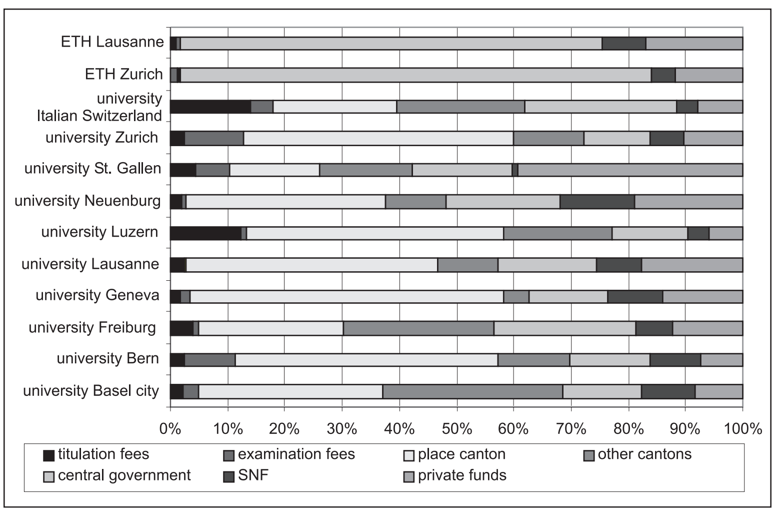
In the context of the educational cost, in Switzerland a very smart solution for the financing of the universities exists. In Switzerland 12 universities exist and 2 of 12—the Swiss Federal Institutes of Technology (Eidgenössische Technische Hochschule, ETH) in Lausanne and Zurich—are institutions of the central government. The remaining 10 universities are located in 10 cantons and therefore 16 of 26 Swiss cantons do not have to finance a university directly. However, it happens very often in Switzerland that a student has his residence in one canton but he attends the university of a neighbouring canton. This situation can be used as a classical example of spillovers, and a possible solution could be the concept of functional, overlapping, and competing jurisdictions (FOCJ) developed by Frey and Eichenberger (see Frey and Eichenberger, 1995).

Nevertheless, the cantons do not use the FOCJ concept to solve this problem, but the canton where a university is placed receives funds from the other cantons, where the commuting students have their residence. The calculation of the funds is very detailed, which means that the different costs of a faculty towards a university as well as the respective duration of every student have to be borne in mind for the calculation.

The total expenditure cost of 12 universities amounted to 3.16 billion in 2004, while nearly 20 per cent originated at the ETH Zurich and 52 per cent was generated by the ETH Zurich, the University of Zurich, and the University of Geneva. Moreover, the impact of the inter-cantonal university equalization differs from university to university and has it highest influence at the University of Basle city and the University of Italian Switzerland.

A detailed overview of the financial structure of the twelve universities can be observed in Figure 1.

While the German system mainly equalizes revenue disparities between the Länder, the Swiss university education equalization system considers the different expenditure needs of each canton.



Source: Werner/Shah, 2006.

Figure 1. Financing structure of the 12 Swiss universities in 2004

Hansjörg Blöchinger from the OECD mentioned in the discussion of the working session 5 that he prefers revenue equalization systems, because they are easier to administer and more transparent. Professor Lars Peter Feld from the University of Heidelberg and a supporter of the idea of cost equalization replied that revenue equalization systems are generally unable to consider spillover. In the view of the author, both economists are right and for this reason revenue equalization should be used solely for regions or provinces, while a local equalization system should be based on cost equalization.[4]

3. Pros and Cons of Independent Drant Commissions

The institutional arrangements for fiscal transfer and their respective equalization system differ. Anwar Shah has created very sound categories for classification:[5] central government agency (Poland, Italy, and China), national legislature (Brazil), intergovernmental forum (Canada, Germany, and Indonesia) and independent agency (Australia, India, and South Africa).

In the following paragraphs the different concepts of an independent agency and an intergovernmental forum are explained using the examples of Australia and Canada.

