Federations

What's new in federalism worldwide

volume 1, number 3, march 2001

In this issue

Contributors to this Issue

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The Forum of Federations seeks to enhance democracy and improve governance by promoting dialogue on the practices, principles, and possibilities of federalism.

From the editors...

In this issue of ***Federations: What's new in federalism worldwide*** we deal with a number of different themes:

- *Fiscal federalism*—in Brazil where a "fiscal war" has resulted in a kind of beggar-thy-neighbour policy, and in Germany where some of the more prosperous states have contested the highly equalizing system of revenue sharing in that country;
- *Evolving federalism*—in India, where not too long ago three new states were created in order to accommodate distinct cultural and ecological concerns;
- *Nascent federalism*—in Britain, where the policy of devolution to Scotland and Wales will likely be tested in an election this spring;
- *Centennial federal malaise*—in Australia, where at least some writers find a disappointing lack of enthusiasm for the hundredth birthday of Australian Federation;
- And *Supra-National federalism*—in the "new Europe", where the regions with legislative powers are trying to get the respect they consider to be their due.

We deal with the last theme in our new feature, "the Practitioner's Page". In each issue from now on, in addition to our usual five articles from different regions of the globe, we will devote a page to the particular point of view of a person who "practices" federal governance in one of its many guises. This "practitioner" will share a challenge that he or she has confronted, or a particular initiative with which he or she has been associated. This is part of the Forum's focus on working to improve the *practice* of federal governance by acting as a *clearing house* for knowledge, experiences and best practices.

This issue's practitioner is Llibert Cuatrecases of the Catalan Autonomous government, who talks about his experience in steering the activities of the Congress of Local and Regional Authorities of Europe.

We invite the many practitioners of federalism among our readers to suggest accomplishments, best practices and challenges they might wish to share.

We also invite your letters, which we post on our web site: **www.forumfed.org**

The Forum of Federations has been very busy the past few months working on projects in many different regions of the world. Among the many events coming up in the near future are a roundtable on the role of constituent units in international relations to be held this May in Winnipeg, Canada, and two major regional conferences on federalism to be held later this year, the first in Nigeria and the second in Mexico.

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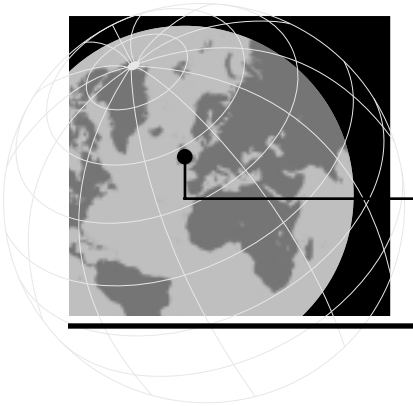


Is British devolution a step toward federalism?

BY *MELANIE A. SULLY*

In 1997 Tony Blair won a landslide victory at the polls for New Labour on a programme that included proposals for radical constitutional reform—with particular emphasis on the devolution of power to Scotland and Wales.

Britain had one of the most centralized systems in Europe and the pressure for greater independence from London had been mounting and threatened potentially to wreck the unity of the United Kingdom.

"Devolution", in this context, means a process by which powers are *transferred,* without parliament relinquishing its supremacy. And soon after it took office, the Blair government drew up a devolution package including a Scottish parliament with tax-raising powers, and an assembly (with much less power) for Wales.

The Conservative Party saw these proposals as the beginnings of the "Balkanisation" of Britain that would lead to increased fragmentation and conflict. Conservatives expressed the fear that such decentralization could lead to a reactionary backlash in England and fuel passions of nationalism and hate.

The debate on devolution is by no means over and has stirred feelings of the English as a separate nation with a distinct history and identity. This is compounded by increasing resentment against rule "from Brussels" which could in the future lead to a split from Europe. Some see closer relations with North America as a logical substitute both emotionally and historically for the European Union.

The Scottish case: a long history

Relations between Scotland and England have historically been uneasy and disputes were common on trade and colonial protectionism.

