



Turning point for federalism in Argentina?

Many hope that new fiscal rules will encourage greater provincial self-reliance and responsibility.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY ERNESTO REZK

Argentina's last constitutional amendment mandated, for the first time, that a covenant-law (*ley-convenio*) should set up – not later than 31 December 1996 – a revenue sharing arrangement for the distribution of a number of direct and indirect taxes levied by the central government.

The Congress, on the basis of agreements between the national government and the provinces, would enact this covenant-law. The constitutional deadline has not been met. But the system the amendment would create is new for the country and would entail a significant change in the way power is shared between levels of government.

The current Argentine revenue sharing system can be traced back to 1935, when it was first used for existing excise taxes and later for the newly created Sales Tax and Income Tax.

In the beginning the arrangement purposely tried to devolve revenues to the provinces and keep some relation with the tax they were likely to collect in their territories. But over time, the system evolved to one in which only 'equity' considerations mattered for revenue distribution among the provinces.

This revenue sharing system and its evolution had an important impact upon both fiscal and political federalism in Argentina. Now, after more than 70 years of use, many Argentines are very critical of it

Ceded powers and too much "equity"

By delegating to the central government the collection of constitutionally assigned taxes (i.e. taxes on income) or taxes upon which there were concurrent responsibilities (indirect taxes such as Sales Tax and later the VAT) what provinces in fact did was to yield an

important part of their taxing power. They did this by moving tax bases to the national government's sphere. Proof of this is the jurisdictional structure of the overall tax revenue yield, where more than 80% is collected by the central government, while the provincial and municipal contributions amount to 15% and 4% respectively.

And so, in spite of constitutionally being a three-tier federation, with, in theory, all orders of government having ample tax powers and spending functions, Argentina behaves as a 'formal' rather than a 'true' federation.

The evolution of the revenue sharing arrangement and the fact of "tax collection concentration" not only weaken the federal fiscal structure, they put at stake the very notion of an institutionally and politically federal set-up.

By relying exclusively on 'equity' considerations, the existing revenue sharing system, which is to be replaced according to the 1994 Constitution, stands in part as the main obstacle to convincing the provinces to further their own fiscal efforts. The more fiscally efficient provinces resent their proportionately low share of the revenue mass and argue for a larger take.

The less fiscally efficient provinces have no incentive to enlarge their own tax sources if obtaining revenue transfers from the central government is both easier and politically less costly than levying their own taxes.

The reason the 'equity' principle, which aims to reduce financial inequality among the provinces (the so called "horizontal fiscal imbalances") did not serve its purpose – and produced, in fact, a "reverse devolution" of power to the national government – can be found in the expenditure performance of the provincial governments.

A sustained decentralization of expenditures – by delegation rather than by devolution – has occurred in Argentina. This is true for education (except for universities) and welfare and, to a minor extent, health services. For instance, provincial share of spending in education and welfare reaches almost 70% and 65% respectively, while provincial health spending makes up more than 40% of the total.

Fiscal and spending policies are organized in completely opposite ways. On the tax side, they are highly centralized; on the spending, very decentralized. Only five of the provinces' own fiscal yields range between 40% and 50% of total revenues. The others are much lower. The result is that most provinces cannot properly be considered fiscally autonomous. (Essential to the notion of fiscal autonomy is that orders of government should aim at enlarging the amount of spending actually covered by their own resources.)

Fails to foster equality

'Equity' considerations alone have not succeeded in reducing financial inequality. Fiscally weaker provinces remain backward despite the statistical evidence that - for decades - their share per capita of revenues received from the national government doubled, tripled and, in some cases, amounted to four times that of more developed provinces.

The hard fact of the matter is that a revenue sharing arrangement that does not reward 'fiscal effort' on the part of provinces will necessarily run counter to the goals of higher provincial accountability and sounder provincial spending policies. This is despite the fact that the arrangement also makes it possible for several provinces to rely exclusively on national grants to meet their budgetary needs.

It is not by chance that poorer jurisdictions, benefiting from more national fiscal revenue per capita, exhibit both the worst performance in terms of quality of public goods and the highest indices of public employment per thousand of inhabitants.

The unwanted consequences of its application of the 70-year-old revenue sharing system undermine the possibility of a sound fiscal federalism in Argentina. They also work against *political* federalism by creating a vicious circle whereby provinces invest great energy in pushing for more of the nation's resources (either from revenue sharing or from transfers), which they can only get after protracted negotiations. This in turn reinforces provinces' fiscal and political dependence on the central government.

Could the reform change the pattern?

If Argentina were to put the revenue-sharing constitutional amendment into practice, would it modify not only the distribution of power between government levels but also induce provinces to meet higher accountability and governance standards?

The answer demands a thorough consideration of the 1994 constitutional amendment.

Although it only refers to revenue sharing systems instead of perhaps a more appropriate reference to all-inclusive interjurisdictional fiscal arrangements, for the first time it gives constitutional status to the fiscal relations between government levels.

Article 75, which deals with this matter, specifically indicates that Congress should enact "a covenant-law...setting up revenue sharing arrangements and guaranteeing that fiscal remittances be made automatically to the provinces". This "automatic" feature would bring about one of the most important advances to the existing system. One of the most serious problems provincial treasuries deal with is the financial strain derived from the poor timing between revenue and spending schedules.

Article 75 states as well that "...the distribution of revenues between the

national government and the provinces (the so called primary distribution) and among provinces (secondary distribution) will be carried out in direct relation to their competences, services and functions, observing objective criteria for delivering revenue." This would apply a sound fiscal principle establishing the need for a correspondence between revenues and spending at each government level.

It also suggests that the arrangement to come will have to introduce criteria other than the single 'equity' objective for revenue distribution and that these criteria would include provinces' own fiscal effort and budgetary performance.

Equity would remain an important consideration. It would be placed in a more far-reaching context of the need of the country's socio-economic sustainability. The amendment states that resource distribution "...will also show solidarity and will aim at an equal development level, quality of life and opportunities throughout the national territory".

