

Chapter Seven

Institutional Arrangements and Issues

7.1 Fiscal forums and advisory commissions

Parliamentary regimes tend to have greater control of fiscal management by the executive branches of governments than do presidential-congressional regimes, where legislatures have more latitude. The structure of the political party system is also of critical importance. Upper houses sometimes play a role in representing the fiscal interests of constituent-unit governments or populations.

Politicians can stay in office only by winning elections, so competitive democratic politics are central to the dynamic of federations, including fiscal management. Politics in every federation are complex and can change quickly on the basis of an election, or series of elections, so that the same major political institutions can function very differently depending on who is in power in which governments. Given this, generalizations about the impact of institutional arrangements on economic and fiscal policy must be approached cautiously.

The major political institutions shape relations and the dynamic of fiscal management in a federation. Most federal governments have either a parliamentary or a presidential-congressional system, and their constituent units usually have the same system. (Exceptions are Russia, which has a presidential-parliamentary system, and Switzerland and South Africa, whose five-member executive and president respectively are elected by the central legislatures, but not subject to votes of confidence.) In parliamentary regimes, the government usually requires the confidence or support of a majority in the lower house to continue in office, while, in presidential regimes, the executive is independent of

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the legislature. Budgets in parliamentary regimes are a matter of confidence, so there are usually strict limits on the extent to which they can be amended (at least without the consent of the government), while in presidential-congressional regimes the legislature can revise the budget without causing the government to fall.

Presidential-congressional systems are thus often seen as having less-disciplined budget processes, since the executive may need to negotiate extensively with the legislature to win its consent (and the legislature must avoid a presidential veto in some cases). This can be seen, for example, in the extensive insertion into legislation of earmarked projects by the United States Congress, as well as in major revisions to the budgets proposed by the president, especially when his party does not control both houses. Nigeria and Mexico have also been characterized by major changes in budgets proposed by the executive. However, some presidential regimes, such as Brazil and Argentina, have seen budgets proposed by the president approved with few amendments, and this reflects inducements the president can use to keep legislative supporters in line. As well, Brazil and Argentina engage in greater intergovernmental dialogue on fiscal issues than do Nigeria and Mexico.

In parliamentary systems, budget deal-making largely occurs before the budget is proposed and it is driven by the executive. Even if this involves serious compromises (which it can, especially when there are coalition governments, as in India), the deal-making is led by the finance minister and cabinet, not by a legislative committee. It can involve extensive consultations with the constituent units.

These differences affect how fiscal federalism is carried out in different regimes. Where the executive is in control, as in most parliamentary and some presidential regimes, the governments of the constituent units will focus their efforts on influencing the federal government, while in presidential-congressional regimes with more diffuse budgetary power, they often try to influence both the central executive and legislators.

Virtually all federations have upper houses, which are elected or named on a different basis from the lower house (which is usually

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popularly elected more-or-less on the basis of population). In many cases, representation in the upper house is equal for all constituent units, but even when it is not, the upper house typically over-represents smaller units, so that upper houses have a bias in favour of their interests. However, the powers of upper houses vary greatly, typically being strong in presidential-congressional systems and relatively weak, especially on budgetary matters, in parliamentary régimes. Germany is an important exception, where the Bundesrat, which represents the Länder governments, must approve any law (including any budgetary matter) affecting them; this requirement produced a very integrated system that has sometimes had difficulty making decisions. Ethiopia is a parliamentary federation whose House of Federations is elected by state legislatures (not governments) and has no normal role in legislation, except that it must review and approve budgets as they affect the states; in practice, it has forced budget revisions, despite the dominant party regime across the federation. In South Africa, all bills affecting provincial competencies must be approved by a majority of the nine provinces represented in the National Council of the Provinces, subject to the National Assembly's being able to override with a two-thirds majority.

