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?

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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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