Australia has a strong, vertical fiscal imbalance in favour of the central government. It corrects this imbalance by using asymmetric vertical grants (based on the goods and services tax) with an implicit equalizing effect. The Australian Commonwealth Grants Commission (CGC), set up in 1933, advises the central government and the Australian states. As an advisory body, the CGC is asked to calculate appropriate ratios of per capita grants for the distribution of general revenue assistance from the Australian Government to the states and territories. The central government as well as states and territories accept the suggested distribution of the grants to the states, even though de jure the right to make the final decision belongs to Commonwealth Minister for Finance and Administration.

The Australian system of fiscal equalization is one of or even the most complex and thorough of all federations worldwide.

Australia has put in place an explicit and ambitious equalization scheme that aims at full, standardized budget equalization. In establishing a point of reference for such a scheme, Australia not only attempts to evaluate the standardized taxing capacity of its states, but also of standardized expenditures adjusted for needs and cost differentials among jurisdictions.

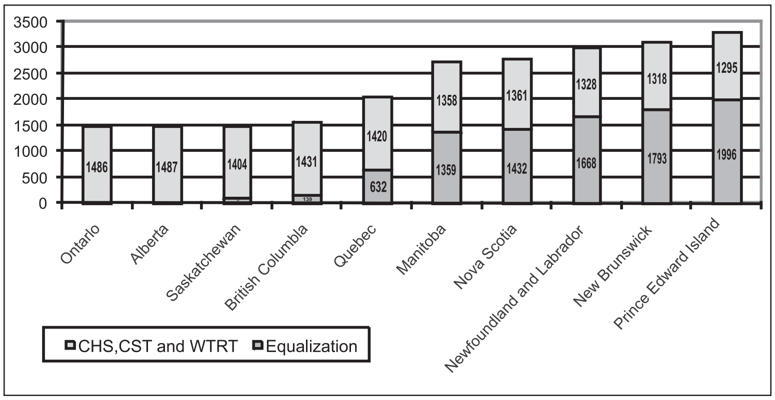
This all-embracing approach to equalization in Australia is often criticized for its complexity and lack of transparency. Even the CGC itself observes that "the simplification of methods should be a priority going forward" (see CGC, 2004,).

The Canadian equalization system is imbedded in heterogeneity of different forms of cultural heritage with the major French speaking province of Quebec, the bilingual mixed province of New Brunswick and the eight English-speaking Anglo-Saxon Provinces. On the one hand, Canada has one of the highest forms of subnational tax sovereignty in the world,[6] but on the other hand, the economically weak provinces, which are mostly located on the Atlantic Ocean coastline, are heavily influenced by the vertical equalization grants of the central government in Ottawa.

The Canadian transfer system consists of four[7] pillars: the Canadian Health Transfer (CHT), the Canadian Social Transfer (CST), the Territorial Formula Financing (TFF), and the Canadian equalization. Figure 2 demonstrates the fiscal impact of all four pillars in the fiscal year of 2005-6.

The Canadian equalization system is based on the fiscal capacity of every province. The measurement of the fiscal capacity includes 33 provincial tax bases.[8] With clear transparency and low cost of administration, the Canadian system has similar advantages to the German equalization system, compared to their counterparts in other federal or unitary countries. In contrast to the German equalization system, the Canadian equalization allows the reflection of different subnational tax rates.

Legal responsibility for the Canadian equalization system falls within the scope of the federal government, which proposes the volume and the formula, and the national parliament finally approves the proposal of the central government. However, the central government and the provinces cultivate intergovernmental



Source: Werner, Guihéry and Djukic, 2006.

Figure 2. Transfer from the Canadian central government to the provinces in the fiscal year 2005-6 (measured in CAN $ per capita)

discussion, through the Fiscal Arrangements Committee. The provinces and the central government consequently share information, consider technical issues involved in the equalization process and discuss problems with less political rivalry.

During the discussion of work session 17, Michael Willcock from the Australian Government highlighted the advantage of the CGC; in his explanation he mentioned that the proposals of the CGC were mostly accepted by all tiers of governments and politicians. David Peloquin from the Canadian Ministry of Finance pointed out the huge complexity of the Australian model and rejected this kind of system for Canada. The author of this paper agrees with the opinion of Mr Peloquin, nevertheless cedes that there was an equal number of supporters and critics of the Australian model among the participants in the round table discussions.

