

Chapter Two

Expenditure Responsibilities

2.1 Expenditure patterns in governments

Over the past century, the relative size of government spending has grown hugely in advanced economies; it has also grown in developing countries, but typically to lower levels. Federalism seems to have little to do with this growth. The big spending programs are usually for social security and welfare, health, education, and defence. Modern governments provide public goods, as well as programs and services that benefit individuals, and such services can have strong elements of redistribution.

Big government is a fact of life in virtually all rich democracies. In some advanced economies, government spending accounts for over half of gross domestic product, while even in the lowest spending ones, it accounts for about one quarter of GDP. Federations can be found across the spectrum from high- to relatively lower-spending countries. Developing countries typically have smaller government spending as a share of GDP because much economic activity is outside the cash economy, and the revenue base for governments can be quite limited. Developing countries usually cannot afford the elaborate social safety nets and welfare programs of advanced economies. One area where governments have retreated in recent years is in the public ownership of corporations—such as utilities, financial institutions, and resource and industrial companies—as many such enterprises have been sold to private interests.

Economic theory suggests governments should provide so-called **public goods**, such as defence and policing, which benefit the whole public because the free market would under-provide such goods.

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Governments also provide such expensive programs as health care, education, social safety nets, welfare, and major infrastructure, which benefit both the public at large and the direct users of these programs, sometimes called **quasi-public goods**. Such programs often have a strongly **redistributive** element, from wealthier taxpayers to big consumers of the programs.

2.2 Principles of expenditure assignment

The literature on fiscal federalism has developed various principles for assigning expenditure responsibilities among governments. In practice, most constitutions assign legislative responsibilities explicitly and expenditure responsibilities only implicitly. Assignment principles include giving responsibility to the order of government whose population benefits from a public good, devolving program administration when there is a strong advantage in feedback from the population being served, and providing for some federal role in major programs that redistribute wealth among individuals. In many program areas there is a justification for both orders of government to be involved.

Constitutions usually assign legislative, not expenditure, responsibilities. The responsibility to administer spending programs normally flows from legislative responsibility. There are, however, exceptions, notably in integrated federations, such as Germany, where the constitution may stipulate that constituent-unit governments (or even local governments) will administer programs in areas of concurrent legislative responsibility.

The issue of how best to assign responsibilities in federations is linked to broader considerations about devolved forms of government. Arguments for devolution claim that it provides greater **public choice** because sub-national units of government are closer and more responsive to local populations, that multiple constituent-unit governments can act as policy laboratories and learn from one another, and that decentralization provides checks against an abusive concentration of power. However, those who emphasize the **welfare** of individual citizens and the need for coherent policies across a country often advocate more centralized government.

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Whatever the general appetite for devolved government, the assignment of specific responsibilities to each order of government must be decided. In the early history of fiscal federalism as a subject, there was a strong emphasis on matching the population benefiting from a public good to the appropriate level of government as provider. For example, defence is a public good that clearly benefits the whole public of the country; local roads, by contrast, mainly benefit a small, geographically limited public. While the theory of public goods seems clear, its application in practice can be messy. Defence and local roads seem straightforward. But many public goods, such as policing, serve national and regional publics in different degrees, so it is hard to draw boundaries.

Moreover, the big spending areas of health care, education, pensions, unemployment insurance, and welfare further complicate the picture. For reasons of cost efficiency and local responsiveness their management may best be decentralized, but this may result in citizens across the country getting very different treatment and create barriers to mobility. Thus, for reasons of equity and program integrity, the central government should have a role. This is particularly true of some transfers to individuals, such as child transfers, pensions, and some transfers based on need, where there may be no particular advantage to delivery by constituent units. A balance may have to be found in which both orders of government share responsibility.

In practice, the main allocation of expenditure responsibility in most federations was decided with little reference to the theories of fiscal federalism. However, the principles can be useful for countries considering federal constitutions and established federations seeking to readjust responsibilities.

2.3 Integrated or dualist federal systems

In dualist federations, governments normally administer their own legislated programs, while, in integrated federations, the constituent units administer federal laws in specified areas. Many federations have elements of both models. Constituent units in integrated federations may have significant administrative or spending responsibilities, but constrained decision-making

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authority. In dualist federations, constituent units don't have the obligation to administer federally legislated programs, but their powers can be constrained by concurrency and a heavy reliance on conditional transfers.

Some former British colonies that became federations (United States, Canada, Australia) were based on the dualist model, so that federal departments are present throughout the country delivering federal programs. Dualist federations often have areas of concurrent federal and constituent-unit powers—for example, agriculture in Canada—but even so, there can be parallel federal and constituent-unit departments working side-by-side. Against this, the “continental” systems (Germany, Switzerland, Austria, Spain) are more integrated in that the constituent units typically administer federal programs in areas of concurrency. The Latin American federations are basically dualist; that of South Africa is integrated; and Nigeria, India, and Pakistan have elements of both.

