

## SPECIAL SECTION:

# Dividing taxes, resources and debt in federations

## Rethinking fiscal federalism

*Some emerging imperatives for cities and regions facing globalization and the Information Revolution*

BY ANWAR M. SHAH

**Fiscal** federalism deals with economic decision-making in federal systems of government in which public sector decisions are taken by various orders of government.

Federal countries differ a great deal in their choices about the character of fiscal federalism, specifically, how the division of fiscal powers is allocated among various tiers and the associated fiscal arrangements.

For example, Brazil, Canada and Switzerland are highly decentralized federations, whereas Australia, Germany, Malaysia and Spain are relatively centralized. Allocation of fiscal powers among members may also be asymmetric. For example, some members may be less equal, and thus enjoy a lower degree of autonomy because of special circumstances, than others. This is the case for Jammu and Kashmir in India and Chechnya in Russia.

Or some members may be treated more equally than others, for example, Sabah and Sarawak in Malaysia and Quebec in Canada.

Or a federal system can give members the choice to be unequal or more equal, such as opting-in and opting-out options in Canada; Spanish agreements with the breakaway devolving regions; and European Union treaty exceptions for Britain and Denmark.

Fiscal arrangements resulting from these choices are usually subject to periodic review and redefinition to adapt to changing circumstances, both within and beyond national borders. In Canada, such a periodic review (the sunset clause) is mandated by law, whereas in other federal countries changes can occur simply as a result of how various constitutional provisions and laws are interpreted

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Photo: Sarai: the new media initiative, Delhi

*Meeting the Information Revolution in New Delhi. New technology and world markets often go hand-in-hand.*

by the courts, as in Australia and the United States, or by various orders of government, as in the majority of federal countries.

In recent years, these choices have come under significant strain from the sweeping changes arising from the Information Revolution and the emergence of a new "borderless" world economy. This article highlights a few key common divergent challenges in federal countries, as well as emerging local responses.

### Challenges to constitutional federalism

The Information Revolution and globalization pose special challenges to constitutional assignment within nations.

The Information Revolution, by allowing transparency for government operations, empowers citizens to demand greater accountability from their governments. With globalization, it is becoming apparent that, as Daniel Bell wrote, "nation-states are too small to tackle large things in life and too large to address small things."

Globalization and the Information Revolution represent a gradual shift to supra-national regimes and local governance. In adapting to this world, there is growing tension among various orders of governments in federal systems to re-position their roles in order to retain relevance. One continuing source of tension is vertical fiscal gaps, or the mismatch between revenue means and expenditure needs at lower orders of government.

Vertical fiscal gaps and revenue autonomy at sub-national orders of government remain areas of concern in federal countries where the centralization of taxation powers is greater than necessary to meet federal expenditures, inclusive of its spending power. This leads to undue central influence and political control over sub-national policies, and can even undermine bottom-up accountability. This is a concern at the state level in Australia, Germany, India, Mexico, Canada, Malaysia, Nigeria, Russia, Spain and South Africa.

In Nigeria, there is a special concern about the central assignment of resource revenues. In Germany, such

concerns are prompting a wider review of the assignment problem and a rethinking of the division of powers among the three orders of government: federal, *Länder* and municipal. A consensus has yet to be formed on a new vision of fiscal federalism in Germany.

The two emerging trends in the shifting balance of powers within nations are: (a) a steady erosion in the role of the states/provinces — and (b) an enhanced, but redefined, role for local governments in multi-order governance.

### ***Diminishing relevance of states and provinces***

The federal governments of Brazil, Canada, Germany, India, Malaysia, and Russia have carved out larger roles in areas of federal-state shared rule. In Brazil, entitlements and earmarked revenues are the restraints on budgetary flexibility at the state level. In South Africa, the task of social security financing has been taken over by the national government. The federal government in the U.S. is assuming an ever-widening role in policy-making areas of shared jurisdiction, while devolving implementation responsibilities to state and local governments.

This is frequently done through unfunded mandates, or with inadequate financing. In Canada and the U.S., the federal governments are partly financing their debts through reduced fiscal transfers to provinces/states.

Another dimension of emerging federal-state conflict has arisen in countries where the federal government and the states or provinces are both constitutionally recognized orders of government such as in Australia, Canada and the U.S., and where local governments are the handmaidens of state governments. In these countries, federal authorities are attempting to build direct relationships with local governments, and in the process are bypassing state governments.

This is a concern in Brazil, Canada and the U.S., where the economic relevance of state governments to people's lives is decreasing, although their constitutional and political roles remain strong. This is making vertical co-ordination more difficult and is also hampering the state governments' ability to deal with fiscal inequities within their boundaries.

In India, the federal government retains a strong role in state affairs through the appointment of federal officials to key state executive decision-making positions. Overall,

the role of the intermediate order of government in federal systems is on the wane, with the exception of Switzerland, where the cantons have a stronger constitutional role as well as stronger support from local residents. However, cantons in Switzerland are similar to local governments in large federations such as Canada, the U.S. and India.

### ***Resistance to a new vision of local governance***

Globalization and the Information Revolution, on the other hand, are strengthening localization and broadening the role of local governments in network governance. This requires local governments to operate as purchasers of local services and facilitators of government networks, beyond government providers, gatekeepers and overseers of state and national governments in areas of shared rule.

Nevertheless, local governments are facing some resistance from their state governments in social policy areas. In Brazil, India and Nigeria, local governments have constitutional status, and thus, a greater ability to defend their roles. In Switzerland, direct democracy provisions assure a strong role for local governments and in both Brazil and Switzerland, local governments play an expansive and autonomous role in their jurisdiction.

In most other federal countries, local governments are wards of the state with little autonomy. The ability of local governments to fend for themselves depends upon the citizen empowerment engendered by the Information Revolution, that is, citizens' awareness of their rights and responsibilities to hold governments to account in view of the transparency and sunshine on government operations brought about by the Information Revolution.

Russia stands out as an example where such a defence could not be mounted. In Canada, some of the provinces have centralized school finances. In South Africa, primary health care has been reallocated to the provincial order of government. In most countries, local governments lack fiscal autonomy and have limited or no access to dynamic, productive tax bases, whereas demand for their services is growing fast. In the U.S. and Canada, existing local tax bases, especially those linked to property, are overtaxed with no room to grow. In the U.S., this problem is compounded by limits on raising local revenues and unfunded mandates in environmental and social spending.

### ***Bridging the fiscal divide within nations***

The fiscal divide within nations represents an important element of the economic divide they experience. This is because reasonably comparable levels of public services at reasonably comparable levels of taxation foster mobility of the factors of production (land, labour and capital) and mobility of goods, as well as help foster a common economic union.

Most mature federations, with the important exception of the U.S., attempt to address regional fiscal disparities through a program of fiscal equalization. In the U.S., there is no federal program, but state education financing uses equalization principles. In Canada, such a program is enshrined in the Canadian Constitution and has even been described as "the glue that holds the federation together."

Photo: Cristiano Sant'Anna, Porto Alegre



*Counterpoint to globalization: the World Social Forum was set up to balance the World Economic Forum of Davos, Switzerland. The WSF met in Porto Alegre, Brazil, in 2003 and 2005.*

Most equalization programs are federally financed with the exception of those in Germany and Switzerland. In Germany, wealthy states make progressive contributions to the equalization pool and the poor states receive funds from this pool. In Switzerland, a new equalization program, starting in 2008, will operate with a mixed pool of contributions from the federal government and wealthier cantons.

There is a great diversity in the institutional arrangements that design, develop and administer such programs in federal countries. Brazil, India, Nigeria, Spain and South Africa take into account a multitude of fiscal capacity and need factors in determining equitable state shares in their revenue-sharing programs. Malaysia uses capitation grants, in which funds are paid on a per-person basis. Russia uses a hybrid fiscal capacity equalization program.

Fiscal equalization programs in Canada and Germany adjust fiscal capacity to a specified standard. The Australian program is more comprehensive and equalizes the fiscal capacity and fiscal needs of Australian states, constrained by a total pool of revenues from the goods and services tax.

The equity and efficiency implications of existing equalization programs are a source of continuing debate in most federal countries. In Australia, there is discontent with the existing formula and the resulting complexity introduced by expenditure needs compensation.

In Canada, provincial ownership of natural resources is a major source of provincial fiscal disparities, and the treatment of natural resource revenue in the equalization program remains contentious.