In relation to the strengthening of fiscal federalism, one of the most important changes may take place in the field of the transfer of services and functions to provinces.

Many transferred services (i.e. education) occurred under the form of delegation for which specific funds, fed from the national budget by the central government, were set up to cater for the financial requirements of the service passed on to provinces. This in turn created a great deal of conflict with provinces in which teachers' wages were superior to the transferred funds for teachers' wages, as the central government - in assigning the funds - only recognized a certain amount for teachers' pay.

In the future this would not happen. The amendment requires that "no transfer of competence, service or function will take place without the respective resource reallocation, approved by a law of Congress and a law enacted by the Legislature of the concerned province". In addition, it states that "...the existing distribution of competences, services and

functions cannot be modified without the consent of the concerned province".

An opportunity for new ideas

The constitutional amendment also opens the debate on a thorough revision of fiscal relations beyond the single framework of a new revenue sharing arrangement. In this regard, many Argentines are saying that this is an opportunity to introduce new and efficiency-oriented mechanisms.

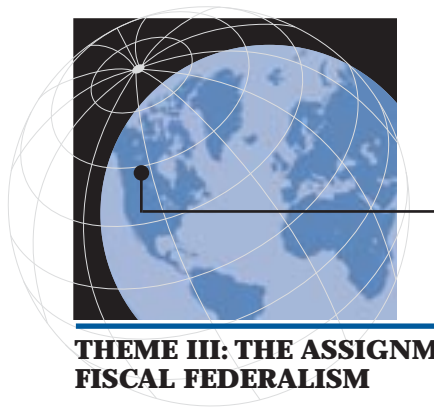
Many academic papers already suggest the convenience of devising mixed arrangements combining revenue sharing systems and a scheme similar to the Canadian Equalization System (in which provinces are subsidized for the amount their per capita tax yield falls short of an average provincial tax yield estimated on a national basis), or the Australian one, in which the subsidy is aimed at permitting states to supply a standard basket of public goods.

The main point remains the possibility of devising an arrangement whose instruments point to more rules-based fiscal and political relationships between the central government and the provinces. As well, it leads to the devolution of fiscal responsibility to constituent unit governments – which, in turn, will enhance their accountability.

Should this prove to be successful, not only would the distribution of fiscal power between levels of government be more transparent but it would also permit provinces to regain part of what they have given up.

In addition, the provinces would gain in the future distribution of political power, as negotiations with the central government would not be distorted by the need to grasp additional fiscal resources.

The Congress is now in the middle of the legislative process, and all options are at hand. It is clear that the "turning point", mentioned in the title, means that Argentina faces now, as never before, the challenge of placing itself in the select group of 'real' federal countries. ☺



Canada's health system – a challenge for fiscal federalism

A cherished system more than three decades old requires a high degree of co-operation between orders of government.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY HARVEY LAZAR

A large majority of Canadians are strongly attached to their countrywide system of universal publicly administered and publicly insured hospital and medical services. But they are also concerned that it may become fiscally unsustainable due to rising public expectations, the proliferation of expensive new technologies, and an aging population. There are further worries that the timeliness and quality of care has begun to deteriorate.

The tools of fiscal federalism were instrumental in the creation of the health care system in earlier decades. Even as Canadians debate the future of Medicare today, questions arise about how these mechanisms can again be utilized to preserve and strengthen the health system to which they are so attached.

Birth of the system

Canada's 1867 constitution assigns to provincial governments much of the legislative authority to regulate health care services. During World War II, while planning for the post-war peace and reconstruction, the Government of Canada became committed to a Canada-wide system of health insurance. Given the constitutional division of authority between federal and provincial governments, the federal government recognized that it could only advance its plan if provinces were willing to implement it. To secure provincial support, Ottawa offered the carrot of cost sharing.

By the mid-1950s, a majority of provinces were anxious for federal cost sharing and legislation was enacted in 1957. The federal government would cover half the eligible operating costs of provincial acute bed hospitals. To qualify for federal funds, the provinces had to provide universal coverage, public administration, public insurance, and portability.

By 1961, all provinces had joined. In 1966, similar legislation was enacted in respect of physicians' services and by 1970 all provinces had joined in. Federal-provincial agreement on the use of conditional shared-cost grants thus enabled a Canada-wide system of hospital and medical insurance to be created.

Deficits and debt

Political priorities then began to change. By the mid-1970s, there was anxiety at the federal level that too much of its budget was being driven by provincial spending decisions, thanks to the cost sharing mechanisms for health and other programs. This concern then merged with a larger concern about annual deficits and rising debt. As for the provinces, they had come to dislike the intrusiveness of federal cost sharing and the fact that it could distort the provincial resource allocation process.

The outcome was a prolonged federal-provincial negotiation and a series of major amendments to the fiscal arrangements. First, block funding replaced cost sharing. In the first half of the 1970s, Ottawa had been operating four major shared cost transfer programs with the provinces – for hospital services, medical care, post-secondary education, and social assistance/services. In 1977, the first three were combined into a single block fund. In 1996 the fourth program was added, making a single large transfer for all four purposes.

Block funding meant that Ottawa's transfer payments to the provinces were no longer linked directly to levels of provincial spending. And with that link broken, the federal government no longer had reason to question and audit provincial health expenses. And any distortion of provincial resource allocation was ended.

Second, Ottawa only paid for half of the new block transfer through cash. The remainder was in the form of transfer of income tax room. Ottawa lowered its income taxes, allowing provinces to raise their tax rates by an equivalent amount without increasing the overall burden on taxpayers. The federal government accompanied this "tax room transfer" with associated equalization payments so that the per capita benefit of the tax points was as large in the poorest provinces as it was in the richest.

As for the *amount* of the total transfer to the provinces in 1977, it was roughly what it had been expected to be under the previous cost sharing formula, with the cash portion legislated to increase at a rate linked to the growth of the economy. The 1977 fiscal arrangements represented a wide measure of federal provincial consensus if not formal agreement.

