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 ethnonationalism. "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 credit-worthiness 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.