A number of federations do regular reviews of their federal fiscal regimes and they name commissions to consult and prepare reports on these. India's periodic Finance and Planning commissions, which are named by the Union Government, have been largely successful in that their members are seen as eminent and independent, and their recommendations carry great weight. Against that, Pakistan's experience has been more problematic in that its finance commissioners are delegates under instruction from governments and they must agree unanimously; as a consequence, there has often been stalemate. Australia has for half a century depended on the Commonwealth Grants Commission to regularly review and make recommendations on their fiscal transfers. The commission's board includes members named by the federal government after extensive consultation with the states; there is a large permanent staff. Its recommendations carry great weight and are usually adopted virtually intact.

Canada faced a major fiscal crisis in the late thirties and appointed a royal commission to review federal fiscal arrangements. Its report had

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a major impact, not just on federal-provincial fiscal relations but on the realignment of constitutional responsibilities, e.g., with the federal government taking on unemployment insurance. More recently, the federal government and the provincial governments both named panels to review certain aspects of the fiscal transfer regime; in the end, the federal revisions were heavily based on the recommendations of the federally named panel.

Federal systems often have well-developed intergovernmental relations, working within sectors and operating at various levels from heads of government and ministers to senior civil servants to technical working groups. In the financial area, it is common to have working groups engaged on financial statistics and accounts, and on tax administration, as well as on major policy matters that will be negotiated among ministers. The strength and depth of such arrangements can depend on the level of development in the country, but also on how institutions function at the highest levels. Thus, the United States has relatively underdeveloped networks for intergovernmental meetings, and states promote their interests bilaterally or through lobbyists; parliamentary regimes, such as Australia, Canada, India, and Switzerland (not to mention Germany with its Bundesrat and especially the different “Minister Conferences” in which the ministers of the Länder meet regularly) are characterized by dense and active networks.

7.2 Courts and dispute resolution

While not all fiscal arrangements between governments in federations are judiciable, many are. Courts can play an important role ruling on fiscal issues related to powers, laws, and the underlying principles of a constitution. Some federations have special courts for tax matters. Some avoid taking certain fiscal matters to the courts, preferring to address them politically.

Courts have played a big role in shaping the constitutional framework of most federations and in ruling on points of importance for fiscal federalism. At the same time, many of the most important issues in fiscal federalism are political, not legal. For example, arrangements around fiscal transfers or revenue sharing are subject to periodic review

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and amendment, and, typically, the courts play a minor role in such matters, which must be resolved politically. As well, some intergovernmental agreements may deliberately be drafted as political, not legal, documents, which gives them a greater flexibility in administration. Even when there are legal rights and obligations, governments may choose to manage disputes politically or through alternative dispute resolution. South Africa's 1996 constitution emphasizes co-operative governance and limits the access of governments to the courts so that it is a last resort, to be used only after other alternatives have been exhausted. In both Switzerland and Ethiopia, the courts do not have the final say on the constitution: in the former case, it is the population, by referendum; in the latter, it is the House of the Federation, elected by the state legislatures.

Some Court Decisions of Importance for Fiscal Federalism

The **United States** Supreme Court has given interpretations to the interstate commerce power, to the spending power, and to the power of pre-emption that have greatly strengthened federal dominance of fiscal federalism. The **Australian** Supreme Court narrowly interpreted state power to tax, most importantly in four cases in the 1940s that effectively transferred income-tax powers from the states to the Commonwealth government. In recent years, the Court's severe limitation of state tax powers was a key factor in the states agreeing to the new centrally administered value-added tax regime. **Germany's** Constitutional Court found in 1992 that the federal government was responsible for a large share of the heavy debts of several Länder, on the grounds of the constitution's "equality" provisions. **Canada's** Supreme Court found that a federal-provincial fiscal transfer agreement could be changed unilaterally by the federal Parliament, whose sovereignty could not be constrained without a constitutional amendment. **South Africa's** Constitutional Court has so far refused to adjudicate intergovernmental disputes, instead urging the governments to exhaust all mediating avenues before litigating against each other. **Nigeria's** Supreme Court has played an active role in adjudicating disputes over oil between the federal and state governments. In

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a recent decision, they denied state rights over certain offshore oil deposits. After the ruling, however, the federal government made a deal to split the revenues with the states that had sued and lost.