Single transfer, 30% cut

By the early 1980s Ottawa's fiscal situation was deteriorating badly and had become considerably worse than that of the provinces. When the provinces showed no willingness to agree to amendments to the federal block funding formula, the federal government acted on its own, making a series of largely unilateral reductions in the planned rate of increase in the cash transfer beginning in 1982. This process culminated in a 1995 federal budget decision that its cash payment to the provinces for the new single block transfer would be cut by over 30 percent relative to previously planned levels beginning in 1996.

Whereas cash transfers had equaled about 25 percent of eligible provincial hospital and medical expenses in 1977, by 1997 they had fallen in value to about ten percent of total provincial health care

expenses. In part, this decline was because of the fiscal cutbacks Ottawa had imposed. And in part, it was due to the fact that provincial health costs had continued to grow rapidly, including in areas that had previously not been subject to federal cost sharing, such as prescription drugs and home care.

The 1995 federal budget also did not include legal commitments about whether and when the reduced cash outlays would again begin to escalate. Provinces were thus left to plan their health care reform efforts without any certainty about future federal payments.

Enforcing principles?

The other important change related to the countrywide conditions. After cost sharing ended in 1977, it became more difficult for the federal government to enforce the principles associated with hospital and medical insurance. When some provinces allowed physicians and hospitals to impose patient charges beyond the standard fees that provincial governments paid them, the federal Parliament enacted the *Canada Health Act* in 1984. This legislation consolidated the principles that had previously been imbedded in the federal hospital and medical care legislation and it added a principle related to access. It also authorized the federal government to penalize provinces financially if the provincial authorities did not enforce these principles. While the provinces moved generally to comply with the legislation, some resented the legislation, especially as the federal share of provincial health costs continued to decline.

From one perspective, the tools of fiscal federalism were successfully used in the 1977-1995 period. They helped the federal government to cope with overall fiscal pressures without undermining the broad principles that governed Canada-wide health insurance. But a big price was paid for these successes in the form of strains in federal-provincial relations.

The current context

By the mid-1990s, these strains had come to be among the most contentious issues in federal-provincial relations. They included:

- A disconnect between the very modest amount of federal cash going into

provincial health care and the amount of policy influence Ottawa was attempting to exert on provincial governments.

- Provincial objections to the way in which the federal government was interpreting and enforcing the provisions of the *Canada Health Act*, with Ottawa acting as prosecutor and judge.
- The idea of Canada-wide health care as a partnership between provincial and federal governments and Ottawa's unwillingness to provide certainty to the provinces regarding the basis on which the block transfers would in future grow.
- The fact that a large and growing share of provincial health costs were occurring in areas that are not part of the Canada-wide insurance system, including prescription pharmaceuticals and home care.
- The disconnect between the idea of countrywide health care as a program of federal-provincial cooperation and the more unilateral federal approach to related fiscal decisions that began in the 1980s.

Since then, the federal fiscal position has improved dramatically. The federal government has increased substantially the amount of its cash contribution. While there is much dispute as to what share of provincial health care costs are now accounted for by the Canada Health and Social Transfer (CHST) cash, a reasonable 'middle of the road' estimate is 15 percent.

Second, the federal government has enacted legislation that indicates the magnitude of the increases in the CHST until 2006.

Third, the effective freedom of the federal government to unilaterally interpret and enforce the provisions of the *Canada Health Act* has been reduced recently through federal-provincial agreement to allow for third party intervention in the event of a dispute. Reports from these third parties, while not binding on the federal government, will be made public. And in September 2000, federal and provincial governments agreed on a Health Accord that may turn out to be a stepping-stone to needed health care reform.

Looking forward

As of the middle of 2002, intergovernmental tensions remain high, in part because provincial health care costs continue to mount, crowding out other important provincial programs. Provinces continue to demand that Ottawa restore former funding levels for health and that, once restored, the federal commitment should increase in a predictable manner that reflects cost pressures on the provinces.

On a variety of grounds, the federal government questions provincial numbers (much of the dispute relating to whether the tax transfer of 1977 should still be counted as a federal contribution). In any case, it is most unlikely that Ottawa will take further action until it has the report of the Commission on the Future of Health Care in Canada, a body it appointed in 2001. That report is expected toward the end of 2002.

The Commission is likely to be guided by values and principles in its final report, not mechanisms. But it is also likely to have to reach once again for the tools of fiscal federalism to translate some of its goals into actions. From the viewpoint of the ability of Canada's system of fiscal federalism to respond to the new challenges, both in health care and intergovernmental relations, key issues include:

- Whether to move toward a single block transfer for health only rather than having a multi-purpose fund.
- Whether to expand the scope of the *Canada Health Act* to include uncovered health services and, if so, how to finance them.
- Whether to increase, maintain, or decrease the conditionality of the federal transfers.
- How to respond to the provincial demands for increased federal funding with a predictable escalator.
- Whether to develop proposals for a fiscal decision-making mechanism that is more collaborative.
- How to improve further the dispute resolution mechanisms between federal and provincial governments.

How the Commission will answer these questions remains to be seen. The toolkit of fiscal federalism can adapt to a wide range of answers. It contains a highly flexible set of instruments for responding to ongoing change pressures. ☺



Local elections or not? Nigerians settle in the courts

An important Supreme Court decision in Nigeria ended an impasse on the timing of elections to local councils.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY JOHN A. A. AYOADE

Local government in Nigeria has gone through many phases. During the colonial phase, it was merely an agent of the central government. It had no identity of its own. At best it was the voice of the central government at the local level. In the immediate post-independence period, local government was in a state of flux. Some Nigerians attempted to make it an instrument of development while others only saw it as an instrument of management.

But the problems that plagued local government made the realization of the objectives difficult. The most important of those problems were finance and managerial capacity. In a way, both are related; without funds, competent staff cannot be attracted.

Early reforms

In the 1970s, Nigeria had a financial windfall from oil proceeds, the revenue from which made the restructuring of local government possible. In 1976, Nigeria moved ahead to create a third tier of government at the local level. The federal government reinforced this decision by granting 100 million Naira to the local governments of Nigeria. The grant helped make the local governments viable and able to perform the statutory functions allocated to them.