In 1707 to guarantee prosperity the Act of Union established a new kingdom of Great Britain merging the English and Scottish parliaments with joint representation in Westminster. At the same time the Union guaranteed the independence of Scotland's Presbyterian church, its universities and its legal system. Other clauses in the Union saw that the two countries should be taxed in the same way, have the same currency and enjoy equal rights in trade giving Scottish traders access to rich colonial markets.

At the end of the nineteenth century a Scottish office was created and a Scottish secretary has usually been a member of the cabinet. Further, Scotland's voice could be heard in parliamentary committees that dealt with Scottish legislation.

In 1979 Mrs Thatcher, a figure unloved in Scotland, came to power as prime minister, representing an ideology anathema to the Scottish political culture. For almost 20 years the political colour of the government in Westminster was at loggerheads with political feeling in Scotland.

During the Thatcher period, legal experts, representatives from the churches, political parties, business groups and labour organisations in Scotland worked out a Claim of Right for the "sovereign right of the Scottish people to determine the form of government best suited to their needs". This Scottish Constitutional Convention published a report recommending a separate Scottish parliament, an idea that influenced New Labour in government.

A White Paper was drawn up in 1997 by Blair's new government for devolution for Scotland including a parliament in Edinburgh. These plans were put to the people in a referendum in Scotland and were given a large measure of support. Three-quarters voted in favour of a Scottish parliament and almost two-thirds endorsed the proposal for tax-varying powers.

A new parliament quite different from Westminster

In 1999 the 129-member parliament was elected for a fixed term of four years. The parliament differs from Westminster in some important ways. Its physical layout is horse-shoe shaped, encouraging a consensual style rather than the traditional government versus opposition style. And it has a First Minister (a Scottish prime minister) who is elected by all the members of parliament, using a modern electronic voting system.

The royal prerogative is preserved in that the First Minister elected by the members must then be formally *recommended* by the presiding officer (Speaker) for ratification by the Monarch. The sovereign also receives the resignation of the First Minister and formally dissolves parliament. All Scottish bills are to receive royal assent and Scotland remains an integral part of the UK and the Queen remains the head of state.

The method of electing members also differs from the Westminster system. Each Scottish voter has *two votes* in selecting the composition of the Scottish parliament, one for a constituency member and one for a party list: 73 members are directly elected and the remaining 56 on the additional member system of proportional representation (based on the German model).

The powers that have been devolved to the Scottish parliament are significant. They include:

- health, education and training;
- law, police and the prisons;

- economic development, fisheries and forestry;
- food standards and liquor licensing;
- animal protection and agriculture;
- the environment;
- housing and transport;
- sports, the arts, and tourism;
- and local government.

"Reserved powers" remaining with London include foreign affairs, defence, security, border controls, economic and social policies, transport safety, employment legislation, common markets for UK goods and services, ethical matters such as abortion and human fertility—*and the constitution.*

The latter is especially important should the Scots seek full independence.

The Scottish parliament could debate this issue but could **not** legally proceed **unilaterally** to full independence.

A complex relationship

A secretary of state for Scotland remains in the UK cabinet and is responsible for promoting communication between the two countries and representing Scotland in areas not devolved. In cases of disputes between the two parliaments reference is to be made to the Judicial Committee and the case heard by the law lords.

To facilitate co-ordination a consultative joint ministerial committee, consisting of members from the devolved administrations and the UK government, is to look at issues where there could be potential overlap between devolved and reserved responsibilities.

Relations with Europe remain the responsibility of Westminster, although Scotland has its own representative office in Brussels—as do German Länder and other regions with legislative power in countries such as Spain and Austria.

Scottish ministers and officials can also participate as part of the UK delegation in meetings of the EU's Council of Ministers. Implementation of EU directives is a shared power between the Scottish minister and the UK minister responsible.

In terms of international relations, treaties concluded by the UK are to be implemented in Scotland.

Wales: language is the main issue

Part of Tony Blair's devolution package also involved a special Welsh Assembly, albeit without tax-raising powers.

In a referendum held in Wales only just over half voted for this plan with a turn-out of 50 per cent. This means only 25.2 % of the actual electorate of Wales supported the proposition. The lukewarm support is perhaps understandable given that the assembly is a consultative, advisory organ only.

