Chapter Six

Economic Management in Federations

6.1 Fiscal federalism and macroeconomic management

Central governments in federations typically lead in managing the economy, but constituent governments can have an important influence and role. Both federal and unitary systems of government can have structural vulnerabilities that encourage irresponsible fiscal and economic management. While these vulnerabilities differ, neither type of system has a clear advantage, and both have performed either well or poorly.

Across federal systems, central governments are always responsible for monetary policy (except in the European Union federations that have transferred it to the European central bank). They are usually responsible for raising most public revenues and for determining key features of the tax system, import tariffs, and investment policy. They often lead on strategic investments in infrastructure as well as research. Thus, central governments inevitably lead on economic management, though constituent units have an important secondary role in some decentralized federations.

Many experts have argued that the decentralized nature of federations makes them prone to uncoordinated and irresponsible macroeconomic management. However, the empirical evidence for this assertion is weak or even contradictory. Indeed, the world's most (and least) successful economies include both federal and unitary countries. Some argue that federations are vulnerable to three major weaknesses.

- First, the central and constituent-unit governments may pursue contradictory fiscal and economic policies. There can certainly be cases where the federal government may be pushing the fiscal accelerator while constituent units are applying the brakes, or vice versa, but it is not a general problem in federations and we shall see how some have avoided it. Unitary countries can also have incoherent fiscal and economic policies, sometimes because of differences among the executive, the central bank, and the legislature.

- A second possible federal weakness is that constituent-unit governments have a structural incentive to bargain or manoeuvre for more than their fair share of resources, thus driving up public spending. Again, such a situation can occur, but its extent seems quite limited because central governments can exert control in various ways. There is also ample evidence of "log-rolling" and other practices in some unitary regimes that drive up public spending.

- The third possible federal weakness is that constituent units often incur debt irresponsibly because they count on the federal government to bail them out. Certainly this has happened in some federations, but unitary countries can get into trouble with debt as well. As we shall see below, there are ways for federations to manage this risk.

It appears that other factors are far more important in determining the quality of fiscal management in a country than the choice of a federal or unitary system. The key point is not which system is better or worse, but recognizing that each can have weaknesses and strengths, and that these depend very much on local culture and the particular arrangements adopted.

6.2 Central banks and monetary policy

Monetary policy is centralized in all federations, though the independence of central banks varies from virtually total to minimal. While the fiscal situation of constituent units can be dramatically affected by monetary policy, their governments are essentially excluded from its formulation. Constituent units in turn can impact monetary policy by fiscal decisions, including their use of borrowing.

While monetary policy is normally a federal responsibility, it is conducted very differently among federations (and many have changed their approach dramatically over time). Some have given their central banks complete, or virtually complete, independence to conduct monetary policy, while others maintain political control through the finance ministry. Typically, independent central banks have more credibility than federal finance ministries in maintaining their monetary policies when dealing with political pressures.

Monetary policies can target inflation rates, exchange rates, or other factors related to the performance of the economy. The choice of monetary policy can be important for constituent units in that it affects their cost of borrowing as well as the performance of the economy, which in turn drives revenues and program expenditures. It can also have significantly different impacts on regions within a federation, depending on their main industries (e.g., commodities versus manufacturing).

Brazilian and Argentine experience shows how dramatically monetary policy can affect fiscal relations in federations. After chronic inflation, Brazil committed to monetary stabilization in the 1990s, initially through sustaining the exchange rate of the currency. A wave of financial crises in emerging economies in the late 1990s forced Brazil to move to a floating exchange rate, so that monetary stability became dependent on an inflation-rate target, which, in turn, was backed up by high interest rates and strict management of public spending. This put enormous pressure on state budgets at a time when federal taxes were rising dramatically. The result was a major reversal of the fiscal decentralization that was part of the structure of the 1988 constitution. Argentina also went through a dramatic crisis, in its case in 2001 when it was forced into a huge devaluation of the peso. The federal government turned to an extensive use of export taxes to compensate for some impacts of the devaluation, but these taxes had highly differential impacts among provinces, and greatly increased the federal revenues that did not need to be shared with the provinces.

