Chapter One

An Overview of Fiscal Federalism

1.1 Political federalism

Federalism is a constitutionally established system with at least two orders of government each of which has some genuine autonomy from the other. The governments at each level are primarily accountable to their respective electorates.

There are over two dozen countries that call themselves federal or are usually considered to be so. They are home to about 40 percent of the world's people. Typically, democracies with very large territories (Canada, USA, Brazil, Australia) and very large populations (India, Pakistan, Nigeria) are federal. So are some small countries with very diverse populations (Switzerland, Belgium, Bosnia and Herzegovina), and some island states (Comoros, Micronesia, St. Kitts and Nevis). Some federations trace their federal origins back to the eighteenth (United States) or nineteenth centuries (Canada, Switzerland, Germany, Austria), while others are much more recent (Malaysia, Spain, South Africa, Ethiopia) or still in the process of becoming (Iraq, Sudan).

These countries and their political systems are extremely varied. The essence of being federal is having at least two constitutionally established orders of government—typically a **federal** government and **constituent-unit** governments (frequently called states or provinces, but also cantons, Länder, communities, islands and other names)—each of which has some genuine, constitutionally based autonomy and a direct electoral relationship with its population. In a few federations (Brazil, India, Nigeria, South Africa), the municipal or local order of government is also established within the constitution.

(Confederations, by contrast, have central governments formed by the member states, not elected directly. The European Union is a unique combination of confederal, federal, and treaty arrangements.) Some countries considered to be federal (Spain, South Africa) may not use the term for themselves. Given the fundamental role of constitutions in federations, the rule of law and democracy are a normal feature of federations, although some countries that claim to be federal may fail on both counts. Federations are extremely varied in their form and functioning, covering a wide range from very decentralized to highly centralized.

1.2 Fiscal federalism

Fiscal federalism studies the respective roles and interaction of governments within federal systems, with a particular focus on the raising, borrowing, and spending of revenues. It examines the functioning of these systems and tries to provide a principled basis for evaluating them. The study of fiscal federalism can also be relevant for the fiscal arrangements in devolved systems of government that are not strictly federal.

While the boundaries of fiscal federalism are hard to draw, the core of the subject is clearly the raising, borrowing, and spending of money in federations. It is a big subject that necessarily includes the means by which money is raised, the purposes for which it is spent, and the respective roles of federal and constituent governments in this process. It can be both explanatory and evaluative: how and why things happen; what would be an optimal or better way?

Take raising money, for example. Fiscal federalism may look at who has the authority to raise various kinds of taxes in a federation, but it can also consider whether to recommend a particular distribution of tax authorities. Does the allocation of taxing powers affect the actual tax policies adopted by one government or another? If so, is this in the public interest? Does the authority to raise money match expenditure responsibilities? Should rich regions be taxed to provide revenues for poorer regions? Which governments should have what rights to borrow money?

Similarly, the spending and sharing of revenues raises major issues. Do constituent units have adequate authority to raise their own revenues to meet their spending responsiblities? If not, what arrangments are in place for them to share taxes with, or receive transfers from, the federal government? Do federal transfers include conditions, and, if so, what do these imply for constituent-unit autonomy, program functioning, or policy coherence? Is spending by governments in the federation centralized or decentralized, and how might this affect relationships and policies?

Regulation, too, is important because both orders of government may make regulations that have economic implications; e.g., regarding financial institutions, labour markets, and trade in services and goods within a federation's internal market.

Fiscal federalism also looks at how decisions are made. Are fiscal decisions made separately, jointly, or cooperatively? Is the federation marked by major tensions or consensus around revenue raising and spending? Are there joint administrative arrangements for delivering programs or raising revenues? How do federal political and fiscal arrangements affect economic performance?

Of course, some **unitary** countries have also devolved significant spending and taxing powers to regional governments. While such devolution may not be constitutionally federal, it can be quite federal in practice. Thus questions of fiscal federalism can apply, for example, to the Nordic countries, China, and Japan—all of which have some decentralized fiscal features.

1.3 Institutional variety of federalism

Federations differ in their historic origins, the number of constituent units, their executive and legislative institutions, their electoral regimes and party systems, and their division of powers. The character of a federal fiscal regime is determined by the who, how, how much, and what for of revenue raising, sharing, and spending among governments. All of these factors can be important when considering fiscal arrangements within a federation.

While this book focuses on the federal fiscal arrangements, these are shaped by broader historical, institutional, political, and social contexts. Take the number of constituent units for example: there can be as few as two (the old Pakistan), or three (the original Nigeria), or as many as 83 (Russia), or 50 (the United States). Federations with very few units tend to be unstable and difficult to manage, while those with many constituent units may tend towards centralization and weak intergovernmental relations. Central institutions matter, too: cabinets in parliamentary regimes usually have more control over budgets than do presidents in congressional regimes; upper houses can have a key role—or no role—in budgetary matters; political parties can be highly disciplined or quite loose coalitions. All these factors will affect a federation's fiscal dynamics.

Federations differ greatly in the allocation of powers:

- Under the so-called classical or **dualist model** of federalism (as in Canada or the United States), each order of government normally administers its own laws through its own civil service, while in the **integrated model** of federalism (as in Germany, Switzerland, or Spain) the federal government passes many laws that the constituent units then administer.