In Germany and Spain, the application of overly progressive equalization formulas results in a reversal of fortunes for some rich jurisdictions. Some wealthy *Länder* in Germany have in the past taken this matter to the country's Constitutional Court to limit their contributions to the equalization pool. In Brazil, India, Malaysia, Nigeria, Russia and South Africa, much controversy and debate is generated by the equity and efficiency impacts of existing programs.

### ***"Fend-for-yourself" federalism***

A lack of fiscal discipline at sub-national levels is a matter of concern in federal countries because there is significant sub-national autonomy combined with an opportunity for a federal bailout. In mature federations, fiscal policy co-ordination to sustain fiscal discipline is exercised both through executive and legislative federalism, and through formal and informal fiscal rules.

In recent years, legislated fiscal rules have come to command greater attention. These rules take the form of budgetary balance controls, debt restrictions, tax or expenditure controls, and referenda for new taxation and spending initiatives. Most mature federations do not permit "bailout" of any order of their governments by the central bank or by another order government. In the presence of an explicit or even implicit bailout guarantee and preferential loans from the banking sector, printing of money by sub-national governments is possible, thereby fuelling inflation.

*The last fish: equalization payments from the Canadian federal government helped the province of Newfoundland after the collapse of the cod fishery in the early 1990s.*



Photo: Des Pink, Halifax

Recent experiences with fiscal adjustment programs suggest that, while legislated fiscal rules are neither necessary nor sufficient for successful fiscal adjustment, they can be helpful for forging sustained political commitment to achieve better fiscal outcomes, especially in countries with divisive political institutions or coalition regimes. For example, such rules can be helpful in sustaining political commitment to reform in countries with proportional representation (Brazil) or multi-party coalition governments (India) or in countries with a separation of legislative and executive functions (the U.S. and Brazil).

Fiscal rules in such countries can help restrain pork-barrel politics and thereby improve fiscal discipline as has been demonstrated by the experiences in Brazil, India, Russia, and South Africa. Australia and Canada achieved the same results without having any legislated fiscal rules, in view of the commitment to fiscal discipline shown by the governments with parliamentary majorities. However, fiscal discipline continues to be a problem in Germany, even though that country has legislated fiscal rules.

The Swiss experience is most instructive as the country has sustained fiscal discipline. Two important instruments in Switzerland create incentives for cantons to maintain such discipline. First, fiscal referenda allow citizens the opportunity to veto any government program. Second, the legal provision enacted in some cantons to set aside a fraction of any fiscal surplus in good times works as a "debt brake" to prepare for rainy days.

### ***Fragmentation of internal common markets***

While preservation of an internal common market is the primary goal of all federal systems and also a critical determinant of their economic performance, removing impediments to such an economic union remains an unmet challenge in federal countries in the developing

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# Berlin's hangover: a € 61 billion city debt

*With no federal bailout possible, Germany's capital looks for ways to save.*

BY KAREN HORN

*The court decision not to bail out Berlin "reminds me of the famous metaphor of the shipwrecked person: we all sit in the lifeboat, and a steamship comes by. We wave, but the steamship pursues its course. Now after that, it would be wrong not to try and row the lifeboat to the shore. Even if there is little hope, that's the only chance we have."*

– Thilo Sarrazin, Berlin's Social Democratic finance minister

**When** the German Constitutional Court refused to order the federal government to bail out Berlin from its accumulated debt of 61 billion euros (\$79 billion U.S.), the city was left to its own devices to dig itself out of this massive debt.

The court decision, rendered in October 2006, will have implications for years to come. Most of Berlin's debt, equivalent to more than three times the city's current annual budget, was created after Germany was reunited in 1990. At the start of the 1990s, Berlin – also one of the 16 *Länder*, or states that make up the country – had a manageable debt of 10.8 billion euros (\$14 billion U.S.). At that time, Berlin received almost 10 billion euros in aid from the federal government and the EU. By 1995, that amount had shrunk to 5.5 billion euros.

Berlin's financial crisis has been attributed to financial misbehaviour after reunification, when federal "Berlin aid" was reduced significantly, especially before 1995, and the city did nothing to reduce its enormous administrative expenses. Also, Berlin failed to seriously invest in its business infrastructure, with the result that businesses have moved out of Berlin and unemployment has increased, raising the city's payments for unemployment benefits and social assistance. One additional problem was the scandal and collapse of a city-owned bank, the *Berliner Bankgesellschaft*, which dug a hole in the budget corresponding to eight per cent of accumulated debt at that point.

## The court said no

This was the backdrop to the Oct. 20 ruling of the Constitutional Court which said Berlin will not receive

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Photo: Kay Schmedes for Deutsche Oper Berlin

*Opera is subsidized by the city of Berlin. Silja Schindler and Jean-Luc Chaignaud perform a modern version of Richard Strauss's *Arabella* at the Deutsche Oper Berlin, to be presented in March.*

extraordinary federal aid in its struggle to overcome its financial crisis. Berlin, the capital of the country, is not in a true "state of need," the court said, adding that "with high probability," Berlin should be able to solve its crisis alone. The judges also held that it is "alien" to the existing system of federal grants to claim that it is the duty of the federal government (the *Bund*) to bail out a *Land*, or state government. These kinds of subsidies – vertical transfer payments by the central government – are admissible only as a last resort; that is, when a financial crisis must be regarded as "extreme," which implies that the *Land* has already exhausted all other possible alternatives. In particular, the Constitutional Court said, the relationship between the interest charges of the debt that Berlin has to carry and the taxes it is able to raise is still not "bad enough" to warrant judicial action. The Court was unusually precise in its recommendations, urging that Berlin should raise its rate of trade tax levied on corporate profits, one of the few taxes for which city governments can not only determine the rates, but which they also are alone to

pocket. The Court also recommended that Berlin privatize more, pointing particularly to the 270,000 apartments that are still owned by the city, and which are probably worth about 5 billion euros (about \$6.5 billion U.S.).

After the ruling was handed down, Thilo Sarrazin, social democratic finance minister of Berlin, insisted that the city, on its metaphorical lifeboat, would not just sit and wait for the next steamship to come by. What he meant was that Berlin would not simply continue its usual financial behaviour, heading for what would sooner or later inevitably become an “extreme” financial crisis, and then turn to the Constitutional Court again. However, this seems to be exactly what is going to happen. Just before the court’s ruling, elections were held to the *Abgeordnetenhaus* – Berlin’s equivalent of a *Land* legislature – which gave a slim majority to the incumbent party, but with slightly different shades of red shared by the social democrats (SPD) and the socialist Left Party, the former ruling party of East Germany.

In their coalition negotiations following the decision from the Constitutional Court, the two parties agreed not to follow the Court’s advice, conforming to SPD mayor Klaus Wowereit’s proud saying that Berlin was “poor, but sexy.” Wowereit insisted that Berlin “will not indulge in any radical cost-cutting masochism.” The coalition agreed not to raise the trade tax, for fear of driving even more businesses away from Berlin, but to resort to a higher rate of real-estate tax. It decided as well to continue borrowing, albeit at a decreasing rate, and to initiate bailout negotiations with the federal government. The city of Berlin maintains that the cost of building the “Chancellor’s” subway line between the Brandenburg Gate and Alexanderplatz should now be borne by the federal government, and that the *Bund* should also cover the entire cost of police in the area of the government institutions, as well as the reconstruction cost of the *Stadtschloss* castle and the budget of one of the city’s three opera houses, the *Staatsoper*, including its coming renovation costs of 130 million euros (\$169 million U.S.).

## Cut staff or sell off property?

As for possible ways to cut spending, Berlin’s finance minister, Thilo Sarrazin, only managed to get agreement for a slight further trimming of the still huge public service, with its tremendous administrative costs. Berlin will reduce its personnel to 95,000 from 115,000 by 2010. This is supposed to represent a saving of 200 million euros each year. It is estimated that Berlin has 40 per cent more administrative staff than similar metropolitan areas in Germany. Privatization of the 270,000 apartments has been ruled out, as has selling off some of the transportation companies, hospitals or the waste-disposal agency. The only item up for sale is the *Gewerbesiedlungsgesellschaft* or GSG, a subsidiary of the *Investitionsbank Berlin*, owned by the *Land*. The problem with selling the GSG, which supports small and medium-size companies by renting them production facilities at low rates, is that the revenue would not flow directly into the *Land* budget.