This made a great difference to local government institutions in Nigeria, particularly because local governments' internally generated revenues were very low. But it also created a new source of possible intergovernmental conflict because the extension of federal grants to local governments necessitated federal overview on how the money was to be spent.

After the restoration of democracy

The 1999 Constitution of the Federal Republic of Nigeria addressed the issue of intergovernmental relations in several

of its provisions. Although federal grants had been given to local governments since 1976, the states were still in control of the local governments. The 1999 Constitution enshrined this when it stated: "the government of every state shall, subject to Section 8 of this Constitution, ensure their existence under the law which provides for the establishment, structure, composition, finance and functions of such councils."

Unfortunately, the Constitution itself is clumsy. Item 11 of the concurrent legislative list appears to have contradicted Section 7, which explicitly placed local government under the purview of the state government. It states "the National Assembly may make laws for the federation with respect to the registration of voters and the procedure regulating elections to a local government."

Local governments in Nigeria had been elected in 1999 under a law that stipulated a three-year tenure. On the other hand, the Constitution prescribed a four-year tenure for the state and federal governments. The Chairmen of the local governments felt that there was need for symmetry and equity in the tenure and advocated a 4-year tenure. In order to realize this goal, they formed the Association of Local Governments of Nigeria.

The Association lobbied the National Assembly, which ultimately passed the Electoral Act approving the extended tenure. When state governments felt that this was a breach of Section 7 of the Constitution, the thirty-six states of the federation took joint action at the Supreme Court to invalidate that section of the Electoral Law. In a landmark judgment, the Supreme Court declared that the National Assembly was incompetent to legislate on the tenure of local governments, as that was a contravention of Section 7. This judicial review is one of the most important

decisions of the Supreme Court in many years.

Effects of the Court decision

The Court decision meant that the tenure of local governments ended on May 29, 2002. Unfortunately the Constitution did not envisage a situation in which the local governments could be dissolved without a successor government in place. That situation would create a vacuum, and in order to avoid the vacuum, either an election must be held or a transition committee must be put in place to run the affairs of the local government.

The first option (holding an election) raised some difficulties – arising from the interlocking arrangement that was established in the Electoral Law. Although Section 197 of the Constitution provided for State Independent Electoral commissions to conduct local government elections, the power to prepare the register of voters was vested in the Independent National Electoral Commission.

State Commissions cannot conduct any election unless the National Commission has produced the register of voters.

As things stood after the court judgment, the political party controlling the federal government did not control fifteen of the state governments. For that reason, the National Commission, which is a federal body, felt it should facilitate local government elections in such states. This being an undesirable option, they instead stalled the registration of voters. The National Commission argued that the federal government had failed to provide money for the registration. In response, state governments argued that the existing register of voters should remain valid until another register is provided.

They buttressed this argument by saying that since the National Commission had conducted by-elections with the existing

register, local government elections could also be conducted with the same register. At the end of the debate, the National Commission agreed that the registration of voters should be carried out to enable the states to hold the local government elections.

The second problem, however, remained. Section 7 of the Constitution, which had been cited by states to justify their control of local governments, is now being cited to prevent them from appointing transition committees. The relevant portion states "the system of local government by democratically elected local government councils is under this Constitution guaranteed". But transition committees are not elected and they therefore constitute a violation of the Constitution.

Some vocal members of the Association of Local Governments insist that they should remain faithful to the Constitution and refuse to hand over their local governments to unelected transition committees. The situation has all the trappings of a possible constitutional crisis.

Obasanjo steps in

The President of the Federal Republic of Nigeria, Chief Olusegun Obasanjo, seized the initiative by calling a meeting of all the State Governors to deliberate on the political dilemma. It concluded that the local government councils could be dissolved on May 29, 2002 in substantial compliance with the decision of the Supreme Court.

In addition, the Governors and Obasanjo decided that the time was too short to hold elections for local councils and recommended that the elections be held on August 10, 2002. The National Electoral Commission was instructed to carry out the registration of voters before that date.

Finally, the meeting of the State Governors and the President agreed that transition committees should be appointed to bridge the period between the end of the tenure of the outgoing councils and the elections of new councils. At that point, the issue appeared to have been resolved.

Subsequent events and pronouncements, however, showed that it was still a live issue.

The Minister of Justice and Attorney General of the Federation, Mr. Kanu Agabi, disagreed with the decisions reached at the meeting and declared that it was in contravention of the Constitution. Some members of local governments' association continued the resistance in the same vein and headed for various high courts for an injunction against the appointment of transition committees.

The Abuja high court restrained state governments from appointing transition committees. Similarly, several state High Courts restrained the state governments. The Governors insisted on appointing transition committees because that was what had been approved at the President/Governors' meeting.

The Supreme Court decision determined that it would be unconstitutional to extend the tenure of local governments. Though the Governors argued that the antics of the Association of Local Governments and the exploitation of legal technicalities must not be allowed to override the judgment of the Supreme Court, it later turned out that all states had appointed transition committees following the expiration of tenure of the local government councils.

The federal government did, however, extend the tenure of the six Area Councils in the Federal Capital territory.

Another federal commission gets in on the act

Even when one would think that the constitutional crisis was over, the Revenue Allocation and Mobilization Commission kept on the struggle. This Commission still held the view that transition committees were in contravention of Section 7 of the Constitution. It therefore argued that it would not release federal grants to local governments run by transition committees. This meant that only the Area Councils in the Federal Capital Territory would qualify for the grants.

There is no provision for the extension of the tenure of local governments councils in the law establishing them and the Constitution does not even make provisions for the extension of the tenure of the National Assembly except when the country is at war and the territory of Nigeria is deemed to be physically

involved and the President considers that it is not practical to hold elections (Section 64 (2)). In that light the extension of the tenure of the (federal) Area Councils could be considered equally unconstitutional.