Of course, constituent units can, in turn, have an important impact on monetary policy. They can adopt fiscal policies that are in conflict with monetary policy (as can the central government when it does not control monetary policy) by being expansionary or contractionary when monetary policy is the opposite. In Canada in the late 1980s, Ontario and some other provinces spent aggressively because of buoyant revenues at a time when the central bank was trying to cool inflation; the central bank responded by being even more restrictive. Some federations have had debt crises brought on by excessive borrowing by constituent units—on occasion, by circumventing borrowing rules and taking on large debts from banks they owned—that then required bailouts by the central authorities.

The European Union's evolving monetary union, bolstered by a common currency in 1999, meant that participating member states could no longer deal, as some had, with excessive accumulations of government debt through inflation and devaluation. Instead, they would need to adjust their spending and revenues within negotiated maximum deficit and debt limits. This is a difficult task with ongoing problems. The same logic applies in all federations that seek to limit the budget excesses of constituent units. In Germany, for example, the federalism reform in 2009 passed a new debt rule linking the Länder to the European Stability and Growth Pact.

6.3 Fiscal policy coordination and stabilization

Fiscal policy typically tries to smooth the cycles of the economy by adding to or subtracting from net demand through government borrowing or surpluses. Federal governments usually play the major role in this regard, especially where constituent units have constrained fiscal flexibility. Good fiscal management can be promoted through common technical frameworks and regular policy dialogue.

Governments manage fiscal policy by spending less or more than their income, thus running surpluses or deficits respectively, and thereby affecting the level of demand in the economy. Typically federal governments have more latitude than constituent units to vary their fiscal policy, particularly to take on debt in periods of economic downturn. Some programs, such as unemployment insurance and social assistance, are natural and "automatic" economic stabilizers with expenditures rising in recessions and falling in periods of growth; it makes sense for the federal government (perhaps with the constituent units in decentralized federations) to play a major role in such programs.

While automatic stabilizers can be important, both orders of government in federations can use their discretion to implement active fiscal policies as well. Approaches to coordinating such policies vary considerably. At one level, developing common budget frameworks and promoting technical dialogue can be helpful in bringing transparency in budgets at the federal and constituent-unit levels, without necessarily constraining the budgetary decisions of governments. Common technical definitions can include major macroeconomic variables—prices, wages, key monetary measures—as well as common revenue and expenditure classifications and fiscal years for all governments. In addition, proper audit and control procedures provide credibility. It can also be helpful if all governments make their budget forecasts well before the beginning of a new fiscal year, and, if there is a forum for discussion and the possible coordination of budget plans, perhaps over a two- or three-year horizon. Predictability in tax shares and federal transfers can be important in helping constituent units avoid unforeseen surpluses or deficits. Finally, contingency reserves against surprises can help with fiscal stabilization. Some of these technical requirements can be imposed within a federal system or negotiated with the constituent units.

Informational and Procedural Measures Promoting Fiscal Coordination in Various Federations

A **German** federal law governing budget management establishes budgetary classification and accounting systems, as well as a multi-year planning framework. **Belgian** federal, regional, and community governments work within an interministerial system that fosters accountability, and all governments exchange data on a monthly basis. **Australian** states report some data into a uniform presentation framework, but may use their own standards for their budgets. **Canadian** provinces take part in regular dialogue with the federal government and accept the standards of the Public Sector Accounting Board, an independent body. **American** states usually adopt Generally

Accepted Accounting Principles (GAAP), but have little dialogue with the federal government on fiscal matters. **Mexico** has had an uncoordinated regime, with major data inconsistencies making it difficult to consolidate a national fiscal account, but has moved to create an integrated accounting regime. **Argentina** also has had a weak system but has made some improvements under its Fiscal Responsibility Law. **Nigeria** has major problems with lack of transparency in national and, in particular, state accounts.

6.4 Debt management and fiscal responsibility laws

Some federations rely heavily on market disciplines, transparent processes, and information, as well as occasional suasion, to manage debt. Others provide formal disciplines on constituent-unit (and sometimes federal) debts, including fiscal responsibility laws or other measures to promote fiscal responsibility. These have had varying success.