In early December, Sarrazin presented the city’s financial plan for the period until 2010. He considers his budget of about 20 billion euros (\$26 billion U.S.), one-quarter of which stems from federal subsidies, to now be “under control,” given that Berlin will benefit from the general economic upswing that is expected to generate more tax revenues. This perspective has already spurred Berlin’s spending proclivity. Berlin will be the first of Germany’s *Länder* to introduce cost-free public kindergartens, which will be operated throughout the city, instead of privatizing them. This will involve an additional cost of 38 million euros until 2011. Also, the *Land* has ruled out cutting back significantly on its overall spending on universities and culture. Even the idea of raising tuition fees at the public universities has been rejected by the Berlin government for “social reasons.” The result of all this is clear: Berlin cannot survive without further borrowing, even though this will be “in decreasing amounts,” as Sarrazin hastens to point out. The amount of credit needed annually is supposed to shrink to 900 million euros (\$1.2 billion U.S.) in 2010.

At this point, Berlin pays 2.4 billion euros in interest every year on its accumulated debt of 61 billion euros. This situation is likely to deteriorate in the future, given that the transfer payment that Berlin receives out of the *Solidarpakt II*, a federal redistribution scheme in favour of the eastern *Länder*, is set to move down from almost 2 billion euros now to zero in 2020. Estimates for the accumulated debt in 2010 are in the order of 65 billion euros; some observers predict as high as 80 billion euros. But to keep the deficit at no more than 900 million euros per year, Berlin has to cut its yearly budget enough to save a total of 1.7 billion euros by 2020.

## Political parties stake out positions

Changes in financial planning, however, are not the end of the story. Many ideas circulate



Kindergarten is free for many Berliners. Toddlers in Berlin enjoy the crêpes they made in the Sparrow’s Nest kindergarten.

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# Sharing taxes with Brazil's states and cities

*Lula's government is being pressed to provide a more generous deal.*

BY **ROGÉRIO BOUERI**

**Brazil** has weathered its share of economic problems in recent years, but the key to its stability is an equitable fiscal relationship among the three orders of government. This relationship encompasses vital aspects of the country's economic development, as it is tightly linked to its tax system and to the capacity of the public sector to invest in basic infrastructure projects.

Brazil is one of the most unequal countries in the world in terms of the relative wealth of the regions. There are substantial differences between the fiscal capacity of the rich states like São Paulo and Rio de Janeiro, most of them in the south and southeast regions, and the poor states of the north and northeast such as Rio Grande do Norte. This inequality also exists between the larger cities, such as the state capitals, which have greater economic activity than the smaller ones.

Brazil's tax system looks complicated to an outsider. There is one income tax, collected by the federal government and known to Brazilians as the IR from its Portuguese initials. However, there are two value added taxes (VAT): a federal VAT on manufactured products, known as the IPI, and a state VAT collected on all merchandise, known as the ICMS.

The poorer states and municipalities, especially those where there is not much manufacturing, have a lower tax base. To help these poorer states and cities, the federal government, in the tax reform of 1965, created revenue-sharing mechanisms, mainly based on two funds: the municipalities' participation fund (FPM) and the states' participation fund (FPE).

## Sharing the tax, Brazilian style

A portion of the proceeds from the federal income tax and the federal VAT provides the finances for these funds. Shortly after the military took power in 1964, this proportion was reduced to 10 per cent from its previous level of 20 per cent. This reduction reflected the centralization of powers that occurred in Brazil during its non-democratic period. But beginning in 1976, when pressure for re-democratization became stronger, the repartition rate began to rise, until 1993 when it reached its peak of 44 per cent. This record rate was made up of 21.5 per cent for the states' participation fund and 22.5 per cent for the municipalities' participation fund. Since then, the rate has remained unchanged.

The distribution formula is based on total population and on the inverse of the per capita income in the case of

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Photo: Wikipedia Commons

*São Paulo, Brazil's richest city, produces more than half its revenue from a value added tax known as ICMS.*

states and capital cities. For other municipalities, only the population size matters. It is interesting to note that, since the collection of the federal VAT and federal income tax is strongly correlated with local economic activity, richer states and cities contribute more than their share to the financing of the system.

The amounts transferred by both the municipalities and the states' participation fund systems are significant, totalling \$24.25 billion U.S. in 2005, or 2.5 per cent of Brazil's Gross Domestic Product. The importance of the states' participation fund in the total revenue of the states varies. In São Paulo state, for example, funds from states' participation fund account for only 0.3 per cent of the state's revenue. But they can account for 56 per cent of revenue in some of the poorer northern states. There is an even greater variation for municipalities, where it is not rare for cities to receive as much as 70 per cent of their total revenue from the municipalities' participation fund account.

## Less funding from the federal government

During the last 10 years, the states and municipalities' participation funds have remained at a stable proportion of Brazil's GDP — about 2.5 per cent — but the proportion of federal tax revenue they receive has fallen in this period. This has occurred because the federal government has directed its tax collection efforts to those taxes which are not shared with states and municipalities.

As a result of this move by the Central Bank, the collection of Social Contributions increased more than that of income tax or federal sales tax (IPI). The combined revenue from income tax and IPI, which in 1995 used to account for 31% of the overall tax collection, plummeted to mere 25% in 2005. "Social contributions" are a special type of tax that, besides being excluded from sharing with states and municipalities, can be charged to the taxpayers in the





*An office of an aid agency for farmers in Apodi, Rio Grande do Norte. The governments of Brazil's poorer states, such as this one, depend on the central government for most of their revenues.*

same year as their congressional approval. This allows the federal government to keep all the proceeds from these contributions and gain more flexibility in its fiscal administration.

For example, one of the most important among these social contributions is the "Provisional Contribution over Finance Transactions" (CPMF), which imposes a charge of 0.38% on all bank transactions. This contribution is going to expire in September 2007, but it is an important revenue source for the federal government (generating about \$15 billion per year) and it is likely to be extended. If the annuality principle held, and the requirement that a tax rate could not be changed in mid-year, the government would have had to approve its extension before the end of 2006 in order to keep charging beyond next September, but as we are talking about a contribution, this principle does not hold and the government can approve the extension this year and keep charging it during the last quarter of 2007.

Thus, it has been a preferred instrument of the federal government in its quest for more net revenue. Its downside comes from the fact that most of the contributions are cumulative and are collected from corporate payrolls, which favour informality and inefficiency in the economy.

In an effort to try to compensate for these losses, states and municipalities have increased their own revenues, but the dependence of the poor states and small cities is still quite great and any improvement of the situation in the short term depends on the prospects of economic growth in the next few years.

Mayors and governors of the states have made several proposals to strengthen the fiscal and financial positions of the sub-national governments. In the latest one, some state governors asked for inclusion of the social contributions in the redistribution of funds. They argued that, even if this inclusion would mean a decrease in their repartition portion, there would be a general improvement in their situation, since future revenue increases would be totally shared.

### ***Demands from the mayors and governors***

The federal government has not been receptive to proposals from the mayors and governors. In fact, the federal government has dismissed all proposals seeking to amend the sharing formula, in part because giving up some of its tax revenues in favour of sub-national governments would make it more difficult to generate a fiscal surplus.

This demand might only be a pressure tactic associated with the other requests that state governments have made to the central government. But the states' most important request is one that proposes to re-open state debt negotiations, which would be contrary to Brazil's fiscal responsibility law. This is a major objective for the state governments. At the end of the last century, the federal government bought the states' debts and established new conditions and a new payment schedule. This renegotiation also led to provisions tying maximum debt-service payments to a proportion of each state's net revenue.

Now, states want to re-visit the purchase of those debts by the federal government, as well as to subtract the states' own infrastructure investments from the calculation base of their net revenue. This would in turn allow the states to provide more basic infrastructure services, which are badly needed in some regions, and would also have the effect of reducing their debt payments to the federal government.

### ***A simple plea***

The plea of the mayors is simpler and more likely to be accepted. They have requested for many years a one-percent increase in their share of the state VAT and federal income tax to municipalities' participation fund (to 23.5 per cent from 22.5 per cent). This measure would cost the federal government about \$1 billion U.S. per year. The mayors already have obtained support in both the upper and lower legislative chambers, but their lobbying efforts were not sufficient in getting a bill passed late last year. It is expected that they will resume their pressure this year with the new Congress.