The level of the marginal rates of compensation, the equalization model and the institutional arrangements for intergovernmental fiscal transfers are always the subject of a fundamental political decision which could be a "hard row to hoe", if we were to consider the lengthy political reform discussions in Germany and Switzerland. For example, the only way of avoiding this political "hot potato" is to delegate the whole equalization measurement to an independent council of economic experts such as the Australian Commonwealth Grant Commission. On the other hand, however, such "political outsourcing" always leads to a lack of democratic control and increases the complexity of the system. This is because bureaucratic experts have to consider other principles than an elected representative.

4. Conclusion

The reasons for fiscal equalization are manifold and are influenced by political and economic views. Fiscal equalization can be used to solve or ease fiscal conflicts between the different tiers of government. However, if the political stakeholders do not possess a common interest such as the continuance of a country as one unit and would prefer to see the secession of a region, even a well designed equalization system would not able to prevent such a situation. The case of Bosnia and Herzegovina is quite unique (see Werner, Guihery and Djukic, 2006), because on the one hand the respective ethnic groups in this country use the distribution of tax revenues to heat up national tension, and on the other hand the international community is working to avert a separation through external political pressure as well as an internally controlled institution named OHR. In some countries like Spain, fiscal conflicts are the result of an unfulfilled wish for independence by the regions and if one erroneous trend in the intergovernmental system is rectified, the political leaders of the autonomous communities bring up another painful subject, instead of considering their huge autonomy and the successful development of Spanish democracy over the last decades.[9]

Another dimension of fiscal conflicts is natural resources and therefore Spahn's suggestion that "such conflicts are best avoided *a priori* through a clear tax and revenue assignment rules" (see Spahn, 2007) is more than reasonable.

Sometimes fiscal conflicts are brought to an end by external shocks as in Indonesia. Since the central government of Indonesia mandates funds to the regions destroyed by the tsunami, the wish for independence in the region of Aceh has decreased enormously.

However, the question as to whether fiscal equalization came first or fiscal conflicts, cannot be clearly answered. Rather, every federal and unitary country has to find its own link between solidarity and subsidiarity.

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Notes

1. For detailed description see, for example, Spahn, 1995 as well as Werner, 2006b.

2. To facilitate the description as a whole, the new regulations in the "Solidarity Pact II" are not mentioned, such as, for example, the so-called premium model which will be newly introduced from 2005 onwards.
3. The new § 132 of the Swiss constitution introduces a tax sharing at the withholding tax, in which the cantons are receiving 10 per cent of the whole tax yield (5 per cent based on the population number and 5 per cent for equalization purpose between the cantons.) Moreover, Switzerland has recently approved a new inter-cantonal fiscal equalization system (*Neuer Finanzausgleich*, NFA) and this equalization system will be fully implemented in 2008 (see Schaltegger and Frey, 2003 as well as Dafflon, 2004).
4. A general description of a local equalization system based on revenues and local needs see Werner, 2006a.
5. See Shah, 2005 as well as Shah, 2007
6. See Hayashi/Boadway, 2001 and Esteller-Moré / Solé-Ollé, 2002
7. The Health Reform Transfer has been introduced recently, and therefore are sometimes mentioned as five pillars of the Canadian transfer system.
8. The calculation of the tax base uses nation wide average tax rates. Furthermore, the Canadian standard measures uses the average fiscal capacity of the five "middle income" provinces.
9. The 17 Spanish regions, called Autonomous Communities, can be characterized as two different groups. The two Autonomous Communities of Navarre and the Basque county possess a special status called "foral" and therefore their independence from the central government in Madrid was extremely high, e.g. they had their own tax administration and a huge tax sovereignty, which was quite similar to that of an independent state. The residual 15 regions, which are called regions of the common rights (*Comunidades Autónomas de Régimen Común*), can influence their tax revenues from the personal income tax by different tax rates or by the arrangement of the tax exemptions. This concept is not similar to the Nordic local surcharges on the PIT, where the municipalities add a proportional surcharge to the national tax rate. The Spanish concept could be compared more with the Swiss solution, where cantons and municipalities can levy their own tax rates and tax exemption for every citizen and only the taxable income is fixed by national laws. If a region uses the same tax rates and exemptions like the central government, the region will receive 33 per cent of the total personal income tax, which is paid by their respective citizens. A huge difference between Switzerland and Spain is that in Spain an upper and lower limit exists for the tax rate.