However, it was not necessary to test this argument in the courts because the Revenue Mobilization and Allocation Commission later rescinded its decision to withhold federal grants to the local councils on the grounds of the unconstitutionality of Transition Committees.

The problem posed by the tenure of the local governments assumed very high political visibility – for several reasons. First, local governments constitute the political bedrock of any nation. The political parties felt that if the states were allowed to conduct the local elections they would have had undue influence.

Second, local government machines are critical to the organization and administration of future elections. It is believed that this will lead to a kind of governmental incumbency that can create an electoral advantage.

The event described here demonstrates certain issues about the political behaviour of Nigerians, notably what for a long time has been identified as political brinkmanship. Nigerians are known to disagree violently over issues, but to eventually reach an abrupt agreement. The about-face often puzzles political observers.

Nigerians have now learnt to exploit the judicial process laid out in the Constitution. The recourse to the courts is a crucial development in Nigerian politics.

State Governors, irrespective of their political affiliations, agreed to challenge the electoral law in court. This is a particularly welcome political development because it is symptomatic of the rise of political consensus in defense of the Constitution.

On the other hand, the actions of the local governments' association showed that they did not accept the principles of the division of powers enshrined in the Constitution. These ideals can only be entrenched when the people have the opportunity to face the challenge from time to time. ☺



Reforming Swiss federalism: who will pay?

The current proposals have a chance of passing in Parliament – but will they pass the reality test?

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY *ULRICH KLÖTI*

The proposal for reforming Swiss federalism that was submitted in November 2001 by the Swiss Federal Government has an excellent chance of getting approved by Parliament. But even so, it may neither satisfy its internal critics nor deal with international pressures.

This package involves both a fundamental redistribution of functions between the federal government and the cantons and a redesigned financial equalization system. The reform aims for a clearer allocation of jurisdictions under the principles of subsidiarity and fiscal equivalence (See box p. 43). The package is supposed to sort out the current tangle of jurisdictions. The package is also supposed to redesign the vertical equalization payments to reduce disparities among different cantons. Cantonal autonomy is supposed to be strengthened and federalism revitalized.

These reforms are not the first attempt to redesign Swiss federalism. After generally unsuccessful reform attempts in the 1960s, the last great effort was in the 1980s. A simple analysis of the situation showed at the time that only very few of the proposals to disentangle functions could be pushed through in individual policy areas. The initiatives to reform fiscal federalism had somewhat greater success, but the outcome of reform remained rather modest on the whole. Little was left of the high-flown plans for fundamental reform of Swiss federalism, except a few adjustments to financial flows. The theoretical foundations of federalism and the political ideals stemming from them did not prove strong enough to give Swiss federalism a new face.

The current proposal is called the Redesign of Equalization Payments and Functions between the Federal

Government and the Cantons (REPF), and was prepared more carefully than its predecessors. The good preparation was due to the joint efforts of the federal government and the cantons. The proposals presented to the Swiss parliament by the Council of Ministers, in agreement with the cantons, have been well received by interested parties and many leading media outlets. They therefore have good chances of success. The reform package is not without its critics, though, on both the academic and political levels.

Equalization payment scheme

The *Redesign of the Equalization Payments* distinguishes between an equalization of resources and an equalization of burdens. The equalization between strong and weak cantons is supposed to be extended beyond that of the present system. This will be done by using a new resource index that measures the financial capacity of the cantons. The index intentionally avoids considering current tax levels. Special burdens borne by the cantons as a result of their geography (for mountainous cantons), population structure, or functions as regional centres (for city cantons) are also supposed to be equalized. Finally, there is the so-called "hardship equalization" that the especially weak cantons are supposed to receive for a transitional period.

This model has been criticized in three major respects:

- First the overall balance sheet is extremely lopsided. Only four cantons (Zurich, Zug, Schwyz, Geneva) and one half canton (Nidwalden) are net contributors. One canton comes out practically even (Glaris). The remaining cantons will benefit from the new calculations. From the standpoint of

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votes, this has the undoubted advantage of assuring a majority. From the standpoint of national policy, though, this result is problematic because the strong cantons feel "blackmailed" by the weak and fear that they could be forced to pay ever-greater equalization. The net "losers" have therefore called for safeguards. This situation is also somewhat problematic from a macro-economic perspective because 91% of the additional redistribution will be borne by just two cantons. One can only hope that the New Equalization Payments will help other cantons to become "have" cantons and net contributors.

- The original model provides as well for horizontal equalization among the cantons. Cantons that act as central service providers for the surrounding cantons are supposed to receive appropriate compensation. However, the amount of this compensation is not specified in the constitution.
- A third criticism comes largely from the political left. These people complain that the New Equalization Payments fail to do enough to equalize the disparities in tax levels among the cantons. The current tax level indices, which vary between 58 and 128, would shrink to a narrow range, between 69 (in Zug) and 125 (in Jura). Ideological conflicts are likely. People who believe in evening out the

levels will feel that the proposed equalization does not go far enough, while those who believe in the pure theory of tax competition will probably feel that the proposed interference in the tax market is already too great.

Disentangling functions

Closely related to the reorganization of finances is the disentanglement of functions and jurisdictions in the REPF. There are four thrusts to the reforms: First, the transfer of functions to the cantons is supposed to strengthen their autonomy (decentralization). Second, when the cantons cannot properly execute their functions on their own, the reforms call for substantially increased inter-cantonal cooperation (horizontal cooperation). Third, new forms of cooperation will be introduced in areas in which it is more sensible, even after the reforms, to have functions carried out by the federal government and the cantons together (vertical integration). Finally, there are also provisions in certain sub-areas for jurisdictions to be transferred to the federal government (centralization), even though this seems contrary to the outline and basic concept.