Both systems have strengths and weaknesses.

- In principle, the integrated model provides for national policy frameworks, while permitting constituent governments the latitude to adapt these to local circumstances. In practice, however, such federal laws are often highly prescriptive and leave little discretion to constituent units. German federalism addresses this by empowering the Länder governments to vote in the Bundesrat on federal legislation affecting them. Over time, this requirement for majorities in both the popularly elected lower house and in the upper house led to frequent deadlock. After reforms, fewer laws now need the approval of the upper house. Excessive entanglement has also been an issue in Spain, where the central government has negotiated new arrangements with some autonomous communities to limit the central government's use of framework legislation to enter into certain areas of local interest.
- The dualist model tends to produce less entanglement, but it can lead to duplication or even programs working at cross-purposes. And while constituent units are not normally obliged to administer

federal laws, federal legislation is almost always paramount in areas of concurrency. Dualist federations are particularly subject to debates over the federal government's using its spending power to influence constituent-unit programs in areas beyond federal legislative competence.

2.4 Spending power

Most federations permit both orders of government to spend in areas beyond their legislative jurisdiction. Such a spending power can be used by federal governments to significantly increase their role, notably in federations where there is little concurrency of legislative jurisdictions.

In all federations, one order of government cannot make laws in areas of the other order's exclusive jurisdiction. However, many powers are not exclusive, and most federations also have some areas of concurrent jurisdiction where federal law is almost always paramount. As well, integrated federations can have constitutional provisions giving constituent units the sole responsibility to administer federal laws—effectively, to do the spending—in certain areas of concurrent jurisdiction.

Beyond these allocations of legislative and administrative responsibility, most federations have constitutional provisions or court rulings that permit governments to spend on any object, even in areas where they could not legislate. So, for example, a constitution may assign education to the constituent units, but this still does not preclude the federal government from having spending programs in the area of education so long as they do not constitute legislation. Central governments frequently use this spending power to influence the programs and activities of constituent units in areas beyond federal legislative competence. The spending power is most important in federations where there are few concurrent powers and the constituent units have exclusive legislative powers in important areas that the federal government wishes to influence.

Legal Provisions around the Spending Power in Some Federations

The central governments of **Australia**, **India**, and **Malaysia** have explicit constitutional authority to spend in areas beyond their jurisdiction. The central government of **Spain** has such a power, subject to strict limits imposed by the courts. The constitutions of the three oldest federations, the **United States**, **Canada**, and **Switzerland**, did not mention a spending power, but each employs it to some degree. In the United States, the Supreme Court has interpreted the federal power to levy taxes for general welfare to permit the spending power. The Canadian Supreme Court has neither affirmed nor denied federal and provincial spending powers, and, in the past, the federal government made much use of it, though not in a manner constituting legislation in an area of provincial jurisdiction. A recent federal-provincial agreement, however, requires a majority of provinces to approve of new spending initiatives in areas of provincial competence and allows provinces, under certain conditions, to opt out with compensation. While the Swiss constitution does not establish a spending power, in practice the only check on federal spending would be through a referendum, which has not happened. The spending power is much less controversial in integrated federations. **Germany**, for instance, has many concurrent jurisdictions, in which cases federal laws must be approved by a weighted majority of Länder votes and then administered by the Länder. **Belgium** is unique, in that its constitutional court has restricted federal spending to areas of federal legislative competence.

Federal governments may use their spending power in three ways:

- to make **general-purpose transfers** to the constituent-unit governments so as to increase their fiscal capacity to meet their responsibilities;
- to make **conditional program transfers** to the constituent-unit governments, requiring them to implement certain programs in a defined manner;

- to create **directly administered federal programs** in an area normally viewed as an exclusive competence of the constituent units.

Constituent units usually have no problem with the first spending power, and the third is relatively infrequent. Most controversy is around the second power, conditional transfers, which may permit a federal government to have strong influence in an area of exclusive constituent-unit competency. Such influence can affect their priorities, especially if matching contributions are required. As well, in some federations, such spending can have a strongly partisan element by providing more program funds to constituent-unit governments aligned with the central government's ruling party.

Defenders of the spending power argue that it allows a federation to adapt and respond to changing circumstances and national priorities. This can be especially relevant in older federations with constitutions drafted in a pre-modern era. The use of the spending power is usually in areas where there is a federal interest in national standards—for example, health care or education—and is consistent with a view that few major subject areas can be neatly defined as exclusively of federal or constituent-unit interest. In practice, the spending power features in the operation of virtually all federations, and is especially important in federations where the constituent units have important exclusive legislative powers. Often the issue is as much over *how* it is used as *whether*.

