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BACKGROUND PAPER

COPING WITH FEDERALISM - THE VIEW OF BUSINESS

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It is a common observation that world wide economic and social trends are transforming political governance, and are prompting a reexamination in many countries of the appropriate roles and responsibilities of different levels of government. From the viewpoint of business, these issues of federalism raise particular concerns about their influence on society's ability to create jobs, wealth and growth.

The economic aspects of change relating to federalism vary enormously from country to country and from time to time and are not easy to summarize. However, one generalization is that some nation states – formerly almost supreme in their sovereignty – are tending to be found to be too small for large issues and too large for small issues, leading to a fundamental regrouping of responsibilities. As “globalization” sweeps the world, some of the traditional areas controlled by such states such as external trade and investment are becoming more subject to international agreements and organizations, as the state effectively cedes control to larger groupings. Equally however, in some areas there are other shifts in the balance of power occurring to move responsibilities to local governments. Such shifts have occurred because of the failures of both communism and colonialism with their centralizing influences, and a growing tendency to fall back on smaller political groupings as a counterbalance to the perceived threatening aspects of globalization. These influences, along with a general decline in the credibility of “big” government, and an increased recognition of individual human rights, are all in part responses to the need to manage diversity and change.

Achieving a particular degree of federalism or decentralization is rarely, in itself, a primary goal for business. But in a changing world, business, along with other groups in society, must recognize the powerful influences for change that are reshaping our societies, and hope to assist in managing such changes so as to provide positive economic outcomes.

In explaining the involvement of business leaders in the Canadian federalism debates, Thomas D'Aquino, President of the Business Council on National Issues, an organization of senior Canadian business chief executive officers, said that “We regard a strong and healthy democracy and effective and accountable political institutions as ... essential prerequisites to sustained economic prosperity”. (1)

What business wants from governments

Business activity and economic prosperity are heavily influenced by both the actions and the structure of governments. Business tends to value most two main contributions by governments:

- A rational, stable, secure and predictable environment in which to operate: the “rule of law” and all that goes with it is the essential foundation to enable business to make long term investments and commitments to support economic growth and prosperity
- A positive inter-relationship with governments, with a mutual recognition of the

need for government policies in broad areas such as taxation, business regulation, and education to facilitate efficient business operations and productivity. Most notably, business wants governments to provide rational and stable monetary and fiscal policies for the economy: these have been the typical responsibility of central governments, although local government units can contribute to fiscal balance. It is the appropriate coordination of an entire basket of policies of all levels of government that provides the positive government environment that business desires.

What is different about the world?

The predominant economic trend in the world today is frequently referred to as "globalization" although in fact some of its components are only distantly connected to international events. It is a broad combination of influences such as a growth in the speed and ease of communication, the rapid rise in international trade and the accompanying mushrooming of trans-border transfers of capital and know-how, and the growth of technology including whole new industries in telecommunication and computer-based products. This global economic revolution has been accompanied by profound change in business management processes: businesses – not merely multi-national but all business – increasingly has a global perspective of markets, resources and opportunities; decision making tends to be accelerated, non-core activities may be outsourced while businesses concentrate only on critical success factors, and in a number of areas the necessary size for survival in a global market place is rising, leading to massive national and international business mergers. It is perhaps ironic that as business units get larger and more international, there are arguments to devolve responsibilities to smaller and more local government units.

This trend towards globalization has been accompanied and facilitated by the growth in new or expanded international organizations and agreements. The European Union, involving the effective economic merger of almost all European states is perhaps the most outstanding example. However, international trade, some aspects of international financial arrangements, and other activities are now increasingly regulated by international organizations such as the World Trade Organization. Overall, there has been a significant shift in responsibility and authority from national sovereign states to international organizations, reflecting in good part the realities of international markets and the fact that countries find it increasingly costly not to join and support such international arrangements.

