A Short Guide to Fiscal Arrangements in Federal Countries

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The structure and institutional arrangements of federal countries -- especially how the regions of a federation deal with one another and with the central government -- vary widely around the world. The current structure of mature federations is often the result of historical accident and long forgotten political or economic forces. Once the institutional arrangements are in place, it is usually difficult to change them, in part because interested parties have adapted to the existing structure and a new set of winners and losers will be created with any change.

One of the advantages of new and emerging federations is that they do not have a set of inherited institutional arrangements that must be accommodated as they seek to find the best way for regions to work together. Indeed, new and emerging federations have the opportunity to capitalize on the experience of other federations -- which includes both successes and failures -- in designing arrangements that are tailored specifically to their own political and economic environment.

Why Federalism?

Federalism provides a way for communities with separate regional, ethnic or cultural interests to have the "best of both worlds." A federal country is not a loose association of independent states. It is a single country comprised of a number of constituent units, which have their own constitutionally defined roles and responsibilities. One of the main advantages of this mode of organization is that it allows a country to be a relatively large domestic economic entity and a significant actor on the world stage - while retaining the flexibility to tailor regional government services to meet particular social and economic needs.

The purpose of this report is to provide policy makers in new and emerging federations with some practical guidance as they design the fiscal arrangements best suited for their federations. Specifically, the report addresses four key areas of fiscal management:

1. Responsibilities for public spending
2. Responsibilities for raising revenue
3. Managing the economy, and
4. Dealing with fiscal imbalances between governments.

We deal with each of the four areas in turn, first by explaining the issue, then by reviewing the experience in other federations, and finally by identifying some key factors for policy makers to consider.

Responsibilities for Public Spending

The issue:

How should the responsibilities for providing public services be divided between national and regional governments?

> ***What's in a Name?***
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> *Federations around the world name their national and regional governments differently. In Canada, Germany and the United States, the national government is called the federal government. In Australia, the national government is called the Commonwealth. Regional governments in Canada are called provinces, while in Australia and the United States they are called states. In this report we will use the terms national and regional to distinguish between the two orders of government*

Experience in other federations:

While all federations share some similarities in how they divide spending responsibilities, there are some important differences. For example, in most federations, responsibility for foreign relations and national security rests with the national government, while responsibility for local infrastructure such as local and regional roads and water treatment facilities rests at the regional or local level.

However, federations may differ substantially in how they provide services like post-secondary education, health care and income support. An added complication comes from the fact that sometimes programs are designed and financed by the national government, but delivered by the regional government.

The case of post-secondary education in Australia and Canada provides and illustration of these differences. In Australia, post-secondary education is a shared responsibility of the national and regional governments, with the national government taking an important role. In Canada, post-secondary education is primarily a regional responsibility with wide variations in programs across regions. However, even in Canada, the national government plays a role through grants to regions, to institutions to support research and to individuals in the form of student loans.

Factors to consider:

Efficient size of programs: Some programs are only efficient if they are delivered at the national level. A good example would be forecasting the weather. Other programs, such as primary and secondary education and health care can be provided efficiently at the regional level.

Spillovers between regions: Sometimes the actions of one region have important effects in other regions. If co-operation between regions is difficult to achieve, it may be best for certain services to be delivered by the national government. An example is financial regulation. Having different financial regulations in different regions increases the cost of doing business and may create barriers to economic growth.

Regional differences in needs and preferences: if regions have different needs for government programs or different tastes for the kinds of programs they demand from government, it may be best to deliver those programs at the regional level. An example would be primary and secondary education programs aimed at teaching the particular language and culture of a region.

Equity and national standards: it may be that for some programs, it is important for equity reasons that citizens get access to the same services regardless of where they live. An example would be old age pensions. In most federations, pensions are provided by the national government, in part, because they are considered one of the rights of national citizenship.

Responsibilities for Raising Revenue

The issue:

How should responsibilities for raising revenues be divided between national and regional governments?

Experience in other federations:

As with spending responsibilities, federations vary widely in how they share responsibilities for raising revenue between national and regional governments. Further, having significant spending responsibilities at the regional level does not always imply that regions will raise a significant share of revenues. In Canada, regional governments deliver the majority of spending programs and raise a little more than half of the revenue. In the United States, the national government spends the most and raises the majority of the revenues. In Germany, the national government raises most of the revenue, but regional governments deliver a significant portion of the programs.

Factors to consider:

Accountability: Democracies work best when citizens are able to hold governments accountable for how they spend public money. Accountability is enhanced if the same government that delivers a program is required to raise the revenue to finance it.

Mobility of taxpayers: Whenever they can, taxpayers try to arrange their affairs so as to pay as little tax as possible. For example, businesses consider the level of taxes when deciding where to locate new plants and other investments. When it is easy for some taxpayers (like businesses) to move among regions, it may be desirable to have a consistent tax treatment across the federation. This can be accomplished either by assigning these revenue responsibilities to the national government or by having a high degree of cooperation among regional governments.

R*edistribution:* Revenue raising is important not only for financing public services, but also for sharing the burden of paying for government services equitably across individuals and regions. Redistribution among individuals is usually carried out by both national and regional governments via an income tax.

If the ability of regions to generate revenue varies substantially, the national government should have the ability to raise enough revenue to transfer resources to less-well-off regions as well as financing its own spending responsibilities.