- There can be legal (Germany) or politically agreed (Canada) rules requiring some level of constituent-unit consent.
- There can be varying degrees of conditionality so as to give constituent units more or less flexibility to design programs that meet national objectives.

These issues are further developed in Chapter Five.

2.5 Distribution of expenditure responsibilities

While there are important commonalities in the allocation of powers to the two orders of government in federations, there are

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also significant differences. There is a greater commonality in the distribution of expenditure responsibilities than of revenue-raising responsibilities across federal systems.

The biggest government spending programs are typically defence, health care, transfers to individuals, social assistance of various kinds, education, and infrastructure. The following gives a sense of the broad patterns in the allocation of major legislative powers relating to these in federations:

- **Defence:** This is always federal, though Australia and the United States reserve a restricted role for constituent units to raise militia. While defence spending in most federations is 2 to 4 percent of GDP, it is notably higher in Russia and the United States.
- **Health care:** Constituent units usually administer the main programs in this expensive and growing area (government costs range up to 15 percent of GDP), though the federal government usually plays a major role in shaping health programs, whether through its legislative or spending powers. Federal governments can administer certain programs directly (veterans, pensioners, aboriginals).
- **Unemployment insurance, income security, social welfare, and pensions:** These are either concurrent, joint, or federal responsibilities with rare exceptions (in India, states are responsible for unemployment insurance; in Belgium and Austria, constituent units are responsible for social services).
- **Education and research:** Primary and secondary education are almost always administered by the constituent units, though the federal government may have concurrent power with paramountcy. Post-secondary education and research show no clear pattern, but federal governments typically play a significant role (sometimes with exclusive competence for post-secondary institutions; sometimes through financial support, notably in student aid). Federal governments usually lead on research spending.
- **Infrastructure:** Federal governments frequently play a key planning and financing role in major infrastructure, though implementation

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may be by constituent units. Local infrastructure is usually the responsibility of the constituent units. This is an area where the role of the public sector versus the private sector varies greatly, and, in many cases, the former has diminished with time. While, in principle, federal governments should focus on nationally significant infrastructure, for political reasons they are often drawn into very local infrastructure projects.

Federations differ significantly in the share of direct spending (after transfers) that is done by the central versus the constituent-unit governments. Federal governments account for between 32 percent (Switzerland) and 85 percent (Malaysia) of total government expenditures after intergovernmental transfers. There appears to be a trend to greater decentralization of spending in several federations. Variations in spending patterns across federations are wide, though less than variations in pre-transfer revenue shares.

Patterns of Direct Spending in Various Federations

Switzerland, Canada, Belgium, and Germany are the federations where the federal government spends least—between 30 and 40 percent of total expenditures—after intergovernmental transfers. In Germany, and to a certain extent Switzerland, this reflects the responsibility of constituent units to deliver some important federally legislated programs, while in Belgium and Canada it reflects more devolved legislative as well as spending responsibilities. Federal government spending in most federations (**India, United States, Russia, South Africa, Spain, Austria, Mexico**) falls within a range of 45 to 55 percent. In **Australia, Nigeria, and Brazil**, federal spending approaches 60 percent, though it falls well short of the highly centralized federations of **Venezuela** (78 percent) and **Malaysia** (84 percent).

2.6 Mandates: Funded and unfunded

Some federations permit the federal government to impose expenditure obligations on constituent-unit governments, without necessarily providing revenues to meet the obligation. There may

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also be constitutional obligations on constituent governments to meet certain standards.

There is a significant difference between having the **authority** to spend and having the **obligation** to spend. In integrated federations such as Germany and Spain, the constituent units have an obligation to carry out federal laws and constitutional provisions; at the same time, it is normally expected that they are provided adequate revenue-raising powers or transfers to meet these obligations. However, there can be occasions when the spending obligation is not met by adequate revenue provisions. In the 1990s, the German Länder of Saarland and Bremen successfully sued the federal government on the grounds that they had not been provided adequate funds to meet their constitutional obligation to ensure government services equal to those provided elsewhere in the country. However, in 2006, the Constitutional Court ruled that such grants shall be provided in the future only in case of a “state of federal emergency.” Consequently, it will be much more difficult for a single Land to claim such bailout payments in the future. A number of constitutions, such as in Brazil and South Africa, set out various principles or rights to certain basic services that could have major spending implications, but usually these are not judiciable.

The United States federal government has a broad (if uncertain) authority to impose mandates on the states, requiring them to execute a federal policy. There was an annual average of two to three of these mandates in the 1970s and 1980s and states complained that they were often unfunded. A reform in the 1990s has limited their use, but has not prevented the imposition of an extremely costly mandate relating to anti-terrorism. States complain as well about costly conditions attached to federal program aid and often call these “unfunded mandates” as well.