Subtheme

Fiscal Federalism and Regional Equity

Work Session 6: How do Federations Reconcile Overall Economic Stability with State Autonomy?

Work Session 18: To What Extent do Central Governments Erode State Jurisdiction using Fiscal Arrangements?

José Roberto Rodrigues Afonso

1. Economic Stability and State Autonomy

Fiscal conflicts are inherent to federations. The greater challenge lies in dealing with them. These conflicts are common to all countries, however, the way each federation solves them is very different. There is no unique solution common to all. Conflicts exist both at the vertical and at the horizontal level. A discussion ensued on understanding the conflicts between the different tiers of a government. The Indian experience, in particular, was the most debated topic in the round table session. A discussion on the arrangements made to reconcile economic stability with federative autonomy gravitated around the enactment of laws that define limits, and the rules and conditions for the management of the public finances of the federative units. The debates focussed on how new arrangements can be organized under the form of fiscal responsibility legislation. The predominant concern was with the possible effects of the law that had been recently approved in India. However, it was pointed out that such questions had already been faced and many of them solved during the elaboration and the implementation of similar laws in Brazil.

It is interesting that issues such as the collection and sharing of taxes, the concession of grants, or even the management of the public expenditure were little debated. Meanwhile, the attention shifted to subnational indebtedness, or rather the use of mechanisms to control it. This summary uses subnational governments as an expression to refer to both intermediate governments (states, provinces, departments or regions) and local governments (municipal or cities) for analytical purposes. The debates then focused on the autonomy of the states with regard to India where the local government is less relevant compared to other federations, such as in Pakistan, South Africa, and Brazil.

Divergences and conflicts of a political order and other fiscal questions were discussed in the debate. Some participants were extremely critical of the restrictions imposed on subnational expenditures or debts by the national legislation or directly by the central government. To illustrate this issue, it is relevant to quote a critic who tries to define the role of the state in the economy: "... neoliberalism simply entails a retreat of the state, a cessation state intervention in economic life". In fact, this view criticized the ability of the central government to take care of economic stability: "… it is the central government that has first gone over to neo-liberalism". Thus, the neoliberal agenda would comprise rules to be applied, or actions proposed, to the subnational governments. These include: fixing limits or conditions to take loans, applying fiscal responsibility law, making public-private partnerships, adopting a national value added tax (VAT) or reducing and organizing the collection of other local taxes. Of course the local authorities concluded by claiming that a more decentralized stance regarding the division of resources and responsibilities between the central and the subnational governments was required.

Those interested in exploring the material distributed in the conference: the papers of the theme "Emerging Issues in Fiscal Federalism" (see Shah, Rezende, Rajaraman and Rao, 2007) and, specifically, the subtheme "Fiscal Federalism and Regional Equity" (see Spahn, 2007), should refer to the Conference Reader which presents a broader overview on the subject than the (short) background paper as mentioned in the programme and distributed in New Delhi. Initially, a specific situation was illustrated when Argentina was brought to focus (see Zapata (2007) for more information about Argentina). The main concern was around the repercussions of cyclical fluctuations of prices or productions on public revenues and expenditures. If the public revenues are concentrated in indirect taxes, the volatility of the budget will increase. The cycle of strong expansion of the worldwide economy created an uncommon situation. There is a dilemma for the allocation of current surplus: infrastructure investment and social programmes, debt repayment, tax reduction and stabilization fund. Argentina tried to reconcile overall stability with state autonomy, at first, by introducing a fiscal responsibility law, which features a coordinated approach based in a national council. It was suggested that the law would have to evolve for the creation of stabilization funds, with mechanisms such as: joint ownership between central and state governments, automatic application of rules for saving and withdrawals, and fixation of limits and exceptions. Mexico was seen as having a good experience in this direction.