All these proposals are temporary fixes in the view of the federal government. Only the approval of the proposed constitutional tax reform known as PEC 285, which has been discussed by Congress for more than two and a half years, could provide a real improvement in the states' fiscal health. Some argue that this reform, by harmonizing the states' consumption-tax (ICMS) rate, would end the fiscal competition between the states and increase the total amount of state tax collection. However, even if approved, this reform would not put an end to fiscal competition among the Brazilian states, because it is fed by the mixed origin-destination principle applied to the states' VAT.

This might be true for the richer, net producer states, such as São Paulo, Minas Gerais and Rio Grande do Sul, which would be the major beneficiaries of such a reform, given the origin-based nature of the states' consumption tax, which now hits the net producer states harder. But for the poorer states in the northeast region, this proposal could lead to even greater dependence on federally transferred resources, as the tax rate harmonization would tend to decrease their own fiscal capacity.

In conclusion, it is likely that in this second term, President Luiz Inácio Lula da Silva's government will have to allow a small increment in transfers to municipalities, but the relationship with the states is not expected to be substantially improved. The state governors will keep talking in favour of the inclusion of other taxes in the repartition funding base, but it is likely that this demand will soon be exchanged for some additional base points in the states' participation fund. ☺

# Fiscal rights for Communities in the Spanish constitution

*Regional leaders add their demands to Socialist Party's plan for constitutional change.*

BY VIOLETA RUIZ ALMENDRAL

**Spain** is not formally a federal state but rather a country going through an impressively fast decentralization process, which started in 1978 and has led to a system that is very hard not to define as federal. The recent proposal put forward by the Socialist Party, to amend the Constitution to reflect the reality of Spain as a highly decentralized country, indirectly confirms its federal nature.

Spain is a country made up of 17 constituent units called Autonomous Communities, including the Basque Country in the north and Catalonia in the east. Spain resembles a federal country in some ways because these Communities have similarities to the provinces, states and *Länder* of Canada, the U.S. and Germany.

But Spain is not quite so federal when it comes to the distribution of revenues, which has always been the subject of considerable debate and, to a large extent, still remains an unsettled issue. After substantial reforms in 1997 and 2002, fiscal federalism is once again a work in progress as proposals to amend the system proliferate. While this is not unexpected, the outcome is still unclear and the present debate on revenues is part of a much larger reform process: that of the federal system itself.

In the last decade, there has been a growing need to reform the Statutes of Autonomy and the Constitution. The first were drawn up between 1979 and 1982, at a time when it was still uncertain what was to become of Spain's young democracy, as shown by the 1981 coup d'état. Back then, the special regions called Autonomous Communities represented a strange reality in a country with a strong centralist tradition. The situation has changed and experts argue the Constitution should reflect Spain's present reality as a quasi-federal state.

## Communities demand fiscal rights

It remains to be seen whether the discussions among the political parties on constitutional change, which started in January and will lead to formal negotiations in June, are going to tackle the rules governing the distribution of revenues between the central government and the Communities. There was really no way that Spain's fiscal federalism challenges could have been solved in 1978. At that point, the initial option to become an Autonomous



Photo: Al Teich

*In Catalonia, people have a different perspective: Visitors take coffee on the terrace of Barcelona's Parc Guell in front of Antonio Gaudí's surrealistic mosaics.*

Community soon gave way to a general enthusiasm for this new form of decentralization – dispassionately called State of Autonomies (*Estado de las Autonomías*) to avoid the controversial term “federation.” By 1982, all territories had become Communities; they had assumed authority and were political realities. Taxation powers lagged behind this decentralization frenzy. First, it was necessary to adequately transfer all powers, as well as the means to finance them. Then would come a greater autonomy in taxation.

In principle, a certain level of fiscal autonomy is a right granted to all the Autonomous Communities, which enjoy “financial autonomy for the development and execution of their authority,” according to the Constitution, which also includes a list of resources that will constitute the Communities' income. This list details almost all kinds of possible existing resources. However, the Constitution also allows the central state to approve a law regulating how these resources will be distributed among Communities and establishing the limits for the exercise of their financial powers on the resources.

Until January, there was a major unresolved question: was it really the role of the central government to decide the financial arrangements or must they be agreed upon by all the Communities and the central government? Or rather, should they be agreed upon on a bilateral basis, between every Community and the central government? A Constitutional Court decision in January put an end to the dispute: the court said the Communities should negotiate with the central government, but the final word and the deciding opinion final belong to the central government.

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## Catalonia usually comes first

In practice, though, financial arrangements have always been discussed first between the central government and one of the Communities, and then extended to the rest. Or rather, Catalonia has normally decided on a fiscal arrangement with the central government that was eventually extended to the rest of the Communities. It is important to take this trend into account because the recently approved Statute of Catalonia substantially increases its financial autonomy. An increase in the taxes shared by the central government and Catalonia is called for. On the other hand, a minimum investment in the Community is required to compensate for the existing fiscal imbalance in this otherwise rich region. For now, these are just proposals as there are at least two problems with this:

First, unless the Constitution is successfully reformed, the new financial arrangements can only be set by a law from the central government. But, because general elections will take place in 2008, a major change in fiscal federalism should not be expected before the elections. Already the Statute of Catalonia has generated great political stress – which was exacerbated by its challenge before the Constitutional Court, with the decision still pending.

Second, as other Communities including Andalusia and Valencia also are seeking their own greater autonomy, any major reform of the financial arrangements will probably not take place until all of the Statutes have been reformed. At this point, seven Communities have proposals to amend their Statutes, which include various versions of the Catalan claim for greater autonomy:

**Table 1:**  
**Statutes of Autonomous Communities in Spain**

Autonomous Community	Date proposed*	Status
Basque Country	Jan. 18, 2005	Rejected
Valencia	July 4, 2005	In process
Catalonia	Oct. 5, 2005	Approved (referendum) June 2006
Andalusia	May 5, 2006	In process
Balearic Islands	June 19, 2006	In process
Aragon	June 26, 2006	In process
Canary Islands	Sept. 14, 2006	In process
Castile and Leon	Dec. 5, 2006	In process

\* Date proposal was introduced in Parliament



Photo: Wikipedia Commons

Spanish Prime Minister José Luis Rodríguez Zapatero was a key defender of the new Charter for Catalonia, adopted in 2006.

## The Catalan Statute and its financial “new deal”

Why are all Communities copying the Catalan model? The answer is simple: while Catalonia has virtually the same level of authority as the rest of the Autonomous Communities, it traditionally has shown a stronger interest in autonomy. It was Catalonia’s Statute in 1979 that set the agenda for a major reform in Spain, which was quickly transformed from a central-state model into a substantially decentralized country. It was also the need for the support of CiU – *Convergència I Unió*, the centre-right nationalist party – that made the different central governments (the Socialist Party in 1993 and the People’s Party in 1996 and 2001) agree on a change of the financial system largely based on a model proposed by Catalonia.

Something similar might happen this time around, but it will not be easy. Discussions on the Statute of Autonomy of Catalonia were bitter and not always productive. The initial use of the term *nation* by Catalonia created great concern and was the subject of passionate political discussions. According to some analysts, this represented the perfect smoke screen to avoid negotiating even touchier issues such as the distribution of revenues. If, however, other Communities keep increasing their demands for greater fiscal autonomy, this discussion will be unavoidable.

The changes introduced by the Statute of Autonomy of Catalonia will not be implemented until a decision is made by the central government, because most of them involve the central government giving away some of its taxation powers to Catalonia. Thus, the cornerstone of Catalonia’s new fiscal deal is an increase of so-called “ceded taxes,” which are taxes created by the central government, which then delegates some powers onto Communities (see Table 2). The Statute of Catalonia defines these taxes as its “own” resources, altering its definition as a tax returned by a voluntary action of the central government. It will be necessary to wait for the process of reform of the Statutes of Autonomy to be completed to see a real reform in fiscal federalism.

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# Moscow and regions share Russia's oil and gas revenues

*"Have-not" regions press Moscow for a share of oil and gas revenues.*

BY GALINA KURLYANDSKAYA

**The** Russian Federation shares first place with Saudi Arabia in terms of extraction of hydrocarbon raw materials (oil and gas) in the world. Oil and gas production account for about nine per cent of Russia's Gross Domestic Product — \$70 billion U.S.

The extraction of hydrocarbons is subject to taxes that are applied to mining operations, while their sale abroad is subject to export duties. Extraction of oil and gas is being carried out in 39 of Russia's 83 regions.