7.3 Asymmetric arrangements

Constituent units in federations normally have the same formal constitutional powers in relation to fiscal matters, but there are a few exceptions. Asymmetric arrangements are more common through administrative or political arrangements.

Constituent units within federations have very different characters, capacities and needs. Some of them create strong political pressures for devolution, while others do not; some face unique financial circumstances. One way to address such differences is to adopt arrangements that treat constituent units differently. However, constitutional asymmetry can create difficulties if it appears that one constituent unit is receiving greater powers or favourable treatment. The experience in Spain is that special arrangements agreed to with the autonomous communities of the “historic nationalities” are usually sought by the others. At present, the Basque country and Navarre have special fiscal arrangements that permit them to collect all taxes, provide less support for the central government, and use their corporate tax to attract investments; while these arrangements are rooted in history, the asymmetry is creating pressures that are still not resolved. Russia had severely asymmetric arrangements in the early stages of its new federal constitution, but these have been quite systematically eliminated. Against this, the small Borneo states in Malaysia have special constitutional powers over forests, fisheries, and petroleum that relate to their character and method of entering the federation, and these have not led to generalized demands for the same treatment.

Certain kinds of asymmetry may simply be practical, non-constitutional arrangements, where different constituent units work out various arrangements to suit them. Thus, in Canada, the federal government has reached bilateral agreements on tax administration with the provinces, with the offer being similar but the take-up

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different. In this and in some other arrangements, such as pensions, there is a limited degree of “specialness” to the treatment accorded Quebec, which is largely accepted by the other provinces. Furthermore, there may be no problem in providing special grants to poorer constituent units so long as it is done in a principled, programmatic manner so that all of them get similar treatment. Political problems can arise when the federal government resorts to favouritism for particular constituent units for partisan or other reasons, and this certainly happens in some federations.

7.4 Capitals, territories, and aboriginal peoples

Federations can have special fiscal arrangements for their capitals, territories, and tribal areas or aboriginal lands.

While constituent units with the same constitutional status are the main subnational feature of federations, there are some cases where parts of the national territory are under a distinct constitutional regime. This can be true for national capitals, territories, and aboriginal or tribal areas. In each case, there may be special fiscal arrangements.

Whether a federation's capital city is in a separate federal district (Argentina, Australia, Brazil, India, Malaysia, Mexico, Nigeria, the United States, and Venezuela); is a federal city (Ethiopia, Russia), is a city-state (Austria, Belgium, Germany); or is a municipality within a constituent unit (Canada, Spain, Switzerland), there can be special financial arrangements for the capital. These may recognize the symbolic importance of the capital as a showcase for the country, or simply the extra costs associated with hosting a national government. Federal policy towards national capitals varies greatly. In many cases, the federal government assumes major costs for infrastructure, parks, and cultural institutions, while in others (such as Switzerland) the capital city receives minimal special treatment beyond compensation for such direct costs as enhanced security. For their property in the capital, federal governments may pay taxes to the capital's government, grants in lieu of tax, or nothing at all. In Nigeria, the federal income tax applies only to federal employees and residents of the national capital.

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A number of federations also have areas with the status of territories, which typically do not have constitutional autonomy as they are legally subservient to the federal government. These territories can have large areas and small populations (Australia and Canada). In Australia's case, the Commonwealth-grants regime applies to both the states and territories, and includes a calculation of both fiscal capacity and need, which takes account of the high costs of operation in the Northern Territory. In Canada, the equalization regime looks only at fiscal capacity, not need, so a special and much more generous regime has been developed for the three northern territories in order to recognize their special needs.

In both Canada and the United States, there are lands reserved for aboriginal peoples with autonomous governments. Canada has over 600 Indian bands living on reserves, while the United States has a few hundred Native American reservations, the largest of which are greater in area than the smallest states. These communities have legal and fiscal regimes that are distinct from those of the surrounding provinces or states. Federal and provincial taxes normally do not apply to aborigines for earnings or transactions on their lands. Ultimate title for property rests with the community, and the costs of local government are borne overwhelmingly by federal payments. In many cases, these regimes have proven ill-adapted to promoting economic development, often creating deep dependency syndromes, especially for smaller or more remote communities. In recent years, a variety of new fiscal approaches have been tried by individual communities.