- Some federations have many **concurrent** legislative powers, where each order of government can legislate on the same subject (but with federal law normally being paramount), while others tend to a clearer division of powers to one order of government or the other.

- In most federations, governments make their decisions on their own, but some provide for **joint decision-making by governments** (Germany, and to some extent South Africa and Ethiopia).

- The **allocation of specific powers** differs significantly between federations. Some are highly centralized and others are decentralized. Key taxing and economic powers can be assigned very differently across federations.

A federation where the federal government raises most revenues and finances constituent units through highly conditional transfers will be quite different from one where the constituent units are largely funded by taxes and borrowing that they decide for themselves. While some see only the latter model as being truly federal, federal practice and thinking includes both.

1.4 Fiscal arrangements and flexibility

While some basic fiscal arrangements, such as taxing powers, are typically set down in a federal constitution, many important features are not. Fiscal arrangements are usually more flexible than the basic division of legislative and administrative powers of the two orders of government. This flexibility means that fiscal arrangements are often central to political debates in federations.

Typically most of the defining features of a federation—the number of constituent units, its major institutions, the division of legislative and administrative powers—are set down in the constitution. These are usually hard to change because constitutional amendments normally require special majorities (though some federations permit powers to be delegated between orders of government). However, constitutions cannot specify many major fiscal features of a federation, such as how much is to be spent on what, what taxes are to be most important, and the specifics of fiscal transfers from the central to the constituent-unit governments. Such features must be worked through in day-to-day politics, which can be competitive as well as co-operative.

1.5 Evaluation of federal fiscal regimes

The study of fiscal federalism includes the evaluation of fiscal arrangements. Evaluative criteria include economic efficiency, equity, administrative simplicity, incentives for innovation, accountability, balancing responsibilities and means, predictability, and stability. Some criteria are conceptually difficult, and different criteria can conflict with one another. Many of these criteria apply equally to unitary regimes. There is no best model of fiscal federalism: a preferred choice will depend on the value and interpretation assigned to different criteria.

Economic efficiency is a central concern of economics. It focuses on using scarce resources in a non-wasteful manner. Fiscal federalism looks at different dimensions of economic efficiency:

- One is the efficiency of internal markets. In federations, different governments may create internal market distortions because of **policies that protect or favour local producers**, e.g., in procurement decisions, regulations, or the right to invest, and create barriers to the efficient flow of investments or labour among constituent units.

- Similarly, well-off constituent units may use their **fiscal advantage**, as opposed to their underlying competitive advantages, for low taxes and good services to attract investments and labour.

- Finally, federal arrangements can affect the efficient provision of public goods and services, including their **costs and benefits**, as well as **administrative simplicity**. Efficiency in this case includes considerations of economies of scale, of spillovers of costs and benefits across the borders of constituent units, and of the distinct preferences of different populations.

Equity or fairness is also central to many fiscal debates. The meaning of "equity" is not always clear, though it requires treating like cases alike and different cases with a fair measure of proportionality. In federal regimes, there are two aspects to this:

- First, equity both between the federal and constituent-unit governments, given their responsibilities (**vertical equity**), and among the constituent-unit governments, given their different means and needs (**horizontal equity**)

- Secondly, equity among citizens. Addressing disparities among citizens across a federation implies a more interventionist role for a central government than addressing disparities among governments. Putting the central government in a more direct role with citizens can draw it into areas where the constituent units may have major responsibilities.

Some believe equity should apply only among individuals, rather than among governments, which strengthens the argument for a regime's providing similar standards of public services in all constituent units.

Efficiency and equity can be in conflict or in harmony; for example, a view of equity that undermined rewards for hard work would also undermine the efficient operation of an economy. On the other hand, investments in the equitable provision of education, health care, and infrastructure in underdeveloped regions may build the wealth of a nation and prove efficient. We shall repeatedly encounter the issues of efficiency and equity because they pervade thinking on fiscal federalism (as on public policy more generally). These important concepts are not given to easy answers, and political opponents sometimes use the language of efficiency and equity to justify very different positions.

A central justification for federalism is that it permits a governmental system that is more **responsive**, in that different governments—federal and regional—can respond to the particular priorities of their populations. A further justification claimed for federalism is that it provides **incentives for innovation** because different governments can compete and try out alternative approaches and learn from one another. But the wrong types of competition can themselves create distortions.

Some evaluative criteria relate to the operating principles of a federation. These include the following:

- **Adequacy** of fiscal arrangements in finding a reasonable match between spending responsibilities and revenues or revenue powers (another way of thinking about vertical equity).

- **Predictability and stability**, particularly for constituent-unit governments that may depend heavily on federal support and have limited access to broad tax bases or debt markets.

- **Accountability**. Federal governments often raise funds that they transfer to constituent units. To whom should constituent units be accountable for these funds: the federal government, their own publics, or both?

Central governments in federations can have important powers in relation to constituent units—powers to disallow legislation, impose legal mandates, attach conditions to fiscal transfers, and even suspend constituent-unit governments. Such provisions are often criticized as non-federal or **quasi-federal**, but ultimately the choice regarding such arrangements is for each country to make, given its own priorities, values, and balance between national and sub-national communities. Federations such as Canada and India started with a number of quasi-federal aspects and moved over time in a more decentralized, classically federal direction, while other federations became more centralized.

It should be clear from this overview of criteria for evaluating fiscal regimes in federal contexts that there can be no single best arrangement, even for a particular federation.