Overview: Fiscal Options in Power Sharing Arrangements

by Roger Wilkins

Federalism and its relevance

The defining institutional characteristic of federations has been the combination within a single political system of shared-rule and self-rule through the constitutional distribution of powers between the federal and regional governments.

Federalism provides a pragmatic response to a growing range of concerns that communities currently face. Shah argues that internationally there is a gradual shift from unitary constitutional structures to federal forms of governance.[1] The role of central governments around the world is changing from one of managerial authority to a leadership role in a multi-centred government environment.

Amongst other things, a key structural characteristics of federations involves a constitutional allocation of revenue resources between the two orders of governments and processes and institutions to facilitate intergovernmental collaboration and fiscal transfers.[2]

Fiscal federalism

The study of fiscal arrangements is critical when examining and considering options for the political structure of a federal system. The allocation of financial resources to each level of government within a federation is important for two key reasons:

- Resources enable or constrain governments in the exercise of their constitutionally assigned legislative and executive responsibilities.
- Taxing powers and expenditure are themselves important instruments for affecting and regulating the economy.[3]

When considering jurisdictional design, the fiscal federalism literature argues that assigning responsibility for spending must precede or at least be done at the same time as, assigning responsibility for taxation. This helps ensure better matching of taxing and spending powers, improves accountability and avoids over-reliance on transfers from central government in financing regional government expenditure.[4]

Principles for organising

There are a number of principles that influence the organisation and distribution of fiscal functions and powers in federal systems. This includes:

Macro-economic Management - Central government needs to be in charge of macro-economic management and this generally includes sufficient control over debt, interest rates and taxation.

[1] Shah, A. 2004, Fiscal Decentralization in Developing and Transition Economies, Progress, Problems, and the Promise, World Bank Policy Research Working Paper 3282, Washington, DC. p.4.
[2] Watts, R. 1999, *Comparing Federal Systems* 2nd edn, McGill-Queen's University Press, Kingston. p.7
[3] Watts, R. p.43.
[4] Shah, A. p.8

***Fiscal Responsibility and Accountability* –** Ideally revenue raising functions should match the expenditure functions of each level of government. It is arguably more efficient and accountable where governments use the revenue they raise from taxation for the direct delivery of services for which they are responsible.

***Equity* –** As far as possible citizens should be given the same opportunities and level of services irrespective of where they live. This requires consideration of fiscal transfers across regions to account for economic differences and differences in the cost of service provision.

***Efficiency* –** Fiscal functions and responsibilities should be assigned in the most efficient way. Incentives should remain that encourage governments to deliver services efficiently. To some extent this has to be balanced against equity efforts that may result in fiscal transfers to governments without incentives to improve performance.

***Subsidiarity and Decentralisation* –** To some extent this is a subset of efficiency. The principle of subsidiarity aims to provide more freedom for regional level governments in order to increase the efficiency and accountability of public sector services and fiscal management.

There exists a body of research, however, suggesting that in developing countries, the institutional and social underpinnings necessary for decentralisation to succeed, are not fully in place.[5] It is not always easy to assign to regional governments taxes that are sufficiently robust to adequately contribute to their expenditure needs. This places greater pressure on the need to establish effective revenue sharing arrangements with the central government. However, this in turn, makes regional governments dependent on the central government and to some extent defeats the purpose of decentralisation. When this is the case, promoting decentralisation may in fact contribute to further fiscal imbalance across levels of government. Fiscal arrangements need to carefully manage the competing demands for local autonomy and broader nationally efficient funding arrangements.

Allocation of taxation responsibilities

Governments rely on a wide variety of taxes to raise revenue. This includes direct and indirect taxes, general and specific taxes, business and individual taxes.

The need to maintain a stable fiscal system means that central governments retain control of the major tax instruments that may influence budget deficits or inflation.

The following key principles, as developed by Musgrave, provide a useful guide for assigning taxing powers to levels of government:[6]

- Taxes suitable for economic stabilisation should be levied by the central government.
- Progressive re-distributional taxes should be assigned to the central government.
- Lower-level governments should tax revenue bases with low mobility between jurisdictions.

[5] Tanzi, V. 2000, *Policies, Distribution and the Dark Side of Economics*, Edward Elgar, Cheltenham, UK p.257.
[6] Musgrave, R. 2000, *Public finance in a Democratic Society*. Volume III The Foundations of Taxation and Expenditure, Edward Elgar, Cheltenham, UK. Cited in Fjeldstad, O. 2001, Intergovernmental Fiscal Relations in Developing Countries, WP 2001:11, Chr Michelsen Institute, Bergen. p.6.