Most businesses are strong supporters of this movement towards international coordination and management of important global economic issues. There is no doubt that overall, the influence of economic globalization has been positive in terms of aggregate economic output and average per capita living standards. But the process is not one without losers and victims: local industries and their workers have perceived themselves disadvantaged by globalization in some specific cases. (On occasion the international organizations have made special support programs available for some of the losers.)

These trends towards globalization have also led to the increased mobility of capital, technology, people and even culture. But the degree of change has not been uniform: investment capital, technology and know-how, and managerial processes have a far greater ability to move across national boundaries than do people. While highly trained and skilled individuals may have a substantial degree of mobility, most individuals find it difficult, for a variety of reasons, to move from their domiciles and are therefore likely to find their view of globalization influenced by a local perspective, to which local units of government may be responsive.

At the same time, while global economic trends are imposing new disciplines on areas of traditional control and regulation of nation states, there are trends at work which are leading to building up the autonomy and powers of political subdivisions. Again, the trend is by no means uniform, and rests on different reasons in different states. Amongst the

generic causes of the trend for more local autonomy seen in Italy, United Kingdom, Spain, Canada and elsewhere are the following:

- Citizens are generally approaching their relationships with government on a more questioning, even cynical basis: unquestioned acceptance of authority and legitimacy is declining. To a degree, citizens can relate easier to a smaller unit of government, which are felt to be closer to their needs and to be basically more understandable and accountable. (In part, this is because local governments may not need to cope with all of the major compromises necessary in a modern democratic nation state.)
- The trends towards globalization introduce fears and apprehension about the rate and the direction of change, in social and cultural as well as economic areas. Local governments, not directly connected with the multinational organizations and commitments that are facilitating such change, seem more likely to be responsive to individual citizens on such issues. (In some cases, this may cover a rear guard action against international specialization and operating efficiencies.)

An economic perspective on change and federalism

The attainment of the basic goals of business in an environment that involves significant political decentralization, and where both the traditional nation state and its political sub-divisions play important roles in economic and related policies involves major complexities.

With respect to the primary business aim for a stable and predictable environment, the relations between a federal government and political sub-divisions, at a time when roles and responsibility are subject to strain and to change can involve tensions and conflicts. These tensions and conflicts may reduce the stability and predictability of the economic environment for business, and may therefore be seen as a negative. (Regardless of any other issue, the great majority of business interests in Canada, inside and outside Quebec, are opposed to Quebec separation on the grounds that it introduces additional uncertainties in the Canadian business environment). In a decentralized state, the involvement of more than one level of government in establishing the environment for business is regarded as essentially less stable and predictable, and vague commitments to consultation and coordination do not totally respond to such concerns.

A shift of responsibilities in areas of major interest to business, such as infrastructure, education and training, taxation, etc. may also be viewed in some circumstances as a negative development by business, since it could mean that such issues will be dealt with on a narrow regional or local basis rather than with a recognition of broader needs.

At the same time, it is important to consider the economic and other aspects of changing federalism in a broad context. As Anwar Shah has noted, "The debate has focussed on the strawmen of 'centralization' vs. 'decentralization' ... and ignored the precepts of federalism that appropriate institutions and mechanisms must be introduced in support of the constitutional assignment of responsibilities in multilevel or multicentered governments ..."

(2)

Tax Issues in a Federal State

Business is of course keenly interested in taxation and how it may impact the twin desire of business for a stable and predictable system, within an overall environment that encourages productivity and growth. Of course, in policy terms taxation is always something of a residual, in a sense that countries or sub-divisions do not fashion a tax system in isolation from other policies: rather, a variety of social and political choices are made by governments, and the tax system is thereafter used to finance and reinforce those policies. Taxation is universally used not just to raise money to finance governments, but to support social and other goals, including encouraging research and innovation, favouring job creation, achieving a more equal distribution of incomes, and responding to social needs.