Ownership of natural resources: Revenue coming from natural resources poses a special problem in federation. Because natural resources cannot move, the revenue from them is often regarded as the property of the region in which they are found. However, if the revenue from natural resources is large and is concentrated in some regions but not others, then equity among regions becomes a problem. In such cases, the national government needs either to share in natural resource revenue or have sufficient revenue from other sources to address these equity issues as well as meet its own spending responsibilities.

Keeping administration and compliance costs low: In reality, tax collection is one of the 'services' that governments provide to the public. The system for collecting taxes therefore should make it simple for individuals and businesses to pay their taxes (low compliance costs) and be as efficient as possible (low administrative costs). This implies that, regardless of whether national or regional governments get the revenue from a particular tax, it may be most efficient to have a single agency collect the taxes rather than have each region set up a parallel collection system.

Managing the Economy

The Issue:

What responsibilities should national and regional governments bear for managing fluctuations in the economy?

Experience in other jurisdictions:

Modern governments attempt to manage economic fluctuations using monetary policy (control of currency, interest rates and exchange rates) and fiscal policy (control of government spending and taxation, debt management). In virtually all federations, monetary policy is controlled at the national level -- often by a central bank that is independent of the government -- and fiscal policy is a shared responsibility.

Factors to consider:

Monetary policy: Currency and financial capital is extremely mobile and with electronic transfer of funds using personal computers, difficult to control. As long as there is free flow of goods, services and capital between regions in a federation, it is virtually impossible for regional governments to conduct an independent monetary policy. Because they control the supply of currency, national governments can exert some control on the economy through monetary policy. However, in an environment of global financial markets, even the largest countries face some constraints in monetary policy decisions.

Fiscal policy: In practice, both national and regional governments in federations attempt to manage economic fluctuations using fiscal policy. The size of their efforts depends on the size and source of the fluctuation, the political ideology of the government and their capacity to offset the fluctuations. Political mechanisms to co-ordinate fiscal policy have been successful in some federations like Australia.

It is important to distinguish between 'active' stabilization policy -- where governments deliberately change spending level and tax rates to attempt to partially offset fluctuations in the economy -- and 'automatic' stabilization policy. Except in cases of extremely large and long lasting fluctuations, active stabilization policy has been shown to be largely ineffective, mostly because it is not possible for governments to act quickly enough to have an effect when it is needed.

Automatic stabilization policy takes place whenever government spending and taxes are sensitive to economic conditions. For example, income tax revenue will fall when the economy slows down and this will partly offset the effect of the slowdown on the private sector. Both orders of government may routinely engage in this automatic stabilization.

Debt Management: The ability to borrow to offset severe economic fluctuations and to finance capital investment is an important fiscal policy tool. However, evidence from emerging federations shows that governments need to be disciplined to prevent debt from becoming a source rather than a solution to economic and fiscal problems. Here again, co-ordination of fiscal policy may be critical for success.

Both national and regional governments may need to establish clear rules to govern borrowing with specific penalties for decision makers if the rules are broken. An example would be a debt/GDP or debt/revenue rule. Accurate, up-to-date information on government expenditures, revenues and debt levels is critical for success. Regional governments should not borrow from enterprises that they own or control (for example, state owned banks or trading companies) because this limits transparency and accountability.

In addition, a clear 'no-bailout' policy is desirable so that lenders know that the national government provides no explicit or implicit guarantee of regional government debt. This policy will help lenders to understand the nature of the risks they are accepting and reward regional governments that are prudent fiscal managers.

Dealing with Fiscal Imbalances between Governments

The Issue:

What mechanisms do federations need to deal with fiscal imbalances between governments?

Experience in other jurisdictions:

Virtually all federations employ some mechanisms to deal with fiscal imbalances between governments -- both between the national government and regions as a group and among regions themselves. In most federations the mechanism takes the form of transfers from the national government to regional governments. However, in some federations (for example, the United States) it takes the form of a large number of federally financed programs that are administered by the individual regions.

Factors to Consider:

Measurement: An essential pre-requisite to dealing with fiscal imbalances is being able to measure them. At at minimum, it is necessary to measure government revenue and expenditure and population in a timely way. More complex mechanisms may require measurement of additional variables such as tax bases.

Imbalances between national and regional governments: In most federations, spending and revenue responsibilities are not perfectly matched. In other words, one order of government collects more revenue than is needed to finance its own programs and the other order does not collect enough. While, for the accountability reasons discussed above, it is desirable to minimize such imbalances, there are legitimate reasons for them to exist. Such imbalances may be resolved either by transfers (with or without conditions on how the money is spent) or by revenue sharing. Revenue sharing is where one order of government earmarks a portion of the revenue from a specific tax or taxes and transfers it to another order of government.

Imbalances between regional governments: Most federations have a mechanism that transfers resources to regions that have below average capacity to raise revenue. Such mechanisms can be simple (revenue sharing according to population) or extremely complex and may simply equalize revenue or revenue *and* needs for certain government expenditures. Typically, transfers that address imbalances between regions do not include conditions on how the money is spent.

A key consideration is whether the transfer mechanism is a net or gross scheme. Net schemes (such as in Australia) divide a fixed amount of revenue among the regions and thus put a limited and predictable burden on the national government. Gross schemes (such as in Canada) base the size of the total transfer on the size of the imbalances and thus expose the national government to an unpredictable and potential unsustainable burden if regional imbalances grow while national government revenues do not.