The reforms seem balanced, at first glance, and more moderate in comparison with the draft plans drawn up by economic experts. Nevertheless, there will still be criticism. The discussions will probably focus above all on the following points:

- The political left takes a sceptical to hostile view of the decentralization strategy. It fears that the financially weak cantons in particular would be completely unable to carry out the functions over which they would receive full authority for the first time. This could lead to a reduction in government services, especially social services. The left is therefore demanding minimal federal standards in various areas. This would be contrary to the disentanglement thrust of the reforms. There are also objections to decentralization from the third level in the federal state – the municipalities. They fear that the cantons might delegate some of their newly acquired functions further down the line, meaning the municipalities would have to bear the financial costs.


- Some objections have also been raised regarding horizontal cooperation by theoreticians of the state and democratic government. They complain that a *de facto* fourth level of government is being instituted, alongside the three existing levels in the federal state. This further increases the complexity and thereby the lack of transparency in the Swiss political system. People also point out the danger of a stronger trend toward executive federalism. They say that there lacks sufficient parliamentary supervision of the decisions made in the inter-cantonal committees of government and administrative representatives, not to mention the fact that these decisions are beyond the reach of all the processes of direct democracy. The problems are said to be especially serious where inter-cantonal legislation could be declared generally binding, even if only in exceptional circumstances.

The strong cantons feel 'blackmailed' by the weak and fear that they could be forced to pay ever-greater equalization.

- There have not been any fundamental objections yet to the new forms of vertical cooperation. This is not surprising in view of the fact that these forms of federalism are closest to what was usually done in the previous system. Given the relative consensus surrounding vertical integration, people have wondered whether all areas in which decentralization or horizontal cooperation models have failed to emerge should not be organized along the same lines as vertical cooperation. However, this would mean restoring as a mainstay the very model from which we are trying to distance ourselves and on which we were going to fall back only when forced to do so.

The current plans to reform Swiss have been quite well received. However, serious objections have been raised to a number of aspects of it. The reforms will therefore probably not have an easy ride through the forthcoming parliamentary debates and all the necessary constitutional votes.

The long-term success of the reform of federalism faces another problem that has not been addressed yet. Economic, social and cultural trends are not heading in the direction in which the reforms attempt to steer them. Switzerland is a highly developed country with ever-stronger internal ties. Its political borders, not least of all the cantonal borders, are becoming less and less important to the approximately 70% of the population who live and work in cities and urban agglomerations. There are fewer and fewer problems for which it is sensible to have different regional solutions. Even though not a member of the European Union, Switzerland has far-reaching international ties. The problems in transportation – by air and by land – and in education for instance (originally a purely cantonal realm) show very clearly that the solutions to major problems more often have to be found on the international level rather than on the cantonal level. All levels of government will have to be involved.

A reform of federalism that views disentanglement as its highest purpose is very promising from an economic standpoint. However, it is basically an attempt to turn back the clock. From the perspective of a social scientist, such an undertaking may be hopeless in the long run. There will probably be only one alternative to continuing centralization in the decades to come: vertical integration in which players from all levels – the municipalities, cantons, federal government and trans-national bodies – are taken seriously in networks that are not very hierarchical. If the current reform of federalism is also successful in finding new, intelligent forms of cooperation and financial equalization, it will be an important step in the right direction. 



India decentralizes, but do the poor benefit?

Recent efforts to decentralize India's fiscal system may be exacerbating disparities between the haves and have-nots.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY *NIRMAL JINDAL*

The process of economic liberalization – in the wake of globalization – has caused great changes in the practice of fiscal federalism in India. There is pressure for restructuring, devolution and decentralization of powers and the demand for fiscal decentralization has become particularly pervasive. Deregulation, disinvestment and privatization in the fields of industry and trade and the monetary and fiscal spheres are influencing intergovernmental structures, institutions and practices.

India is moving towards greater "federalization" with an emphasis on local responsibility and government effectiveness.

In Indian federalism the fiscal powers have been uneven and highly centralized. This is true despite the fact that according to the Constitution the centre, state and local governments had their own fiscal jurisdictions and they have clearly defined revenue sources and responsibilities.

Centralized at the outset

Early on India adopted a centralized planned economic system to ensure growth and economic development in a country of vast size with various diversities and regional economic disparities. The nature and magnitude of interstate disparities and the backwardness of physical and human resources in some states was so deep that it was felt that they required direct action of the centre.

As a result states were given lesser autonomy in fiscal resource distribution. This made the states dependent on the centre on the one hand and vulnerable to the centre's interventionist policies on the other.

As well, fiscal federalism in India functions in a highly centralized manner partly because the Congress Party was in

Distinguishing two Commissions

The Indian Finance Commission is composed of five members, most of them economic and financial experts. The President appoints the Commission every five years.

The Commission draws its authority directly from the Constitution, not from the governments of the day, whether at the federal centre or in the constituent states. Its principal mandate is to award shares out of the proceeds of a number of constitutionally specified federal taxes and excise duties to the governments at both levels, and also among the states. It also determines how much extra assistance should be diverted to the resource-poor states, naturally at some cost to the better off, to help them improve their resources.

The total amounts of transfers to the states the Finance Commission handles are sometimes smaller than those transfers handled by the Planning Commission, which is a federal government body established by parliamentary resolution in 1950 and chaired by the Prime Minister.

Both Commissions draw only upon the resources of the federal government for transfers to the states. The federal government is obliged by the Constitution to share the proceeds of certain taxes according to a fixed formula specified in the Constitution and distributed on the recommendation of the Finance Commission. But the additional amount the federal government may give to states is discretionary, is funnelled through the Planning Commission, and depends on how the federal government views the state's "Five Year Plan". Distribution of additional funds to the different states the states is also in accordance with certain principles, which have evolved over the years.

complete majority both in the centre and states for about two decades after independence. The centralization of fiscal powers had grown under the guise of planning for development.

Fiscal transfers from the centre to the states are budgetary transfers, carried out on the recommendations of two central bodies known as the Finance Commission and the Planning Commission (see box), and of the key economic ministries of the central government. Financial assistance is also distributed through All India Financial Institutions, Industrial Banks and Commercial Banks. The union government shares tax levied by it and collected by the states. Some taxes are levied and collected by the union and shared by the states.