Laws for Wales are still made in London although the new assembly has taken over decision-making functions on economic development, agriculture, fisheries and food, industry and training, education, local government, environment, planning, transport, arts and culture, the Welsh language, historic buildings, sport and recreation.

It also has some scope in implementing legislation passed in London which has reserved powers in the fields of foreign affairs, defence, taxation, overall economic policy, social security and broadcasting.

The implementing process works in the following way:

Acts of the British Parliament are broad *framework* laws (primary legislation). An Act is divided into sections containing all the detail, and here the Welsh Assembly, after a debate, can issue its own regulations. For example the Assembly has power to revoke the ban on beef on the bone.

Wales, however, would like to have powers on *primary* legislation, as is the case in Scotland.

The English and Welsh languages have equal status in the assembly. According to the 1991 census, 19 per cent of the population said that they spoke Welsh. There are bilingual signposts and in schools Welsh is taught to most pupils between the ages of five and sixteen.

Language is, in fact, the most important component of Welsh nationalism—unlike Scotland where nationalism is expressed in an institutional form. And unlike Scotland there is no separate legal system in Wales.

Elections to the assembly are held every four years, with 40 members elected by majority vote representing constituencies and another 20 elected by the additional members system of proportional representation on the basis of party lists.

The devolution experience in both Wales and Scotland has, even at this early stage, changed British political culture significantly. It has brought about not only a greater federal element for the British political system but has also encouraged a greater use of referenda and reforms in the electoral procedures (such as proportional representation).

But devolution is not exactly spreading like wildfire to other parts of the British Isles. Indeed, after the narrow referendum result in Wales, plans for regional assemblies in England itself were postponed.

Half-way federalism?

At present devolution seems to be an experiment running its course through uncharted waters. Some argue it creates more problems than it solves.

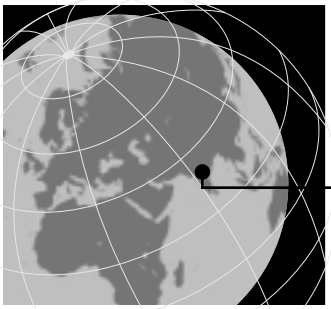
One of the problems still unsolved is what people in Britain refer to as the "West Lothian Question", whereby Scottish members of parliament in Westminster continue to have a say in English affairs while English MPs have no influence in Scotland. William Hague, leader of the Conservative party, has tried to exploit this paradox with talk of "English votes for English laws".

Much of the impetus behind devolution was *ad hoc* and little thought went into constitutional reform as a whole. What has emerged is a patchwork quilt of lopsided devolved power with little coherence in centre-periphery relations.

Radical reform is perhaps alien to the British who, as constitutional experts have noted, "like to live in a series of half-way houses".

Britain was never a unitary state in the sense of uniformity, but rather a union state in which traditionally Scottish and Welsh identities were accommodated in the framework of a multi-national state.

For the time being it seems that this haphazard British approach has staved off more radical calls for outright federalism. In the long run, though, it could whet the appetite for more fundamental reform. And that could cause more headaches in London, already distressed at surrendering power upwards to Brussels and down to the regions.



India creates three new states

BY *HARIHAR BHATTACHARYYA*

The Indian federation took a very significant turn in November 2000 with the creation of three new states.

Although infrequent, the creation of new states is not unusual here. India has a long history of what is called "states reorganization".

Language: the original basis for statehood

The formation of states on the basis of language was a pledge and a demand of the anti-colonial nationalist movements in India. The federal idea in India began to take shape on this vision.

The Indian National Congress (INC), as the main party of India's independence, began to encourage the idea of linguistic states from the beginning of the 1900s. It officially endorsed the demand as early as 1920 when it reorganized its own party units on the basis of regional linguistic boundaries.

The nationalists pledged to reorganize India after independence on the basis of the linguistic characteristics of the country. This pledge led to an awakening of interest in self-rule among various nationalities and ethnic groups prior to independence. Many of the post-independence movements for statehood had their origins in this pre-independence phase.

A dynamic period of change

When the Indian republic was established in 1950, there were 27 states of different status and powers.