India has six so-called "tribal" states located in its northeast that have special funding arrangements, tribal land protection and other laws. As well, there are tribal districts and regions within some states with particular arrangements around land and other local matters, but not normally including distinctive fiscal regimes.

7.5 Government enterprises

Government-owned corporations engaged in commercial activity have had a major impact on fiscal federalism in some federations.

Federal and constituent-unit governments in many federations have had a large presence in the commercial economy through corporations

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owned by them. When these corporations have operated in a purely commercial manner, including private borrowing and the payment of taxes (or equivalent), this has had a minimal impact on fiscal federalism. But more often than not, there are special arrangements for these corporations, which can affect fiscal federalism.

- Some public companies are important sources of ongoing revenue for governments. Federal governments may be able to use such arrangements to avoid or limit tax-sharing obligations with the constituent units. Constituent-unit governments, for their part, may use them to enjoy revenues that will not be included in the calculation of their fiscal capacity for purposes of transfers from the federal government. As well, when government-owned corporations are privatized, the proceeds may not count in revenue-sharing arrangements.
- Government-owned companies may be protected from paying corporate income tax or other taxes to the order of government that does not own them, on the grounds that one government cannot tax another; this is the case with large, provincially owned power utilities in Canada. In many cases, government-owned companies are completely outside the corporate tax regime and make other types of payments to the governments that own them.
- Such companies may provide products or services at subsidized or less than market prices, as has been the case for state petroleum companies in Malaysia and Venezuela. Subsidized pricing reduces the revenues available to governments from companies they own; it can also force major expenditure if the subsidized prices are not adjusted to follow the rising cost of imports, such as oil, as has happened in India, Malaysia, and Pakistan. Alternatively, government-owned corporations may use their monopoly to impose higher prices than a competitive market would—which is equivalent to a tax.
- The accounts of government-owned companies can be “off budget” so that their debts are not consolidated with those of the government, thus reducing fiscal transparency and discipline. Such companies may provide payments, easy credit, or loans to the government that owns them, which can undermine efforts at debt

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management and even bring on a debt crisis. In Brazil, the federal government was forced to intervene in a debt crisis brought on when lending institutions owned by the states provided too much credit to their governments; eventually, this situation led to the privatization of these institutions.

Thus in examining fiscal arrangements in any federation, it is important to look at the extent of public ownership of commercial enterprises and, where it is significant, to consider how such government-owned corporations relate to the fiscal regime. Special arrangements for them can have a major impact on revenue flows to and among governments.

7.6 Corruption

Corruption plagues many countries and undermines economic growth, environmental quality, and human development. It does not appear better or worse in federations. Corruption within a federation can corrode trust between governments and undermine fiscal arrangements. It poses issues about appropriate transparency and accountability arrangements between governments.

Transparency International's annual reports on perceived corruption levels around the world show federal countries to be among both the best and worst performers. Experts have advanced opposing arguments showing why decentralization can lessen corruption or aggravate it, but there is no consensus on whether there is a strong tendency one way or the other.

Corruption is a complex phenomenon that can be deeply rooted in a society and its governance systems. It can be particularly serious when governments have very high resource revenues because voters seem less sensitive to these revenues being captured by corrupt elites than they are in the case of taxes they themselves pay. Competitive party systems can sometimes limit corruption (because opposition parties expose misdeeds), but they can also be part of the problem (because parties divert funds to their members and organizations).

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Within federations, corruption can exist at all levels of government. Central governments have access to greater resources, so may have more risk of large-scale corruption. However, regional and local governments can be taken over by corrupt local bosses, who often face weak opposition and have little or no media surveillance. Corruption can undermine trust between governments in a federation: constituent units can suspect the federal government of not fully reporting on revenues that are meant to be shared, while federal governments can be concerned with how transfers' revenues are used or misused.