- Tax bases distributed unequally between jurisdictions should be centralised.
- Benefit taxes and user charges may be appropriately used at lower levels.

While these principles are a useful guide, country specific factors play a larger role in the assignment of taxation arrangements. Generally, the case for centralisation relies on macroeconomic considerations and the case for regional government taxing powers, on efficiency considerations.[7]

Vertical fiscal imbalance

The division of spending and revenue responsibilities in a federation is primarily set out in the particular country's constitution.

Almost without exception, countries assign more expenditure functions to regional governments than can be financed from the revenue sources allocated to those governments. This mismatching of functions and finances means that regional governments are generally dependent on transfers from the central federal government.[8] Fiscal imbalance is addressed through intergovernmental transfers in the form of revenue sharing arrangements and grants. Revenue sharing arrangements and grants serve as coordinating mechanisms, which allow decentralised expenditure to coexist with centralised tax collection and with redistribution.

Revenue sharing

Since the central government generally collects the majority of taxes, one way to fill the fiscal gap for regional governments is to give them a share of the major national taxes collected in their jurisdiction.

Grants

Besides revenue sharing, the main mechanism for intergovernmental transfers is grants from central to regional governments. Generally, grants from central governments fall within three broad categories:

- ***Unconditional grants*** **–** general purpose transfers aimed at addressing vertical imbalances.
- ***Conditional grants*** **–** grants carrying conditions regarding the use of the funds.
- ***Equalisation grants*** **–**grants used to address horizontal imbalances between regions, addressing differences in revenue or expenditure.

Horizontal fiscal imbalance

Horizontal fiscal imbalance arises from the fact that geographical areas usually differ with respect to resource capacity and need. Designing fiscal systems to cope with this complexity is often problematic and may be further exacerbated by political imperatives that resist the acknowledgement of unequal conditions.

Horizontal equalisation grants acknowledge that tax bases vary between regions and the purpose of such grants is to channel funds from relatively wealthy jurisdictions to

[7] Fjeldstad, O. 2001, Intergovernmental Fiscal Relations in Developing Countries, WP 2001:11, Chr Michelsen Institute, Bergen. p.7.
[8] Fjeldstad, O. p.8.

poorer ones. Such transfers are often based on equalisation formulae that measure fiscal need or capacity of each regional government.

One problem with equalisation grants is that they fail to provide an incentive to high cost, low taxing jurisdictions, to improve the efficiency of service provision.

Fiscal aspects in other countries

Intergovernmental fiscal systems need to promote the efficient allocation of resources, income distribution, and macroeconomic stabilisation. As with other policy decisions, intergovernmental fiscal policies must take into account, both the political constraints facing policy makers and the preferences of key groups involved in political decision making.[9]

An examination of the fiscal characteristics of Canada, India, Switzerland and Australia, illustrates some of the variations that exist.

***Canada* –** Key features include: decentralised federal/provincial relations; strongly distributive; flexible and highly adaptable. More than half of all government revenues are collected by sub-national governments. Equalisation programs deal only with differences in province revenue raising capacity.

***India* –** There exists a long-standing vertical imbalance between the expenditure and revenue raising responsibilities of state governments. Central government is assigned the most important taxation powers and raises about two-thirds of all government revenue.

***Switzerland* –** Taxation powers are relatively decentralised, with each tier of government endowed with a full or partial tax authority for a number of taxes. States' (cantons') dependence on central government grants is low. Differences in the taxable capacity of cantons are equalised through asymmetrical vertical grants provided by central government.

***Australia* –** Highly centralised revenue collection with central government collecting around 70% of all government revenue and sharing this with the states through conditional and unconditional grants. Horizontal fiscal imbalance is addressed through the use of an independent assessment body (the Commonwealth Grants Commission) aimed at equalising the level of services available to citizens.

Maintaining fiscal relations within a federal system.

There are a range of different institutional approaches taken by federations to manage fiscal transfers, which may be categorised as either:

- independent expert commissions or bodies;
- intergovernmental negotiation; or
- central legislative or constitutional processes.

Independent expert commissions or bodies

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[9] Fjeldstad, O. p.13.

Some federations use independent expert commissions or bodies to determine the extent or nature of vertical and horizontal fiscal transfers. These can be standing bodies, such as in Australia, or one-off bodies, such as in India.