About 90 per cent of Russia's gas production is concentrated in the Yamalo-Nenetskiy Autonomous Area, while almost 60 per cent of oil production is carried out in the neighbouring regions: the Khanty-Mansiyskiy and the Nenetskiy Autonomous Areas. These regions are situated in the north of the European part of Russia and in the north of Western Siberia (see map). They account for 8.5 per cent of the territory of Russia and a mere 1.3 per cent of the country's population.

Export duties on oil and gas, like all other customs duties in the Russian Federation, accrue exclusively to the federal government. However, several federal taxes, such as those on mining operations (including oil and gas), are shared between the federal and regional budgets. This sharing of those tax revenues is carried out on a derivation basis: an equal share of revenues in all regions accrues to regional budgets in proportion to the amount of taxes paid by the taxpayers registered in each region.

## Taxes on mines split with producing regions

Until 2002, 60 per cent of taxes levied on mining operations, 39 billion rubles (about \$1.3 billion U.S.), accrued to the budgets of mineral-producing regions, while 40 per cent, 26 billion rubles (about \$900 million U.S.) accrued to the federal budget. As a result, even with the relatively low oil and gas prices prevailing at the time, the per-capita tax revenue of the three principal oil-producing regions in 2001 exceeded by almost five times the average tax revenue of the other Russian regions.

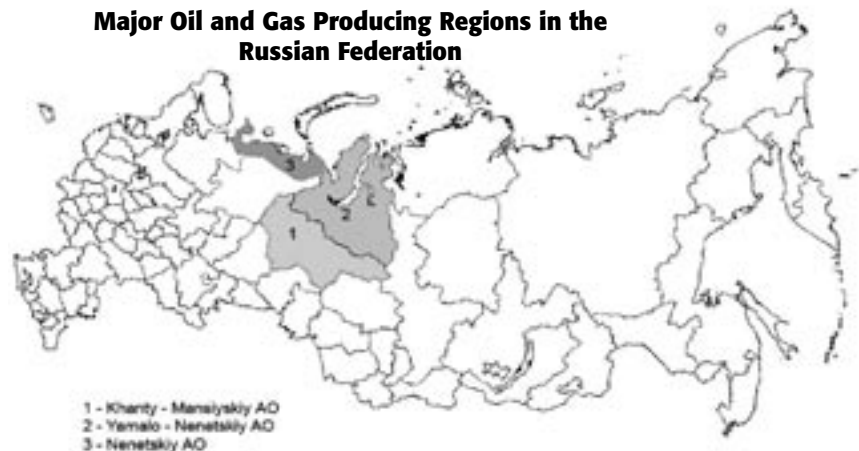
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Photo: Kinef Corporation

The Kinef Corporation's oil refinery in Kirishi, Leningrad region, about 100 km southeast of St. Petersburg, was one of the five largest in the Soviet Union in 1972.

## Major Oil and Gas Producing Regions in the Russian Federation



These large revenue disparities were only partially offset by disparities in expenditure needs. The cost of living in the oil- and gas-producing regions is only one and a half times greater than the mean Russian level – reflecting the severe climate and the limited availability of transportation. A considerable proportion of the population of these regions, notably those working in the oil- and gas-producing industries, view themselves as temporary residents, and some production work is carried out completely on a rotational basis. As a result, the need to create and maintain a social infrastructure and to provide public services is relatively smaller in oil- and gas-producing regions than elsewhere. Overall, budgetary revenues in these regions considerably exceeded reasonable budgetary requirements – even after taking into account the high cost of providing public services – and led to ineffective expenditures.

## Gas price increases boost revenues

With the increase in oil and gas prices in recent years, the budgetary revenues of oil- and gas-producing regions grew

even larger and the federal government decided to change the mining tax sharing ratio between the central authority and the regions in its favour. In 2002, the share of taxes on oil production accruing to regional budgets fell from 60 per cent to 20 per cent; in 2003, the share declined to 15 per cent and, in 2005, to five per cent. Since 2004, tax revenues from natural gas production have accrued exclusively to the federal budget.

The decision to centralize tax revenues from oil and gas production at the federal level was dictated by several factors. First was the need to curb the growth of budgetary expenditures caused by the increase in windfall revenues from the climb in prices for oil and gas, and the resulting inflationary pressure on prices. To “freeze” a part of these windfall revenues, the federal government set up a Stabilization Fund as part of the federal budget, effective Jan. 1, 2002. This fund has been one of the principal instruments for holding down excessive liquidity, lowering inflationary pressure and decreasing the dependence on volatile revenues from the export of raw materials. The fund accumulates the revenues derived from the portion of export duties on oil and from the tax on oil production that corresponds to the price for oil of the Urals grade exceeding \$27 U.S. per barrel. As a result, 15 per cent of current revenues now accrue to the Stabilization Fund, 55 per cent to the federal budget and 30 per cent to sub-national budgets.

### **Disparities among Russia's regions**

The second factor in the centralization of tax revenues from oil and gas production was the growth in horizontal revenue disparities among the regions, and the resulting pressure on the federal government to equalize those disparities by means of vertical transfers, in this case payments to the regions from the federal government. Horizontal equalization – taking revenues from “rich” regions and turning them over to “poor” ones – is not practiced in the Russian Federation; equalization transfers flow into less affluent regions only from the federal budget. The federal budget therefore needed additional resources with which to fund increasing equalization transfers required by growth in horizontal disparities.

Also playing no small role in the centralization of mining taxes was the federal government's refusal to impose unfunded mandates on regional budgets and its adoption, starting in 2005, of an obligation to specify how such mandates are to be funded in all regions, taking into account their financial well-being. The provision of cash and non-cash benefits to such categories of the population as veterans of the Second World War, invalids, victims of the Chernobyl disaster, etc. is an example of the kind of mandate covered by this obligation.

Today, the tax on oil production generates 630 billion rubles (about \$23 billion U.S.) which equals 12.5 per cent of federal revenues while the tax on gas production produces 92 billion rubles (about \$3.5 billion U.S.) or 1.9 per cent of federal revenues. Export customs duties on oil make up another 16.2 per cent of federal revenues, generating 820 billion rubles (about \$30 billion U.S.), while those on gas account for 5.3 per cent of federal revenues or 270 billion rubles (about \$10 billion U.S.).



Photo: Wikipedia Commons

*Aboriginal people, including the Nenents, live in two major oil-producing regions of Russia: the Yamalo-Nenetskiy Autonomous Area and the neighbouring Nenetskiy Autonomous Area. The Nenents family at left lives by traditional hunting and reindeer herding.*

In the principal oil- and gas-producing regions, mining taxes currently account for

- 27.8 per cent of budgetary revenues in the Khanty-Mansiyskiy Autonomous Area, or 26.5 billion rubles (about \$1 billion U.S.);
- 16.5 per cent of budgetary revenues in the Nenetskiy Autonomous Area, or 1.3 billion rubles (about \$47 million U.S.), and
- 7.4 per cent of budgetary revenues in the Yamalo-Nenetskiy Autonomous Area, or 5.2 billion rubles (about \$193 million U.S.).

### **Mining revenues centralized**

Centralization of the revenues from mining operations conforms to the notion that mineral resources should belong to the Russian nation as a whole, and that tax revenues on their extraction, which are in essence economic rents, should therefore not be concentrated in individual regions, but utilized in the interest of the entire population. The centralized resources from mining taxes are in particular used by the federal government to decrease regional disparities, although there is no direct tie-in of these resources to the transfers directed into the regional budgets.

The total amount of all kinds of transfers passed on from the federal budget into the regional budgets comprises about half of the total revenues from oil and gas that flow into the federal budget. Oil and gas revenues are thus used to equalize the budgetary revenues of the regions and deliver on constitutional guarantees to the population in all regions of Russia.

Investments made from the Stabilization Fund are another instrument whereby federal budgetary revenues from oil and gas are used in the interest of the entire population. In accordance with the legislation governing the Fund, accumulated amounts in excess of \$20 billion (a threshold that was surpassed in 2005) may be used by the federal government at its discretion. By decision of the federal government in 2006, an Investment Fund was established in the Russian Federation to direct resources of the Stabilization Fund to state support of investment projects of national importance.