The case of the India, in general, was presented with radically distinct views, depending on whether the participant represented the central government or one of the country's subnational governments (see Rajaraman (2004), amongst other authors who analyse the fiscal situation in India). As it was already said, the debate about reconciling stability and autonomy mostly concentrated on the fiscal responsibility law issue. On the one hand, the supporters of the law claim that there is a commission to represent and to express the interests of the subnational governments in the definition of the plans and the budgets. They refuse the idea of an eventual conflict between fiscal and social responsibility in the public administration. On the other hand, the critics claim that a development strategy is lacking, that the deficit target is excessively low and that the increased revenue generation did not result in more investments in social programmes. They also complained that the loans granted by multilateral organizations would limit the autonomy of the state governments to define their expense priorities.

The Brazilian experience was presented as a counterpoint (see Serra and Afonso (2007) for an update overview about fiscal federalism in Brazil). In this case subnational governments are allowed to borrow funds in accordance with national limits and criteria. They are also allowed to take loans from domestic and foreign banks and in principle to issue bonds in domestic and foreign bond markets. Temporarily, many states are forbidden to issue bonds due to the condition imposed for the last renegotiation of debts contracted with the national treasure. The central government does not have the right to interfere (only to register the operation). Despite this autonomy, the credit has been of minimal importance to subnational finances nowadays. Brazil suffered, until the mid 1990s from an uncontrolled subnational indebtedness, induced sometimes by economic politics and sometimes by improper recording of debts. Two major reasons explain the debt growth and the failure of the previous system. First, the rules on debt rollover were extremely permissive. Second, the central government became used to bailing out insolvent state and local governments. However, the restructuring of the government in mid 2000 culminated in the approval of the fiscal responsibility law, which applied to all three tiers of the government and resulted in a turnaround in the fiscal, economic, and social spheres.

The international experience with fiscal responsibility legislation shows that the differences in the solutions adopted begin in the way they are applied to the states: is it by adhesion or imposition? (For a comparative analysis of the legislation most recent, see Webb, 2004.) Also, the limits for subnational indebtedness and deficit (including zero-deficit rules) motivated intense controversies in workshop. It was pointed out that many federations in developing countries tend to present a more centralized arrangement. For instance, in majority of these countries, subnational governments can take loans only with guarantees made by central government.

But, at least in these cases subnational governments can take loans. In Pakistan, for example, it is forbidden by the Constitution.

One hypothesis raised was that the fiscal centralization would be associated with higher regional and individual inequality. The conclusion that emerged was that the central government should be necessarily very strong to promote the redistribution of resources among regions and families. The United States was seen as a radically opposing case, combining high fiscal decentralization with great fiscal deficits and debts. So, a participant suggested a test: to suppose the application of the deficit zero in all of the US. In this context, a paradox was also pointed out. Federal countries have solved stabilization problems better than unitary countries. If stabilization is always a typical function of the central government, it is important that federations delegate monetary policy to an independent central bank and that the central government is not a lender of last instance for subnational governments, which means no bailout. According to Spahn; "One particular type of fiscal conflict is associated with public borrowing and potential moral hazard by public administrations. Such conflicts are often easily controlled in unitary states than in decentralized governments because multiple governments require special provisions of fiscal coordination. Where such coordination is lacking jurisdictions within a federation could abuse their sovereign rights to incur large public deficits expecting other governments to bail them out. It could lead to macroeconomic instability and fiscal crises affecting the whole country."

In the conclusion, many participants mentioned that the intergovernmental transfer system can be used as an instrument to solve fiscal conflicts. However, the debates made it clear that the question proposed for that work session was more complex and the alternatives were broader. First, "reconcile" is the key word in the proposed question. This means: "to bring into agreement". The idea is to recover something that would have been settled in the past. Second, the question presupposes an implicit contradiction. On the one hand, overall macroeconomic stability is seen as an exclusive attribution of the central government, and the subnational governments would not have any obligation with such an objective. On the other hand, the states usually understand autonomy as freedom to do anything. The fiscal conflicts then occur, for example, when state debts affect the fiscal national targets, when subnational expenditure pressures the national demand, when increase in the state tax affects inflation or when state and local debt increase is harmful for the macroeconomic policy (see Wallack and Srinivasan, 2006, for an overview of effects of the globalization and modern economic reform to eight big federations).