Federal governments can be good or bad fiscal and economic managers, but when they do poorly they usually must redress the situation largely on their own. By contrast, when constituent units are poor fiscal managers, and especially when they accumulate excessive debt, the federal government may need to intervene because of the risks that such large debts may have for economic stability and the federal government's own finances.

All federal governments are subject to the twin disciplines of capital markets and their voters in relation to their borrowing and debt. Some federations rely on the same disciplines to manage the debts of constituent units, and the credibility of such a market-based approach depends not only on well-functioning capital markets but also on a widespread belief that the central government will not engage in bailouts. Such credibility may also be enhanced by legislated requirements on balanced budgets or debt control, such as are common with American states and Swiss cantons. In Australia, the central government chairs a loan council that oversees federal and state borrowing, but its role has been largely informational, rather than controlling, and it was redundant in a period of surpluses; the council now also advises on whether total government spending on major capital is consistent with the government's inflation target.

In some federations, voters and market mechanisms are ineffective in disciplining constituent units. As well, when constituent-unit governments rely overwhelmingly on federal-tax sharing and fiscal transfers, the markets may assume the federal government provides an implicit bailout guarantee for constituent-unit debts. In these two cases, the central government may try to control or reach understandings on constituent-unit debt. These measures can include limits on total debt or debt servicing in relation to revenues, permitting debt only to finance capital expenses, requiring federal approval of borrowing, or requiring that borrowing be done through the federal government.

The European Monetary Union is unusual in being a monetary union where the central government's fiscal weight is extremely small (its revenues are just over 1 percent of GDP). Thus, all countries in the monetary union have agreed to three main fiscal targets, with limits on annual deficits and total indebtedness in relation to GDP. Austria, Belgium, Germany, Italy, and Spain have all had to work out arrangements between their central governments and constituent units on how they will meet these targets on a whole-of-government basis. In some cases, they have had only qualified success because of weak constraints on constituent-unit deficits.

Federations in the developing world present a mixed picture of systems with long-established federal controls on borrowing and newer systems that have moved to stricter regimes following credit crises with their constituent units. In some cases, federal controls have gone beyond controls on borrowing to more comprehensive **fiscal responsibility laws**.

Borrowing Controls and Fiscal Responsibility Laws in Various Federations

In 2000, **Brazil** adopted a fiscal responsibility law that was negotiated with the states following the renegotiation of their debts and a prohibition on their issuing new bonds. The law constrains both orders of government, with limits on spending for government employees, on debt (not exceeding a ratio of current revenues), on recurrent expenditures (which must have a matching revenue source), and on short-term spending in election years. It also provides a multi-year planning process and various transparency and oversight provisions (e.g., on contingent liabilities). Tax breaks and new expenditures must be justified with a longer-term impact assessment. Importantly, the federal government can withhold payments to states that do not comply, and criminal proceedings can be brought against elected officials. Since Brazil adopted the law, public sector deficits have fallen substantially.

Following the 2001-02 debt crisis, the **Argentine** government offered to bail out the provinces in exchange for their accepting the Fiscal Responsibility Law to which 22 of the 24 provinces have agreed. The law establishes guidelines to promote consistent and transparent public accounts, limits on expenditures and debt, and sanctions on non-compliant provinces. It also provides for the establishment of fiscal stabilization funds (six provinces have done so in a modest way), which could be important given Argentina's large commodity exports. In 2006, **Mexico** adopted a law on the federal budget and fiscal responsibility that includes provisions for planning, debt limits, transparency of public finances, control of civil-service costs as well as mechanisms for handling petroleum revenues. **Nigeria** passed a fiscal-responsibility and procurement act in 2007, but its application was limited to the federal government alone because the Senate rejected its application to the states; since then, a few states have agreed to join the system.

