Theme Paper

Emerging Issues in Fiscal Federalism

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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 proximity*	*Consumer sovereignty*	*Economic evaluation of sectoral choices*	*Composite*	*Efficiency*	*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.