The main answer to the question raised in this work session is coordination. The central governments must work together with the states and the local governments to pursue the fiscal balance. It is recommended that with the application of limits and targets to maintain the fiscal balance and total debt, and occasionally for some expenditure, states should have more autonomy in taxation and spending. Fiscal rules must be defined by formal or informal agreements. For instance, some countries apply laws while others prefer intergovernmental mechanisms. In the end, the degree of fiscal discipline is dictated by the penalties applied in case the targets are not met. It is said that people believe in rules, not in politicians. The optimistic message passed in the work session is that dichotomy between stabilization and autonomy cannot be prevented. It is necessary to have coordination between governments to apply basic fiscal rules and to pursue good practices. Fiscal responsibility laws contribute a great deal to the pursuit of such objectives, the important point being that they are applied to all the government levels and not only to subnational governments. Enabling the local governments and ensuring accountability are fundamental as well. Thus, it is possible to combine fiscal decentralization with good macroeconomic management. Therefore, it is possible to conclude that federalism helps to build this undeniably complex solution because it is about the best form of government to accommodate and conciliate the differences.

2. Erosion of State Jurisdiction

Work session 18 explored the flipside of the issues raised in Work session 6. An argument was put forth in the favour of states, to defend their autonomy from the fiscal arrangements defined by the central government. The session was addressed to the central government. An important point raised in the backgrounder to the session stated, "… through the mechanism of tax assignment, devolution and transfers the central government erodes the state jurisdiction". The debate was motivated by a presentation of three cases: on India, Russia and USA. India and Russia are examples of high fiscal centralization while North America is the complete opposite.

The work session referred to different aspects of India's federative system. It was felt that the autonomy of states could be harmed by the mechanisms of the fiscal and financial relations between the governments. State programmes are financed by grants defined by a commission commanded by the central government without any flexibility for application. Authorities of the central government had criticized the high costs and the quality of services delivered by the state governments. A consensus was reached on the importance of new and clearer rules, regulating the finances and making efforts to prevent or at least reduce conflicts especially for social programmes.

Russia was seen as an example of a country with a very centralized system indeed. However, it was considered a success when it came to the redistribution of resources within a singular country with continental dimensions and deep differences between various regions. The grants have a crucial role to play in this context; therefore they must be simple, clear and transparent. A parcel of 15 per cent of the budget of the central government is transferred to the other governments that have fort independence for its application. Taxes are concentrated in the central government but Value Added Tax (VAT) and income taxes are shared with regional governments, with periodically negotiated criteria of distribution. It is then defined as a case of high fiscal centralization with maximum redistribution.

USA constitutes an extremely opposite case. In the US the inequality between regions and families is smaller than in many other countries. This guarantees a concession of the bigger fiscal autonomy for the state and local governments. The matter of concern in this case is another one: to improve symmetric federalism. The exposition emphasized the autonomy for the collection of the state and local taxes, especially the sales tax by state and property tax by local governments. The concern with the erosion of state autonomy is something more recent and based in the financing and the execution of social programmes, especially those that benefit the population directly. The central government has exercised a more active position by providing funds to social programmes, mainly in the area of medical assistance and also by giving subsidies to the poor, to facilitate education, transport and environment. The states reacted by deciding not to participate in national programmes, sometimes claiming significant costs or insufficient funds provided by the central government. Therefore, in the case of other federations, the main objective of the central government at the time of allocation of funds should be taking care of individual needs. It is more important to equalize the demand between individuals than to redistribute resources among different tiers and units of governments.

The debate concluded that in developing countries states have to depend on grants as compared to developed nations like USA where there is a surety of taxes.

Tax assignment is an object of conflict between central and state governments, affecting both developed countries, such as Canada and Italy, and emerging ones, like India and Brazil. The conflict has an exact address in many cases such as tax reform. In developing countries this concerns the Value Added Tax, VAT (see Bird and Gedron, 2005). In India, the change of this tax was seen to be the reason for the recent increase in the centralization of the revenue (see the publication by Committee of State Finance Ministers, 2005).