The centre is not bound to accept all recommendations of the Finance Commission. For instance the federal government did not carry out the Finance Commission's most recent recommendations for the financing of

health, education and drinking water. This was because the main focus of the government's economic planning has been on industrial development and import substitution policy.

As well, the Finance Commission is precluded from making recommendations on grants-in-aid and discretionary grants. These grants are within the jurisdiction of the Planning Commission and with regard to these, the latter can play a more effective role than the Finance Commission in fiscal transfers from the centre to the states.

The central government has tended to give Planning Commissions recommendations priority in the monetary, fiscal and economic planning of the country. Central Plan assistance to state plans is project specific and states cannot divert that money for any other projects. This form of tight central control sometimes causes a waste of resources as investments are made according to the plan and not according to actual need.

Since the Planning Commission is perceived to be a political body, the states have been demanding a greater role for the Finance Commission over the years.

Another sort of fiscal transfer involves central Ministries financing some of the states' requirements without necessarily consulting either the Finance Commission or the Planning Commission. These transfers are for schemes relating to education, agriculture, infrastructure, national calamities, improvement of roads, upgrading of salaries of teachers, relief and rehabilitation of displaced persons and other contingent requirements arising from time to time such as police and housing. The terms of these discretionary transfers are more liberal than those of "Plan" transfers.

Highly inequitable

Nevertheless, all types of budgetary transfers including market loans and central investment in public enterprises located in states, and non-budgetary transfers and input subsidy, show that the distribution of fiscal transfers has been highly inequitable. Fiscal flows have gone to states in a manner that have created distortions, controversies and even conflict between the centre and some states.

The functioning of important Union institutions influencing fiscal relations such as the National Development Council, the Interstate Council, the Rajya Sabha and the Supreme Court has also been ineffective. There has been a lack of regular coordination among these institutions and they have failed to address "federal" problems efficiently.

The high degree of central control in the name of equity, efficiency, and economic planning has not brought about equitable development in India. Disparities between different regions continue even in the reformed and liberal economy. One reason for this is that the pattern of fiscal distribution in the public sector ignores differences among the resource rich and North Eastern states.

Public investment by the centre has focused on areas with raw materials and existing infrastructure facilities. The centre did not pay much attention to develop the states lagging behind in infrastructure facilities. More than fifty years after Independence, a large number of states lack physical and human resource development and this pattern continues even in the reformed economy. In practice only developed areas attract

Foreign Direct Investments and other investment flows. Industrially developed states such as Tamil Nadu and Maharashtra continue to attract the lion's share of the total proposed investment. The share of state of Maharashtra alone is as much as the combined share of all the relatively poor states such as Assam, Bihar, Madhya Pradesh, Orissa, Rajasthan and Uttar Pradesh.

Marginalized states such as Bihar and Uttar Pradesh have large populations but receive negligible investment proposals. Bank credit operations are also highly favorable to high-income states. Resources mobilized by all India financial institutions are flowing to relatively developed states.

Liberalization and economic "retreat"

Globalization has encouraged a trend towards decentralization and devolution of power and resources. Due to the changing political and economic system the states have mounted joint attacks against the centre's dominant fiscal position. The centre has been unable to set its fiscal house in order without the states' cooperation. Economic liberalization has brought about a retreat by the central government.

There is a decline in fiscal transfers from the centre to the states. Budgetary support by the central government for the central plan has declined with serious repercussions for state budgets. This has been particularly hard on those states that are the weakest economically.

The central government has withdrawn as a promoter of socially desirable production activities by withdrawing their fiscal and monetary incentives. It has also withdrawn as a regulator that prescribes certain rules and regulations in order to achieve certain macro-economic and other socio-economic objectives. The Centre's declining capacity to reduce regional economic disparities is likely to further widen the gap between states in the years ahead.

In this post liberalization and economic reform period there has been a decline in urban poverty rates but rural poverty remains. Interstate disparities have not only tended to increase but have shown a qualitative deterioration in many ways. In the post reform period, poor states such as Rajasthan, Uttar Pradesh, Orissa have not shown any reduction in poverty whereas rich states such as Andhra Pradesh, Gujrat, Karnatka, Maharashtra, Tamil Nadu and Punjab recorded poverty

reduction. The trend towards increasing disparity among states is likely to make centre-state relations more complex and could pose a serious threat to national unity and integrity.

Many kinds of disparity

In view of the changing economic scenario, interjurisdictional competition among states is replacing intergovernmental relations. The industrially developed states try to redesign their policies to dilute tax laws, giving fiscal concessions and incentives to attract foreign investment. These states have the capacity to reduce their dependence on the centre and generate their own funds. They seek more autonomy in fiscal and political affairs.

Even in some of the economically rich states some regions are deplorably poor and require the centre's assistance. How this assistance is distributed across the states and how states react to such transfers has been an issue of controversy in the recent years.

In line with a more decentralist fiscal federalism, a wide range of powers has been devolved to the local governments. The eleventh Finance Commission fixed the aggregate state share of the centre's divisible pool at 29.5%. These fiscal transfers are more favorable to populous and economically backward states. For the first time, the Finance Commission made recommendations for the provision of fiscal transfers to local bodies. It recommended the transfer of Rs. 16 billion and Rs. 4 billion for Panchayats (rural, local governments) and municipalities respectively. And the 73rd and 74th Constitutional amendments require each state to appoint a state Finance Commission to consider and make recommendations on the financing of local, self-governing institutions.

Cooperative federalism is perceived to be the best device to meet the complexities of fiscal federal relations in India. It would help to bring prosperity to the nation, as different levels of government would share national resources and markets. Cooperative federalism could develop harmonious relations between the centre and the states and among states themselves, while encouraging healthy competition among states. A new federal arrangement to increase the autonomy of states and the activation of grassroots intergovernmental institutions would transform India into a cooperative and constructive federal polity. 6



VIEWPOINT:

Ten proposals for financial reform in Germany

Since 1949, the division of powers in Germany has shifted toward the federal government: the author argues for rebalancing these powers.

THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

BY *ULRICH KARPEN*

"Whoever pays the piper calls the tune!" In a federal state, like the Federal Republic of Germany, the type and scope of federal, *Land* and municipal government activities depend on their financial resources and their powers in financial matters. As Udo Margendant and Werner Heun have shown, their activities are further limited by European legislation (see *references*).

As a solution to the problems faced by the *Länder* and the municipalities, I am advancing these 10 theses:

1. Admit that the jurisdictions of *Länder* and federal government are intertwined. The Constitution of the Federal Republic of Germany, the Basic Law of 1949, has been in effect for more than 50 years and during that time, the decision-making jurisdictions of the federal, *Land* and municipal governments have become highly intertwined. This is contrary to the basic concept of federalism and local autonomy. Many reforms in the regime and in practical policies have had the effect of transferring tasks and powers to the central government. In addition, the Federal Council or upper house, in which the *Land* governments are represented, has played an ever-greater legislative role. As Ursula Männle has shown, the result has been an erosion of the powers of the *Länder* parliaments (see *references*).
2. Distentangle the jurisdictions. A discussion has therefore arisen over how to disentangle and decentralize legal and legislative

powers (subsidiarity principle - see *box*). This is true, as well, of the financial regime and, in particular, the equalization payments between the federal government and the *Länder* and also among the *Länder*.

3. End the disconnect between power and responsibility. There is a great disconnect now between legislative powers and financial responsibility. The connectivity principle entrenched in the constitution – whoever creates and carries out a program must also pay for it – often does not apply to a large extent. There is more and more federal legislation that the *Länder* have to implement on their own and pay for. Federal legislation transfers programs to cities and municipalities, without any firm commitments on the part of the

federal government to contribute to the financing of them. As Wolfgang Renzsch has argued, there is an urgent need to reunite legislative authority and financial responsibility (see *references*) and to introduce a binding co-funding rate for the federal government when it creates cash benefits, for instance in social services.

4. Increase powers for the *Länder*. The leeway of the *Länder* to do as they see fit is too limited, especially by federal framework statutes and joint federal-*Land* programs (the construction of universities, economic development, etc.). Shared funding leads to high administrative costs, delays and inflexibility. Joint federal-*Land* programs should be eliminated.

Solidarity, subsidiarity, and connectivity

German social policy is based in large part on three key principles: subsidiarity, solidarity and connectivity.

"The solidarity principle can be derived from the welfare state principle. It means that members of a certain group, who are affected by similar risks, have to give each other mutual support ...

"The subsidiarity principle however contains the condition that certain groups of persons are to receive assistance from the outside only if their reasonable self-help is exhausted ... "

- *Lehrbuch der Sozialpolitik*, Heinz Lampert, Berlin: Springer, 1998, 5th edition

"The connectivity principle means that any legislature that transfers cost-incurring tasks to the cities, municipalities and districts, must also provide for their financing (Whoever orders must pay the bill)."

- Christian Democratic Party website, "Community politics", <http://www.cdu.de/politik-a-z/kommunal/kap57.htm>

5. End distortions to competition. Federal financial assistance distorts competition among the *Länder*. The federal financial assistance to prevent macro-economic disturbances and encourage economic growth should be eliminated. Equalization payments are so complicated that only experts now can understand them. They are also unfair because they disadvantage politically and economically successful *Länder*.
6. Give taxation powers to the *Länder*. A precondition of strong federalism is that the *Länder* have their own taxation powers. The *Länder* must not become dependent on the federal government. The *Länder* should have full authority to set regionally-applicable taxes (property taxes, motor vehicle taxes, inheritance taxes).
7. Give income tax powers to the *Länder*. Autonomy for the *Länder* in tax matters should be increased in regard to income tax and corporate tax as well.

Three orders of government in Germany

Bund: the federation – the federal government of the Federal Republic of Germany. Its powers were set out in the Basic Law of 1949 (*Grundgesetz*). The origins of the federation go back to the German Empire founded in 1871: there were 25 states in that federation, of which Prussia was by far the most powerful. Both Nazi Germany and the Communist German Democratic Republic (1949-1990) abolished the *Länder*, but the Federal Republic of Germany reinstated them. The so-called “eternity clause” in Article 79.3 of the *Grundgesetz* specifies that the federal system as such must never be abolished.

Land: one of 16 sub-national units in the Federal Republic of Germany. There were 11 *Länder* before the unification of Germany. Only three of them have exact historical antecedents – Hamburg, Bremen, and Bayern (Bavaria). The *Länder* have certain rights specified in the constitution, and possess residual rights for those rights not assigned to the federal government or listed as “concurrent rights”. The exclusive rights of the *Länder* are those of administration plus all those relating to police and public order, culture, the media and education.

Stadt, Gemeinde: city, municipality: the municipal order of government. In addition to the three city-states of Berlin, Hamburg and Bremen (which comprise three of the 16 *Länder*), there 13,682 cities and municipalities in Germany. They have differing powers: there are 112 *Kreisfreie Städte* or “cities without districts” that have the same powers as districts (*Kreisen*).

8. Autonomy for municipalities. The demand for autonomy in tax matters should also apply to cities and municipalities. In local

equalization payments, unearmarked transfers are preferable to transfers for specific purposes.

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- Kurt Döring, “Ein bisschen Wettbewerb” in *Frankfurter Allgemeine Zeitung* v. 14, May 2002, p. 10.

9. Enforce disentanglement, connectivity, transparency, subsidiarity. The watchwords for the reform of the financial regime are disentanglement, connectivity, transparency and subsidiarity (see *box*). There should be greater responsibility, competition should be facilitated, and decisions should be more easily monitored.
10. Renounce “federalism of equality”. We need to renounce the federalism of equality and redistribution and move to competitive federalism. This is not inconsistent with either equivalent living conditions within the federal state or the solidarity principle (see *box*). ☺

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THEME III: THE ASSIGNMENT OF RESPONSIBILITIES AND FISCAL FEDERALISM

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