### **Stabilization fund grew from \$2.5 billion**

The initial size of the fund was \$2.5 billion U.S. The selection of projects for state support should be carried out on a competitive basis. The projects should be directed to such goals as increasing employment levels, improving the

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## Berlin's hangover: a € 61 billion city debt

about how to get Berlin's budget back in shape. The Green party, for example, argues that the trade tax could be raised to the level of neighbouring Potsdam without driving more businesses away. That would create additional revenues of 100 million euros per year. Also, the public service should be rolled back more, with a combination of layoffs and increased part-time work at lower salaries. The Greens also advocate that kindergartens should be privatized. Today, one-third of the kindergartens in Berlin are public. The Greens also flirt with the idea of levying a tax on tourists. The Christian democrats (CDU) urge the sale of apartments to some of the private equity firms that seem interested; they also favour the privatization of Tempelhof airport.

Some more radical ideas are also being tossed around. For example, academics urge that a system of public bankruptcy should be created, making a debt moratorium possible for Berlin. The advantage would not only be that the city of Berlin could get a fresh start, but the system would also be advantageous in terms of incentives, in the sense that creditors would be able to downgrade Berlin as a debtor and become more careful in extending it credit. On the other hand, Eric Schweitzer, president of the Berlin Chamber of

Commerce, pleads for Berlin to become a Special Economic Zone, with preferential tax rates and lighter bureaucracy to attract business. And Wolfgang Tiefensee of the SPD, the federal minister for transportation, would like to add a clause to the German Constitution giving Berlin more rights to federal subsidies, given its role as the nation's capital.

But, more generally, the Berlin case brings home that Germany urgently needs to provide itself with a financial system that gives *Länder* governments genuine fiscal autonomy, and thereby true responsibility. The good news is that talks are already under way within the reform commission which was created on Dec. 15, 2006, called "Federalism reform II". The aim of this commission is to disentangle the money flows and responsibilities between the federal and *Länder* governments, and to create powerful sanctions for unacceptable deficits. One of the more precise proposals in this regard, put forward by the prime minister of Saxony, Georg Milbradt (CDU), is to limit regional deficits to about 1.5 per cent of gross domestic product, beyond which *Länder* would be forced to raise taxes, to give up financial authority over their budgets or to limit the bailout obligation of the federal system, so that financial markets would eventually create their own sanctions for bad fiscal management. 6

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## Fiscal rights for Communities in the Spanish constitution

**Table 2: Taxes shared or devolved by Madrid to the Communities**

Tax	Yield to Communities in per cent	Administration	Maximum legislative power of Communities
Personal income tax	33	Central government	<ul style="list-style-type: none"> <li>• Tax rates (must have same number of tax brackets as the State tax)</li> <li>• Tax credits, under certain conditions</li> </ul>
Tax on wealth	100	Communities	<ul style="list-style-type: none"> <li>• Tax rates</li> <li>• Minimal deduction</li> <li>• Tax credits</li> </ul>
Death and gift taxes	100	Communities	<ul style="list-style-type: none"> <li>• Reductions in taxable income</li> <li>• Tax rates</li> <li>• Deductions and tax credits</li> <li>• Tax administration regulations</li> </ul>
Taxes on transfers and official documents	100	Communities	<ul style="list-style-type: none"> <li>• Tax rates</li> <li>• Tax credits</li> <li>• Tax administration regulations</li> </ul>
Gambling taxes	100	Communities	<ul style="list-style-type: none"> <li>• Exemptions</li> <li>• Taxable base</li> <li>• Tax rates</li> <li>• Tax credits</li> <li>• Tax administration regulations</li> </ul>
Value Added Tax	35	Central government	None
Excise	40	Central government	None
Tax on wine	40	Central government	None
Tax on electricity	100	Central government	None
Tax on vehicles	100	Communities	<ul style="list-style-type: none"> <li>• Tax rates (under certain conditions and limits)</li> </ul>
Special tax on gasoline	100	Communities	<ul style="list-style-type: none"> <li>• Tax rates (under certain conditions and limits)</li> <li>• Tax administration regulations</li> </ul>

The table above shows the distribution of taxes as of January 1, 2002

# How public planning and finance work in India

*The states and the central government co-operate on a wide range of programs.*

BY TAPAS K. SEN

**Three** institutions play important roles in shaping how the system of fiscal federalism in India works in practice, given the constitutional distribution of powers and responsibilities.

The high-level Apex Finance Commission (AFC) and the State Finance Commissions (SFCs) are the agencies constitutionally entrusted with the role of supervising the system and periodically modifying the structure or the parameters as needed.

The third institution, the Planning Commission, despite losing some of its powers, continues to play a key role because of the grants it recommends; its stamp of approval on states' planning projects also allows the states to obtain loan financing for them more easily than would otherwise be the case. The third group includes the line ministries and the Ministry of Finance of the Government of India.

## Transfer payments to the states

Significant transfers are made to states from the central government with regard to central plan schemes, and centrally-sponsored schemes, which are designed by the central authority and implemented by the states.

By convention, the AFC confines itself to the current account (exports minus imports, in goods and services) in general, and major public investments are left to the consideration of the Planning Commission. The usual methodology of the AFC is to project current receipts and current expenditures on the **non-plan** account for each state using a mix of normative and actual-based estimates.

This yields the surplus or deficit, without transfers, for each state. Simultaneously, it decides on the share of the total tax revenue of the central government (this used to be restricted to two taxes – personal income tax and excise duty) that can

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Photo: REUTERS/Punit Parrija

*Economic planning has been crucial for India since the early 1950s. Prime Minister Manmohan Singh (right), Chair of India's Planning Commission, joins Finance Minister P. Chidambaram at an Asia Development Bank meeting in Hyderabad in May 2006.*

be passed on to the states, and then works out a formula for the distribution of the total states' share among individual states. For each of the states with deficits prior to transfers, such deficits are reduced by the amount of estimated tax transfers, and the remaining deficits are awarded to each of the states as grants-in-aid.

Apart from this basic exercise, the AFC also:

- awards some compensatory grants,
- awards grants for specific purposes at its discretion,
- advises on fiscal mechanisms for calamity relief and
- advises on necessary measures with regard to state indebtedness to the central authority.

Occasionally, other specific issues of central government-state fiscal relations are also referred to it for its opinion.

## The Five Year Plans

Since 1951, the central government of India has set out Five Year Plans for the growth of the economy in specific sectors. The Planning Commission's basic mandate is to advise the states and the central government on the formulation and implementation of their Five Year Plans, and to approve these Plans. In the process, it also acts as a channel for central assistance to states for Plan purposes. Such assistance is largely formula-based, with a small amount of discretion available to the Planning Commission. However, it has an indirect role in certain other transfers from the central government to the states.



*Montek Singh Ahluwalia (right), Deputy Chairman of India's Planning Commission, is greeted by Virbhadra Singh, Chief Minister of the state of Himachal Pradesh.*

Central Plan Schemes (fully centrally funded) and Centrally Sponsored Schemes (usually partly centrally funded) are also approved by the Planning Commission and administered by the concerned line departments of the central government. Some of the former and all of the latter programs are actually implemented by the states. While all expenses related to implementation of central plan schemes are payable to the implementing states, there is usually a matching grant system with respect to centrally sponsored schemes. There are at least two areas in which the latter have come to dominate – the poverty alleviation and employment generation programs and primary education.

Apart from the role of line ministries with respect to the central plan schemes and the centrally sponsored schemes, individual line ministries often have major interactions with the states, which get woven into the fabric of fiscal federalism in India. For example, the ministries of petroleum and mining play a key role in the division of public resources generated from these two sectors. The states are entitled to royalties, the rates of which are determined by the central government.

### ***Making oil and gas royalties obsolete***

However, recent changes in the system of exploration and exploitation of petroleum and mining fields have started the process of making royalties obsolete. This issue was studied by the AFC, which recommended sharing with the states the profit share that would flow to the central government as a result of the changes in the system. Similarly, the central Ministry of Food and Agriculture has a key role to play in the allocation of a large amount of food subsidies (actually a combination of subsidies to consumers, producers and the public sector).

As mentioned above, State Finance Commissions (SFCs) are the second type of agency constitutionally entrusted with the role of supervising the fiscal system. The SFC mechanism could be a powerful lever in improving state-local fiscal relations in India; however, the SFC has not yet made its presence felt.

The Ministry of Finance is a key institution in the practice of fiscal federalism in India because it has the responsibility for implementing all the recommended transfers and ensuring the actual flow of resources to the states. Besides, the finance ministry is often left with the job of filling in the details of recommendations made while implementing them; this, in fact, provides it with some discretion. A recent example illustrates this well. Following recommendations to

pass on international assistance to states at the same terms and conditions as originally granted, the centre agreed to do so.