Indian states can borrow only domestically and require the agreement of the Union government for new debt if they have outstanding loans with it; even so, state debts have risen significantly, partly through off-book devices such as debts taken on by state-owned utilities. The central government has a fiscal responsibility act that obliges the government to show how it will achieve budget balance within a five-year period; however, it excludes the very expensive subsidies for fuel and fertilizer, which are off-budget and do not apply to the states. The **Russian** federal government now strictly limits regional debt and deficits. In **South Africa**, national legislation circumscribes provincial borrowing. The **Belgian** federal government makes agreements with constituent-unit governments on borrowing, based on recommendations of the Higher Finance Council and the national bank.

6.5 Microeconomic policy

Microeconomic policy, which focuses on the efficiency and productivity of the economy, necessarily involves all orders of government in federations. Some federations have strong measures to promote internal markets, and to frame consistent competition and sectoral and regional policies. Others have a diffuse assignment of regulatory responsibility for internal markets and major challenges of coordination. Regulatory policies dealing with natural monopolies, labour markets, capital markets, and environmental standards are particularly important.

An important part of economic management in federations is addressing the operation of the internal market so as to limit barriers to trade in goods and services, to investment, and to the mobility of labour. Open markets within a federation are generally thought to promote the efficient use of resources. That said, the governments of constituent units can often try to promote local interests by favouring them through regulations, tax measures, subsidies, and in other ways. As well, they may sometimes introduce measures for other reasons, such as environmental protection, the provision of electricity, or the improvement of a service, where the way it is carried out creates a barrier within the federation's internal market. The risk of internal barriers tends to be greater where the constituent units have important taxing powers or legislative powers touching economic subjects. Constituent units often own or regulate public utilities, which they can protect as local monopolies closed to competition from elsewhere in the federation.

The challenge of limiting internal barriers is constant in federations because new ones can be created at any time. There are three broad approaches to doing so, which can be combined in different ways:

- **Constitutional provisions**: Federal constitutions can include principles relating to the internal market that permit the barriers to be challenged in the courts.

- **Federal government jurisdiction**: Federal constitutions can empower the federal government to pass laws that constrain or override constituent-unit laws. This is most obvious in cases of concurrent jurisdiction, where federal laws are almost always paramount. A federal power to regulate internal trade and commerce can also be important. Other federal powers, including a power to pre-empt (as in the United States) can be used to limit internal barriers.

- **Collaborative efforts**: Federal governments may not have the legal authority to limit barriers created by constituent units, or they may have the authority but not be prepared to pay the political price of intervening unilaterally to strike down a measure that is popular in a region. In such cases, federal and constituent-unit governments may work together to address internal barriers—and this can be done variously through negotiations, studies, and joint industry-government task forces.

Federations differ in the priority they give to reducing internal barriers and in the approaches they adopt. The European Union, which was founded with the objective of creating a unified market, offers valuable lessons that could be used by federations, including the powerful role of the European Court and the adoption of weighted majority voting, rather than unanimity, to make new rules. While some federations, such as the United States, have relatively strong federal trade and commerce powers, others, such as Canada, do not. Even where the federal powers are quite strong, there are always some barriers that cannot be addressed by federal fiat or by a legal appeal to the constitution, so co-operative mechanisms can be important.

6.6 Regional development

Federations may use regional-development policies to address regional economic disparities as a complement to federal transfers and tax sharing. Some federations favour addressing such disparities through economic and social policies rather than through fiscal sharing and transfer arrangements.

Chapter Five presented an overview of tax sharing and fiscal-transfer arrangements in federations, including equalization. Regional development, or other economic development programs, can be used to supplement or substitute for such fiscal sharing arrangements. Many federations have special programs aimed at the economic growth of less-developed regions. In India, for example, the revenue-sharing arrangements proposed every five years by the Finance Commission are complemented by strategic investments proposed by the Planning Commission to promote national and regional development; these can take the form of significant conditional transfers to the states. As well, broad-based federal programs directed at individuals—such as social assistance, unemployment insurance, labour-market training, and pensions—can be an important part of a federation's approach to regional disparities. The European Union, which has very small fiscal resources compared to federal governments, has created funds for investments in poorer member states (less than 90 percent average EU income) and in targeted poor regions, rather than any kind of fiscal equalization program. Such regional development programs seem to be most successful when they upgrade basic infrastructure and the quality of the labour force rather than providing targeted assistance to particular industries.