In a number of countries, as political sub-divisions have acquired new responsibilities, tax revenues have also been adjusted. In some jurisdictions, this has been accomplished by

block transfers of tax revenues from the central administration, while in other cases the political sub-divisions have achieved greater "tax room" to impose their own levies. Accountability and transparency are improved when the right to make expenditures is accompanied by corresponding taxation authority.

A primary concern of business with respect to the decentralization of the tax system is the risk that it may create a dysfunctional tax jungle, with each level of government independently devising its own rules and rates without coordination with each other or the central administration. (The creation of such a tax jungle in Canada in the 1930's was remarked upon in the Rowell-Sirois Report (3) in Canada in 1940).

Political sub-divisions normally desire the ability to manage their own revenues, by setting their tax rates independently. But beyond this, there is also the desire to use the tax system to support and reinforce their other social and economic policies.

This desire of the political sub-divisions for flexibility in setting tax policies conflicts with the desire of business for a rationalized and largely uniform system, particularly where two or more levels of government are involved in levying taxes in the same field, as for example personal or corporate income taxes. If two sets of government impose taxes on the same source, but under different rules, the possibilities for complexity at best, and contradictory and inefficient systems at worst, are apparent. In Canada, in recent years, as well as in a number of other states such as the United Kingdom with respect to the newly devolved Scottish government, the local levels of government have by and large employed the federal or national income tax base and rules with respect to computing income and allocating that income between the jurisdictions in which an enterprise carries on activities. In other countries, including some in the United States, as well as in Switzerland, there may be significant differences in the tax base and approach of local and national governments.

In a world being swept by globalization, the need to reconcile the separate tax systems of sovereign states has already been widely recognized. For example, there are now over 2,000 bilateral tax and related treaties between countries governing the interface of their tax systems, so as to avoid double taxation of the same income and facilitate international flows of capital and knowledge. However, not even this large number of treaties is sufficient to deal with all of the "border" problems between tax systems, and it is always the edges where different tax systems come together in their application to an enterprise that raise difficult issues.

With the growth in the importance of local taxation, the interface of the edges of such systems with other local systems, and with national systems, is becoming more important and more worrisome. International bilateral tax treaties frequently do not bind political sub-divisions and in some cases it has proven difficult to get the sub-divisions to address the need to reconcile their systems with those of their neighbours as well as with those of other national states.

The concern of business is essentially that the growing importance and independence of political sub-divisions means that the tax systems in many countries are more complex, and leave the possibility of duplication in compliance and filing requirements. Differences in determining, and then allocating the income of a single enterprise amongst jurisdictions can lead to double taxation of the same profits, and equally business can use aggressive planning techniques to reduce its taxes by finding gaps between the uncoordinated taxes of different governments.

Most businesses would prefer, in the long-run, a coordinated approach to tax issues where a federal government and its constituent units agree on common approaches in the definition of the tax base and the allocation of income, leaving it to each individual unit to set its own rates and therefore in this way to control its own tax revenues. But it is difficult indeed to achieve this degree of coordination: one only has to look at the European Union where despite the clear success in reaching common agreement on trade and many other issues, continuing efforts to harmonize personal and corporate income taxes have been

largely unsuccessful. In many federal countries, the desire of the political sub-division to use the tax system to encourage local investment, and to deal with local priorities in the social and welfare area, has again made coordination difficult.

There is the further issue that in an increasingly international world, countries are facing the need to achieve a higher level of coordination and cooperation in the tax area, so as to avoid tax leakages to tax havens, deal with new and complex issues such as the taxation of trade on the internet, and reconcile different approaches. Smaller units of government find it increasingly difficult to effectively tax international flows and transactions, and even central governments are driven to international coordination to cope with such issues.