### ***Foreign currency loans***

But in the case of foreign currency loans, a mechanism was needed to take care of the exchange risk. It fell upon the Finance ministry to work out alternative ways to cover such risk, inform the states about the alternatives and persuade them to choose one. Its role in fostering discussion and debates on important issues, and its leadership role, are also crucial to the healthy functioning of the federal system, as was evident in the long drawn-out case of the introduction of VAT at the state level.

Another recent development needs mention as an illustration of the changing contours of fiscal federalism in India. After a long period of administered interest rates, they have been more market-oriented since the 1990s. Initially, this raised interest rates for everyone, and the states' interest burden shot up to unprecedented levels, creating serious fiscal problems. The central government came to the rescue by introducing a debt-swap program, whereby costly debt was replaced by cheaper debt. By the time this program wound up, interest rates had come down.

The lower level of interest rates made debt from the central government expensive in comparison. As the largest amount of debt owed by the states was to the central government, a reduction in interest liabilities was possible by substituting states' debt to the central government by states' market borrowings. This was achieved by discontinuing the practice of providing a part of the plan assistance to the states in the form of loans. Only the grant portion was transferred and the loan portion was substituted by market borrowings. For states that had problems raising loans from the market, the central government offered its assistance.

This overview of the practice of fiscal federalism in India is meant to highlight some of its more positive aspects. In a rapidly changing world, and even national background, comparatively fixed provisions, as found in the Constitution, need to be supplemented by a system that is responsive to changing needs. Basic changes can, of course, be achieved only through modifications in the Constitutional provisions; one illustration of this is provided by the 73<sup>rd</sup> and 74<sup>th</sup> amendments to the Constitution, according formal recognition to rural and urban local bodies.

But the institutions responsible for implementing the system at ground level have to be ready to adjust the system within their competencies to be in tune with the surrounding reality. The flexibility exhibited by the system of fiscal federalism in India bodes well for its future. The other positive aspect has been the willingness of the parties concerned to play according to the rules of the game. The best example of this is provided by the fact that neither the central government nor the states have ever seriously challenged the awards of the AFC, an absolute must for an effective arbitration process, as the Finance Commissions are, after all, arbitrators between the grantor and the grantee governments. ⑥



# Swiss cantons still compete for taxpayers

*Fiscal equalization does not compensate for all differences among cantons.*

BY LARS P. FELD

**Tiny** Switzerland has surprising news for its critics: instead of the usual slowness in political reform, Swiss federalism has recently undergone significant changes in a short time. To bring the different income taxes for each canton more in line with one another, a federal law on cantonal tax harmonization was enacted in 1993 that gave the cantons until 2001 to adapt their income and profit tax bases to certain minimum standards. Despite a wide interpretation by the Swiss federal (supreme) court, the tax harmonization law did not aim at complete tax harmonization, as tax rates and large parts of tax bases have remained cantonal responsibility.

In a referendum in 2004, Swiss citizens accepted a package of reforms of the fiscal equalization system. The old system had almost exclusively involved transfers from the confederation to the cantons and municipalities – what economists call “vertical transfers,” or transfers of funds from the central authority to the constituent units. Up to now, the cantons got 30 percent of the federal income tax as unconditional grants, and received additional matching grants. The unconditional grants comprised about a quarter and the conditional (matching) grants the other three quarters of total transfers to the cantons. Moreover, the cantons contributed to the federal social security schemes. All in all, total transfers amounted to about 15.5 billion Swiss Francs (about \$12.425 billion U.S. dollars).

But beginning in 2008, these transfers, which were for the most part paid as matching grants, will be replaced by a new system combining both vertical and horizontal transfers (transfer payments among entities of the same order), and based on unconditional grants. The new transfer system will consist of a so-called resource equalization scheme and a plan to equalize particular cantonal burdens. The federal government will contribute the funds for the equalization of specific burdens with a sum of 688 million Swiss francs per year. These transfers are paid to compensate for the burdens associated with living in mountainous and urban areas.

## Not compensating for everything

The resource equalization scheme is funded by the federal government with about 1.8 billion Swiss Francs (about \$1.44 billion U.S.) and the eight resource rich cantons with about 1.3 billion Swiss Francs (about \$1.12 billion U.S.). This money is distributed to the 18 resource poor cantons according to their position on a resource index that is derived from their aggregated (income and wealth) tax bases.

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Photo: Konrad Busslinger

*Zurich: no place for millionaires? An unmarried taxpayer in Zurich with a taxable income of a million Swiss francs pays cantonal and local income taxes of 25.1 per cent. One hour away in Wollerau, in the canton of Zug, that person would pay only 7.9 per cent.*

Fiscal equalization will compensate for differences in economic resources, instead of financial strength. In other words, a canton cannot get extra transfer payments simply because it chooses to keep its tax

rates below those of other cantons. The reform package also contains a new assignment of tasks to the cantons and the federal level. However, what could amount to more than half of today's matching grants to the cantons will not be replaced by unconditional grants, but abolished as the federal government will take over the corresponding responsibilities and assume the cost of this expenditure. The new fiscal equalization system is also being created in order to compensate for the effects of tax competition between the cantons.

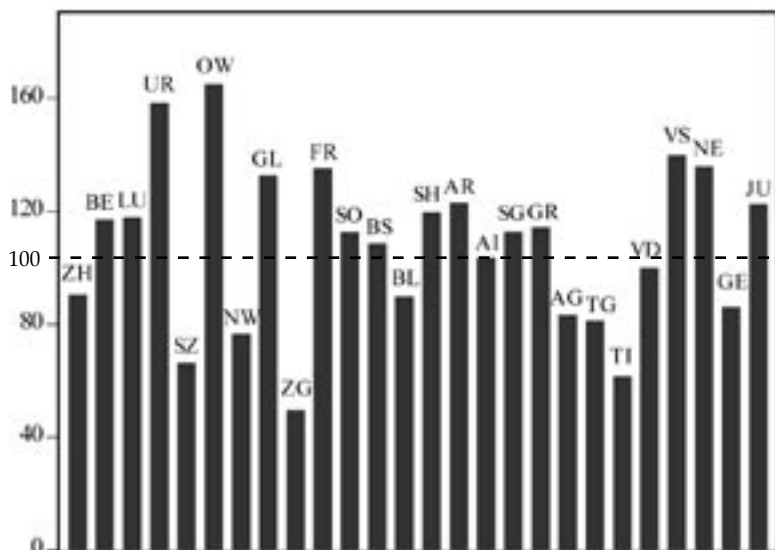
As if this was not enough, the Swiss Social Democrats announced in late 2006 a popular initiative calling for a referendum on their proposal to essentially harmonize cantonal taxes with fully harmonized tax bases as well as minimum tax rates. The initiative awaits its official launch, which requires the collection of a legally specified number of signatures to hold a referendum. As this initiative has gained additional attention after several cantons have recently introduced regressive income tax schedules, observers expect the Social Democrats to aim at using this political momentum to increase their voting share in the federal parliamentary elections in 2007.

Those not familiar with Swiss federalism might raise their eyebrows and wonder what is going on. Swiss citizens will have to ask themselves whether tax competition is sufficiently important to cause such political turmoil, and whether tax competition really affects their well-being.

## The Swiss fiscal constitution

The Swiss fiscal constitution is unique among the classical federations as it results in a stronger decentralization of direct taxes than in any other federation. While the Canadian provinces or the U.S. states rely to a considerable extent on indirect taxes, the Swiss cantons have the basic

Figure 1: **AVERAGE TAXES BY SWISS CANTON IN 2005:**  
Index of the cantonal and (weighted) local income and wealth (property) tax burden.



Some cantons, such as Zug (ZG) and Schwyz (SZ) have a tax burden far below the average index of 100. Others, such as Freiburg (FR) and Obwald (OW) have much higher taxes.

Cantons: Zurich (ZH), Bern (BE), Lucerne (LU), Uri (UR), Schwyz (SZ), Obwald (OW), Nidwald (NW), Glarus (GL), Zug (ZG), Freiburg (FR), Solothurn (SO), Basel-City (BS), Basel-Country (BL), Schaffhausen (SH), Appenzell-Outer Rhodes (AR), Appenzell-Inner Rhodes (AI), St.Gall (SG), Grisons (GR), Argovia (AG), Thurgovia (TG), Ticino (TI), Vaud (VD), Valais (VS), Neuchâtel (NE), Geneva (GE), Jura (JU).

a strong incentive to move to cantons with relatively lower tax burdens – if other attractions are the same.