It appears corruption decreased in many local governments in India during the 1980-90s when the new panchayat system brought three million locally elected politicians into office. The new councils responded to their electorates and increased the accountability and performance of civil servants and teachers at the village level. In short, empowering locally elected governments may reduce corruption in certain cases.

Nigeria has recognized its challenge of corruption, which grew especially under military rule. Certain of the state governments have diverted major resources for corrupt purposes, thus leaving schools, health care, and infrastructure underfunded. The federal Economic and Financial Crimes Commission has exposed many serious cases, some of which have led to the impeachment of state governors; but such operations always face suspicion of a biased approach to enforcement because the commissions may not be wholly independent. Thus, the national assembly and senate have engaged in their own inquiries. While some experts advocate introducing anti-corruption agencies only after the rule of law is more or less secure, the Nigerian experience, despite its flaws, suggests this course may be too cautious.

Efforts to limit corruption succeed best when they address simultaneously the needs for the rule of law, an independent media, public participation, professional bureaucracies and courts, and transparency and accountability. As well, countries providing foreign investment have a responsibility to police nationals who may offer bribes in foreign countries. While the risk of corruption is strongly related to the level of human and economic development as well as resource wealth, all countries can take measures to improve their performance.

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A major problem in confronting corruption in government is creating credible checks and balances. Federal systems may have a potential advantage here, though they have not really exploited it to date. Where a federal government provides large transfers or shared revenues to the constituent units, it has a natural interest in the probity with which these funds are used. The constituent units, for their part, have an interest in transparency at the federal level, at least in relation to revenues that must be shared. So if autonomous oversight mechanisms within each order of government are weak, perhaps there is room for each order of government to have some formal oversight over the other.

Conclusion

This little book has provided a brief overview of fiscal federalism. The subject is both political and economic. It is political in that money is a type of power: how it is raised and used is intimately linked to the decision-making structure and political dynamics of a federation. It is economic in that the management of divided sovereignty in such matters as taxation, government spending, and regulation can have a substantial impact on the functioning and stability of an economy, its efficiency, and its sharing of wealth.

We have looked at the allocation of expenditure responsibilities, the structure of tax regimes, the allocation of specific tax and revenue sources, the sharing and transfer of revenues between federal, constituent-unit, and municipal governments, and some aspects of broader economic management and institutional arrangements in federations. In all these matters, there is a tremendous variation in practice among federal countries. The variety of arrangements reflects the very different histories and characters of federations. There is no single best way to manage things and each country must find its own solutions.

That said, we can learn much from the study of fiscal federalism. The subject provides us with analytical tools and evaluative criteria that aid understanding and critical judgments. The different experiences of federations can provide both inspiration from their creativity and cautionary tales from their mistakes.

It is hoped that this introductory overview has given the reader a sense of the range and nature of issues in fiscal federalism, and insights into how to think critically about them.

Further Readings

Fiscal federalism has a rich practical, theoretical, and comparative literature. The following are a few important and largely current selections.

Ahmad, Ehtisham and Georgio Brosio, eds. *Handbook of Fiscal Federalism*. Northampton, MA: Edward Elgar, 2006.

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Watts, Ronald L., and Rupak Chattopadhyay, eds. *Emerging Issues in Fiscal Federalism*. New Delhi Viva Books and Forum of Federations, 2008.

Useful websites

"The Federalism Library," online: *Forum of Federations*, <http://www.forumfed.org/en/federalism/library.php>.

"Fiscal Federalism," online: *Institute for Public Economics*, University of Alberta, <http://www.uofaweb.ualberta.ca/ipe/federalism.cfm>.

"OECD Fiscal Federalism Network," online: OECD, http://www.oecd.org/department/0,3355,en_2649_35929024_1_1_1_1_1,00.html.

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Federations, <http://www.forumfed.org/en/products/federations.php>.

Publius: The Journal of Federalism, <http://publius.oxfordjournals.org>.

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