During the first major territorial reorganization in 1956, the number of states was reduced to 14, largely on linguistic lines, each having equal powers and function.

But from then on, new states were created to accommodate India's manifold diversity.

The first state created for linguistic reasons in the post-independence period was Andhra Pradesh, in 1953, after its legendary leader Sri Ramalu's fast unto death. This prompted the Government of India to form the States Reorganization Commission in 1953, and on the basis of its recommendations, to pass the States Reorganization Act in 1956.

As a result of this Act in 1956, India undertook the first major reorganization of states, and the reasons were strongly linguistic: the new federal units were created so that the states' boundaries would better correspond with linguistic boundaries.

Since 1956, there has been a more-or-less continuous process of states reorganization. For most of this period, the creation of new states was based on both ethno-regional and linguistic characteristics. In the 1950s and the 1960s, language played the most determining role with the sole exception of the case of the creation of Punjab (1966) in which the linguistic factor combined with religion.

In the 1970s, India's northeast (now comprising seven federal units) became an area of major states reorganization. Three new states were created as a political recognition of tribal identity.

New States and the Indian Constitution

The Indian constitution is quite flexible in its provisions for the creation of new states.

The Indian federation, constitutionally speaking, is an indestructible union of destructible states. The Indian Constitution (Articles 3-4) empowers the Union Parliament—the Lok Sabha (popularly elected Lower House) and the Rajya Sabha, (the Council of States)—to reorganize the states for territorial adjustment.

It is provided that Parliament may by law:

- *form a new state by separation of territory from any state, or by uniting two or more states, or parts of states, or by uniting any territory to a part of any state;*
- *increase the area of any state;*
- *diminish the area of any state;*
- *alter the boundaries of any state;*
- *and alter the name of any state.*

The legislative requirement on the part of Parliament to do so is by a simple majority, and by means of the ordinary legislative process. However, a Presidential recommendation for introducing such a bill is required, and the President is required, before the recommendation, to refer the bill to the legislature of the state to be affected by the proposed changes. The President is not bound to accept the view of the state legislature.

So far more than 20 Acts have been passed by the parliament to give effect to states reorganization. In the cases of the three new states, the constitutional procedures have been followed, and the legislative assemblies of the three affected states have debated the proposed changes for years before agreeing to them.

In the 1980s, another three states were created (two in the northeast, and one in the southwest).

One means by which a state is created is upgrading the status of a "Union Territory". Today there are seven Union Territories of different sizes and significance within the federation. Union Territories are directly ruled by the Central Government.

Historically, these Union Territories have often been the precursors of new states in India. Arguing that a Union Territory should be upgraded to a state has remained one means for ethnically significant people living within a given territory to pursue statehood. Statehood means more autonomous powers, and more freedom of action within the federation.

At the heart of demands for statehood has remained the urge for decentralization and autonomy for the protection of identity and for development.

New bases for state-creation

The creation of three new states—Chhatisgarh (carved out of Madhya Pradesh), Jharkhand (carved out of Bihar), and Uttaranchal (carved out of Uttar Pradesh)—has followed the conventional method of states reorganization in India.

In the formation of these states, however, language, as a symbol of identity, has played very little role.

The process of creation of Chhatisgarh out of the state of Madhya Pradesh has been peaceful, unlike that of Uttaranchal and Jharkhand. A movement for a state such as Chhatisgarh has existed from about the 1960s.

When the parent state of Madhya Pradesh itself was created in 1956, there was very little demand for a state of Chhatisgarh although the cultural distinctiveness of the people of the region was well-known.

The community which has spearheaded the movement for Chhatisgarh are the ex-Malgujas—the rich peasants who collected land revenues on behalf of the Maratha (indigenous rulers) and the British rulers—and who seek to become numerically powerful in a new state.

The most significant political aspect of the creation of Chhatisgarh was that, since 1993, the issue has been an electoral pledge of the two leading political parties, namely Congress and the Bharatiya Janata party (BJP, the leading partner of the National Democratic Alliance government in India). The immediate political beneficiary of the new state has, however, been the Congress, the party in power in the parent state, which played a very active role in the creation of the new state.