Similar differences are found in the area of profit taxation, and as before they are larger at the local level than at the cantonal level. In this case, however, taxation is becoming more differentiated, with specific tax provisions. For example, tax holidays are offered for newly founded firms or holding privileges, special agreements for division of a company's taxes among the cantons and so on. In many Swiss cantons, "holding privileges" give companies exemption from income taxes if either two thirds of the company's income is derived from dividends or two-thirds of its assets consist of participations in other companies and the company does not engage in active business in Switzerland. Moreover, fiscal equalization payments cover between 12 per cent (Geneva) and 51 per cent (Jura) of total cantonal revenue. Three-quarters of these transfers are in the form of matching grants. The relatively small horizontal component of the fiscal equalization system (between entities of the same order) involves direct compensation of spillovers - that is, the effects on other cantons of an action by a neighbouring canton.

### *Is tax competition really taking place today?*

The supposed impact of tax differences in residence or location choices can only be expected if other factors influencing these choices are the same in different regions. This is, however, not necessarily the case in the real world. It is thus fair to ask whether tax differences really matter that much in Switzerland, given other factors related to the attractiveness of each location. Empirical studies lend support for the varying impact of taxes on residence or location choices. The higher the income tax rates, the lower the number of taxpayers with high income in a canton. This phenomenon is especially pronounced at the highest end of the income distribution spectrum. As well, young, highly educated people react relatively strongly to tax-rate differentials. The effect of taxes also is more pronounced for self-employed taxpayers than for employees or retirees. As well, it is stronger at the local level than at that of the canton. Public services partly compensate for the impact of taxes, but there remains a noteworthy net impact. Income and profit taxes also affect the location of firms.

There are several factors that weaken the effects of interregional tax competition. On the one hand, tax levels are reflected in housing prices. The lower taxes are, the higher housing prices are. Thus, people moving from Zurich to Wollerau for tax purposes pay relatively high prices for their apartments. However, the reflection of tax differences in housing prices is incomplete, leaving room for tax competition to have an effect. On the other hand, vertical fiscal externalities exist that counteract horizontal fiscal externalities. Horizontal fiscal externalities might occur when cantonal governments reduce tax rates to attract taxpayers inducing taxes to be inefficiently low overall. However, taxes tend to be inefficiently high if different

power to tax individual income and profits. (An indirect tax is one that is not paid directly by a manufacturer or a vendor, but which is passed on in the form of a higher price paid by the end user, as in the case of a Value Added Tax (VAT) passed on to the buyer.)

More than 95 per cent of Swiss cantons' tax revenue and more than 50 per cent of their total revenue originate from these sources. As well, local jurisdictions add a surcharge on cantonal taxes. The federal level also taxes income and profits, but derives this power from the cantonal responsibility. This is why federal income and profit taxes, including their tax rates, have to be renewed regularly in a federal constitutional referendum. Although the federal level finances a larger part of its budget by VAT revenue, the federal income tax is significant as the upper five per cent of the taxpayers pay more than 50 per cent of federal revenue.

Cantons and local jurisdictions use their taxation powers to a considerable degree. For instance, cantons like Zug, Schwyz and Ticino have 50 per cent or less of the average income tax burden, while Obwalden and Uri have a tax burden higher than 50 per cent of the average. In another example, in Zurich, unmarried taxpayers with taxable income of one million Swiss francs (about \$818,000 U.S.), paid cantonal and local income taxes of 25.1 per cent in 2005. Less than an hour travel time away, in the community of Wollerau in the canton of Schwyz, unmarried taxpayers with the same income only paid cantonal and local income taxes of 7.9 per cent. Although taxpayers additionally pay the federal income tax without any compensating credits between the tax systems, these differences give taxpayers

orders of government tax the same base, and this vertical fiscal externality offsets the tax reduction by some cantonal governments. The picture is completed by evidence of strategic tax setting by cantons and local jurisdictions. They, indeed, set their tax rates to attract desirable taxpayers, although other factors also affect their choices. Thus, the bottom line is that tax competition exists in Switzerland, but it is not as fierce as the tax rate differentials suggest.

### **Where does tax competition lead?**

Given that tax competition exists in Switzerland, does it have the effects that most proponents of tax harmonization fear? Empirical studies of the efficiency of tax competition in Switzerland largely indicate that tax competition enhances efficiency rather than reducing it. First, regional spillovers are less important than is often thought, or they balance each other out. In addition, the horizontal components of fiscal equalization internalize regional spillovers – that is, negative effects of one canton's policies on a neighbouring canton. Second, tax competition leads to lower spending and revenue in the cantons because there is lower tax revenue. Third, tax competition likewise shifts the revenue structure toward a greater use of fees and user charges. (However, larger user fees contribute to an increased inequality of after-tax income.) Fourth, it leads to higher overall labour productivity in the cantons, indicating higher efficiency as the cantons are forced to use their scarce resources at the lowest cost and according to citizens' preferences. However, tax competition also restricts the ability of cantons to redistribute income through broad-based tax-transfer programs, although cantons and local jurisdictions do conduct income redistribution nevertheless. Thus the federal level, with its system of social security and the highly progressive federal income tax, is more important for income redistribution.

### **A balanced approach**

Tax competition between the Swiss cantons and local jurisdictions is thus a very important phenomenon. Given the empirical evidence, however, there are not strong grounds to justify a major tax harmonization at the moment. The Swiss fiscal constitution appears to be well-adapted to the advantages and disadvantages of its competitive federalism. In particular, the federal income tax system plays an important role as regulator of cantonal tax competition and is, thus, able to serve demands for individual equality. The new fiscal equalization system is supposed to lead to a fairer regional distribution of income. Further measures restricting cantonal fiscal competition will only increase inefficiency in the public sector. 6

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### **Moscow and regions share Russia's oil and gas revenues**

quality and availability of public health and educational services, increasing housing for the population, improving the transportation infrastructure, the reconstruction and construction of projects in the communal infrastructure (gas- and water-supply systems, heating systems, etc.) and improving the environment. Thus, the resources of the Stabilization Fund, endowed by the taxes from oil and gas extraction, will ultimately be directed to decreasing regional disparities in living standards.

In conclusion, it is interesting to note that, despite the almost complete centralization of revenue from taxes on mining operations in the federal budget, high prices for oil and gas still allow oil- and gas-producing regions to raise significantly greater per-capita budgetary revenues than in other regions. This is achieved through the tax on the large profits of the oil- and gas-producing companies, and income taxes collected from the high wages of workers involved in oil and gas production. All income taxes paid by workers of these companies within a given region flow into the budget of that region, as does a portion of the taxes on profits of these companies, at a rate ranging from 13.5 per cent to 17.5 per cent. As a result, the Autonomous Areas of Nenetskiy, Yamalo-Nenetskiy and Khanty-Mansiyskiy rank first, second and third among Russian regions in terms of revenue per-capita. 6

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### **Rethinking fiscal federalism**

world. "Beggar-thy-neighbour" or "race-to-the-bottom" fiscal policies and barriers to the mobility of goods and factors of production have the potential to undermine gains from decentralized decision-making, as recent experiences in Brazil, India, Mexico and Spain indicate. The Canadian and U.S. federal systems have, on the other hand, successfully met this challenge by securing a common economic union.

### **Incentives for responsive governance**

In most federal countries, especially in the developing world, intergovernmental transfers are focused on dividing the pie without regard to creating incentives for responsive and accountable service delivery. Revenue-sharing arrangements often discourage local taxation efforts and introduce perverse fiscal incentives through gap-filling approaches. Conditional transfers in most federal countries are focused on input controls and micromanagement, thereby undermining local autonomy. In a few countries such as the United States, they serve as a tool for pork-barrel politics. The practice of output-based transfers with conditions on standards and access to public services but having flexible choices in designing programs and in spending allocations to create incentives for results-based accountability is virtually non-existent. A notable exception is the Canadian Health Transfers (CHT) program by the federal government. The principal conditions of the CHT program are on the universality of access to health care and portability of health insurance across provinces.

### **The ability to adapt**

Federal countries have shown a remarkable ability to adapt and to meet emerging challenges in fiscal federalism. While the challenges they face might be very similar, the solutions they discover and adopt are always unique and local. This represents a remarkable attestation to the triumph of the spirit of federalism in its never-ending quest for balance and excellence in responsive, responsible and accountable governance. The long march to attain new heights in inclusive governance continues. 6