In a broad sense, and as noted above, people are likely to be less mobile than capital or technology. This means that local governments, and indeed in the end even nation states, will have greater difficulty in imposing "non-standard" tax and regulatory environment on international capital and technology flows: to impose more onerous conditions than other states may well result in a sharp diminution in flows to the particular territory. A political sub-division may have somewhat more success in establishing its own rules for the taxation of relatively immobile individuals (as for example imposing more or less progressive tax systems, or exempting particular types of income as an incentive) but even here there are likely to be practical limitations because of competitive factors.

Free Trade

Customs duties and restrictions on international trade are generally reserved for nation states, even in decentralized countries. The growth in bilateral, multi-lateral and global free trade arrangements, including a reduction in non-tariff barriers, has facilitated the huge increase in international trade. Overall, the effects of this trend have clearly been positive, both for business as a whole and for standards of living. The WTO and its predecessors, for example, have opened up international trade with generally beneficial effects, but with inevitable implications to some previously protected industries in individual localities. From the viewpoint of a federal state, the arrangement may be regarded as positive, because of offsetting benefits secured under the arrangements. But in a smaller sub-division, the detriments may be clear and the advantages may be diffuse or flow elsewhere. Political sub-divisions will naturally be concerned with international trade issues that affect them: while they should have the opportunity to comment on such international arrangements, it is difficult to see how they can play a direct and independent role in their creation.

Business regulation a concern

In federal states, the distribution of general economic and regulatory powers between the federal government and its political sub-divisions varies substantially. From the viewpoint of business, there is an obvious concern about a duplication of regulation between the levels of government, and for conflicts between regulations and programs. The distribution of powers in the federal state in many cases was arrived at a number of years ago, and while it may have been subject to some modification it rarely represents a rational current view of where regulatory responsibilities could be most efficiently carried out. For example, in Canada, the federal government has the constitutional responsibility for establishing and regulating banks, but aspects of the regulation of other financial institutions – insurance companies, trust companies, credit unions, etc. – rest with the provinces. Trends in financial markets mean that there is a growing degree of overlap and convergence between different institutions in the financial sector, but with split constitutional responsibility, it is difficult to arrange for one comprehensive regulatory regime that would more closely reflect the realities of present markets and institutions. In some countries, responsibility for the overall management of natural resources belongs with the central government, while in others it rests at least in part with local governments: in both cases the need for revenue sharing from such resources can create complex issues.

The overall concern of business is that the distribution of responsibilities between levels of

government should be rational and clear, that there should be as little duplication or overlap as possible in programs, and that the costs of operating national or even international businesses should not be inflated due to jurisdictional conflicts or over regulation. The precise nature of such concerns, in turn depends on the actual distribution of powers on the one hand, and on the ability of governments to reconcile and adapt their original constitutional responsibilities to a new economic climate. (4)

With respect to other government programs that can provide important support to economic activities, (5) again there is a potential for a less than optimum solution in the view of business. If education is a local responsibility, then will a local government spend sufficiently on education if in fact a high percentage of graduates are likely to take jobs elsewhere?

Redistribution

One of the responsibilities of government is to consider the distribution of incomes, between income classes and even between regions, and to take action if this is deemed to be inappropriate. In many federal states, there may be various income support programs for lower income individuals, as accompanied of course by tax measures which bear more heavily on higher income individuals. Such measures can have the effect of not only redistributing income between income classes, but also between regions, as some will have higher income than others. Further, federal governments may provide a variety of other programs and support measures, including direct payments to political sub-divisions based on needs, which again can involve significant regional reallocation.

Such regional reallocations are part of the glue that keeps many federal states together, through providing for common standards of support and services. But they may also impose strains between regions which are net contributors to the process, and those who are not recipients. In an era of growing international business, and a relative decline in intra-country trade, a prosperous region may have a declining incentive to support regional sharing as the other regions become less important as customers.

There can be a conflict between ensuring that common standards of government services are available throughout a country, and the need for some incentives to induce less favoured regions, and those who live in them, to adapt to changing circumstances. Programs that provide substantial subsidies for economic activities to be carried out in regions where they would not otherwise take place, involve from a viewpoint of society, significant costs that result in an overall less competitive position for the jurisdiction. Reconciling this conflict is one of the trickier aspects of cooperative federalism.