The redistribution between governments would not have to depend on political decisions but the usage of technical criteria to reduce the disparities between regions and federate members. This is a particularly sensible issue for centralized countries, not only for emerging ones like Russia, India and China, but also for developed countries such as Australia and Germany. Each one adopts different forms and mechanisms according to the design of the system of intergovernmental transfers. More distribution was asked for, with formulas in place of political negotiations and ad hoc decisions.

The right to autonomy doesn't give states an excuse to shy away from their responsibility to deliver basic services. In this age of globalization and information, decentralization and increasing responsibilities to states and local authorities tend to get more stimulated.

The discussions addressed the issue of increasing demands for local governance to extend fiscal accountability and to adopt mechanisms of more direct popular participation in governmental decisions. Moreover, it is interesting to quote the alert by Tanzi, in the keynote address presented at the recent conference: "In conclusion we may look forward to a world with an increasing number of countries, a growing supranational structure, and with more important municipalities. Economists interested in fiscal federalism should address these developments and pay to them the attention that they merit."

A new approach to fiscal conflicts involves the local government. It tends to occupy an increasingly bigger space in the consolidated government, in the legislative responsibility, in the collection of taxes and, over all, in the public rendering of services. The cases presented and others commented in the work session referred to new and increasing conflicts between states and local governments. In a particular case (Brazil), it was mentioned that the head of the national executive (President) negotiates and contracts directly with the respective head of the local executive (Mayors), without demanding the participation of the head of the state executive (Governors).

It was said that local governments tend to erode the state's responsibilities, including autonomy to spend and even to govern. Of course, this trend is bigger in more decentralized countries. For example, USA does not have serious problems with regional disparities, so the local government is more important and efficient in delivering basic services such as education. The question in this case is to separate political calls from individual rights. In developing countries, the local government plays a more important role, for example, in the case of Pakistan, South Africa, and China. (In China, the local government responds to about 30 per cent of national public expenditure.)

However, other participants criticized that an exaggerated importance was being given to local governments because of its lack of organization and capacity. Moreover, in those countries where regional disparities are more accentuated, local government would not have to foment the development and reduce poverty. (Also see Ahmed, Brosio and Tanzi, 2007.) Examples opposite to this would be Russia and India, where citizens from very different regions and cities, with extremely different economic and social conditions, need to receive the same treatment from the government. In this scenario, the central government would need to centralize the prescriptions, the plans, the budgets, the redistribution of resources and even the decision to spend. The conclusion in the debate addressed the issue of a more direct involvement of citizens in governmental decisions and the control of the public accounts. For example, many cities in Brazil have adopted participative budget, with the people choosing directly which investments will be prioritized for their quarters or regions. This brought to the debate aspects presented in the fiscal responsibility laws adopted by some countries, for example, the recent case of India. Fiscal transparency claims more information for citizens and experiences show that this strengthens the fiscal austerity.

3. Conclusion

The citizen's power is changing the views and practices of traditional federalism. This is seen as a good thing for those more worried about the democracy deficit. This new vision about the local governance is explored by Shah and Shah; according to them, "Globalization and the information revolution are reinforcing those conceptual perspectives on a catalytic role for local governments. This view is also grounded in the history of industrial nations and ancient civilizations in China and India. This view is critical to creating and sustaining citizen-centered governance, in which citizens are the ultimate sovereigns and various orders of governments serve as agents in the supply of public governance." In the end most delegates agree that simple solutions do not exist. Historical reasons explain different solutions by each federation. Citing the mentioned cases, the US is as right to prioritize the local government in services delivery, as Russia and India are right while fortifying the central government.

Forum of Federations recently published a comparative analysis of federative practices in twelve countries (see Shah, 2007). It is important to establish clearly what the tax assignments are of each tier of government, the mechanisms of intergovernmental grants and also the expenditure responsibilities attributed to each tier of government.

Finally, the summary writer would like to recommend the reading of two papers contained in the Conference Reader: the paper about emerging issues in fiscal federalism by Anwar Shah, Indira Rajaraman, Fernando Rezende, and more specifically, the paper about resolving fiscal conflicts by Paul Spahn. They present an overview more comprehensive than the backgrounder to the programme. They also present extensive suggestions for useful reading material.

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