- In Australia, general purpose payments and health care grants are distributed among the states and territories on the basis of relativities developed by the Commonwealth Grants Commission (CGC). The CGC is an independent expert commission formed by the Commonwealth. The CGC evaluates the revenue raising capacity and the needs of the states and territories and recommends per capita relativities to the Commonwealth Minister for Finance and Administration.
- The Indian President is required by the Constitution to appoint a Finance Commission every five years (or sooner if necessary) to recommend fiscal transfers from the Union to State Governments. To address vertical fiscal imbalance, the Commissions determine the share of tax revenues from certain shared taxes that will go respectively to the Union and the states over the five years. To achieve horizontal fiscal equalisation, the Commission recommends additional grants-in-aid to states in need. Since federation, 11 such Commissions have been appointed with their recommendations usually being accepted by the President.

Intergovernmental negotiation

Another way of managing fiscal federalism is through negotiation between the executive branches of different levels of government. This can occur through formal (as in Australia) or informal (as in Canada) intergovernmental agreements.

- In Australia, all revenue from the recently imposed Goods and Services Tax (GST) is transferred unconditionally from the Commonwealth to the states and territories under a formal intergovernmental agreement that was part of the political settlement that enabled implementation of the GST. Similarly, most specific purpose payments (SPPs), such as the Australian Health Care Agreements, are agreed between executive governments of the Commonwealth and the states and territories. These intergovernmental agreements in Australia are normally negotiated through ministerial councils.
- The Canadian Constitution includes the principle that equalisation payments be made by the federal government to enable provincial governments to have sufficient revenue to deliver comparable levels of services at comparable taxation levels. How this is done is technically a decision of the Canadian parliament, which does not include representation of the states. However, in practice fiscal transfers are the subject of extensive negotiations between the federal and provincial governments. An interesting development that may shape these negotiations in the future is the recent formation by provincial and territorial premiers, of the Canadian Council of the Federation.

Central legislative or constitutional processes

Some federations distribute funds to sub-national governments through specific constitutional or legislative processes of central government. A key distinction in this approach is between processes that involve the direct input of the state governments in determining the transfers (such as Germany) and those with no such direct input (the USA).

- In the USA, fiscal transfers occur through the budget legislation process of the Congress. The states are represented in the upper house, or Senate, which plays a significant role in this process. Fiscal transfers occur as grants or spending within specific program budgets. That is, all transfers from the federal government to state governments are conditional. As such, fiscal transfers in the USA are essentially a program delivery choice rather than a tool to address vertical fiscal imbalance or attempt horizontal fiscal equalisation, although in some programs, federal grants are shaped by formulae based on indicators of need, such as per capita income.
- The maintenance of fiscal balance between the federal government (Bund) and the states (Länder) is enshrined in the German Constitution and managed through a mechanism that automatically adjusts the revenues of the two levels of government to put them in a similar budget position. The mechanisms and rules by which this is done are contained variously in the Constitution and in federal legislation. The Länder are directly represented in the upper house (the Bundesrat) of the federal parliament meaning that these rules and mechanisms must be approved by the Länder. Equalisation transfers among the Länder are made based on complex but transparent formulae, aimed at meeting the Constitution's requirement for uniformity of living standards throughout the federation, which must also be approved by the Bundesrat.

Questions for consideration

1. To what extent do economic concerns contribute to the pressures for federalism in Sri Lanka?
2. Which principles are useful guides for the allocation of fiscal responsibilities within a federal Sri Lanka?
3. Should the principle of subsidiarity/decentralisation be the primary determinant for allocating fiscal responsibilities?
4. How decentralised should revenue raising and expenditure responsibilities be, within a federal Sri Lanka?
5. Should it be a priority of federal fiscal arrangements to reduce the need for horizontal fiscal equalisation transfers?
6. What issues would impact on revenue sharing arrangements in a federal Sri Lanka?
7. What institutional mechanisms for maintaining fiscal relations are likely to succeed in Sri Lanka?
8. Are the current mechanisms for maintaining fiscal relations in Sri Lanka likely to adapt to a more federalist model of governance?
9. Will pursuing the principle of subsidiarity and efforts towards decentralisation undermine prudent federal fiscal arrangements?

Recommended Reading

Shah, A. 2004, Fiscal Decentralization in Developing and Transition Economies, Progress, Problems, and the Promise, World Bank Policy Research Working Paper 3282, Washington, DC.

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Tanzi, V. 2000, *Policies, Distribution and the Dark Side of Economics*, Edward Elgar, Cheltenham, UK. Chapter 14, Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects. pp. 231-263.