Conclusion

It is important not to overstate the concerns which business may have with respect to federal institutions and trends. Business represents only one of the sectors in society, and even those who own or manage major businesses may be heavily influenced by non-economic factors with respect to their view of federalism and its related issues.

However, overall business does have a legitimate concern that first of all federalism per se, and secondly a possible increasing trends towards decentralism in some areas, not inhibit economic development and growth. Issues such as regulatory and service overlap, inappropriate local regulation of what is a national or international operation, lack of rationalism in support services, and conflicting tax regimes are all matters that can arise in the working out of federalism, and are all matters of direct concern to business.

However, some of the same issues can also arise in conflicts between nation states, and in the dealings of international organizations and arrangements, and on the whole it has proven possible to make progress in resolving such difficulties through discussions and coordination. The difficulty with the problems that arise within a federal state is that there may not be institutions, processes and goodwill to reconcile and coordinate policies for the common good: the very number of political sub-divisions, and their emphasis on local as opposed to broad issues, are two of the reasons for this.

Business flourishes on government harmony and cooperation, not conflict. In many federal states, the realistic view is that both federal and local governments inevitably influence one another, and the need is for more ways of supporting constructive dialogue, including institutions and processes of reconciliation within a framework of accountability. (6)

Developments in business managerial processes, and indeed the total environment in which businesses operate, are changing around the world. Business finds that it must recognize and adapt to global issues, even in local markets: it must function in a more competitive and dynamic matter, with increased attention to innovation and change, and concentration on broader markets.

In this environment, business generally will be supportive of parallel developments in political governance, moving from institutions and processes which are closed and slow, bureaucratic, and unduly controlling, to these which are more open, responsive, internationally sensitive and cooperative.

But business does recognize the essential unity of business processes and economic developments worldwide, a unity that is leading to some erosion of responsibilities of nation states to international organizations and arrangements. In the view of most businessmen, these influences – which will continue – also require that all governments in federal states recognize the clear need to operate in a way which coordinates their policies with those of other levels of government. Just as globalization has eroded the absolute sovereignty of nation states, it also restricts the unbridled ability of political sub-divisions to make choices within their assigned constitutional responsibilities without the fullest recognition of consequences.

Going back to the discussion of the central goals of businesses in relation to governments – stability and predictability on the one hand, and a competitive and growth oriented environment of the other – both of these goals require a cooperative working together of different levels of government in a modern state. This in turn may require new institutions and processes to support a common community of purpose with respect to business and economic objectives within federal states.

Footnotes

1. From an address to a University of Ottawa colloquium on Canadian Federalism for the Future, August 1997.

2. Anwar Shah, *Balance, Accountability, and Responsiveness: Lessons about Decentralization*: World Bank, Washington, 1998; p. 1

3. Royal Commission on Dominion-Provincial Relations; Ottawa, Queen's Printer, 1940.

4. "The optimal assessment of powers ... depends on the overall economic goals pursued by the federation. A change in the nature of these economic power objectives will probably call for a corresponding change in the division of powers (either de facto or de jure)." Thomas J. Courchere, *Economic Management and the Division of Powers*, Toronto, University of Toronto Press, 1986, p. 232.

5. The issue of overlap, duplication and conflict between levels of government may be solvable with goodwill and appropriate inter-government co-ordination: for example, a 1991 Canadian report concluded that "... in large measures, [federal and provincial] governments are managing program overlap effectively, [but] ... considerable scope remains for improving ... harmonization. Federal Provincial Overlap and Duplication: a Federal Program Perspective", Treasury Board, Ottawa, 1991.

6. "Institutions of accountability is the key to the success of decentralized decision making": Anwar Shah, *ibid*, p. 14.