The new state of Uttaranchal was carved out of the northern mountainous regions of Uttar Pradesh, India's most populous state (some 140 million in 1991). For the first time ever, ecology as the defining factor of ethnic identity played the most active role in the creation of a new state.

The creation of the state of Uttaranchal is the culmination of a ten-year long movement by the hill people for statehood. They sought autonomy to address the problems of economic development, and to protect their cultural distinctiveness born of the ecological distinctiveness of the region. Essentially, the lack of development in the hills defined the tenor of the statehood movement.

The rise of Uttaranchal has provided the minority hill people of Uttar Pradesh with the political institutions to transform themselves into a majority in a state of their own, in which they will play the major role in governance.

The state of Jharkhand, by contrast, is the culmination of more than a century of struggle by some tribal peoples in Bihar for the protection of their identity, for power over development in their region, and for a state of their own.

The ethnic bases of the new state are complex. Although they began to assert tribal identity some decades back, the tribal groups are no longer in the majority in this state of their "own". But they do constitute a significant element.

In the creation of Jharkhand state, however, regional underdevelopment and a sense of deprivation have combined with these tribal affiliations. And as in the other two cases, language factors played no role in carving out the state.

Can statehood provide more democracy?

India's social and cultural landscape is dotted with various movements for statehood, rooted in communities' concern for their identities. There are such movements as:

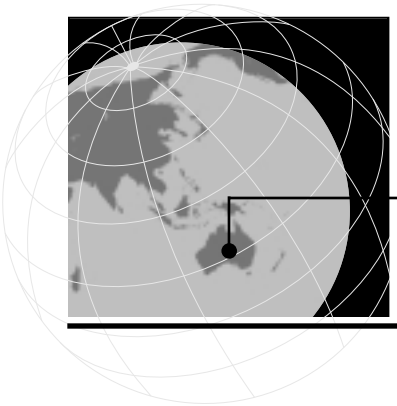
- Harit Pradesh in western Uttar Pradesh,
- Vindhyachal in Madhya Pradesh,
- Telengana in Andhra Pradesh,
- Vidarbha in Maharashtra,
- Kodagu in Karnataka,
- Gorkhaland and Kamtapuri in West Bengal,
- and Bodoland in Assam.

The federal structure of India since her decolonization has shown flexibility in politically accommodating the needs of diversity. Short of full statehood, various institutional measures such as the District or Regional Councils, Union Territories, and Associate State or Sub-State units have been the states' responses to ethnic grievances. In many cases, the statehood movements have grown out of dissatisfaction with those institutional measures.

This vast country contains complex diversity coupled with regional imbalances, social and economic inequalities, and mass poverty.

Statehood provides an institutional framework for autonomy and decentralization to respond to the need for development and the protection of identity. The three new states offer a tier between grassroots governance from below—an issue that has acquired considerable momentum in India since the 1980s—and the federal government at the top.

Still, the real effectiveness of statehood for underprivileged sectors must depend on the extent to which the powers and opportunities now made available are democratically devolved further down the strata of society.



Australia's centenary of Federation: a mystery and a muddle?

BY *DAVID HEADON*

Students of Australian Federation were hopeful that, with the onset of the centenary, the country would engage in a long overdue debate on its system of federalism. This has not happened. With some exceptions, the malaise of previous generations persists—despite the opportunity provided by 1 January 2001 and the ensuing twelve months.

* * *

As if to reinforce some of the stark facts of Australian political, social and cultural history since Federation in 1901, Australians in the year 2000 tried their best to forget the Commonwealth's imminent centenary birthday.

Yes, there was an excuse. The nation, after all, was gearing up for its biggest international showcasing opportunity since globalisation and the world of IT had become a reality: the Sydney Olympics.

But the Federation centenary and the hosting of the Games did not *have* to be mutually exclusive propositions. Australians just accepted that they would be.

Cathy Freeman, Michael Klim and the rest of the marketable black and bronzed Aussie athletes completely overwhelmed any possibility of thoughtful empathy with the bearded white men who, one hundred years ago, created a nation.

Students of Australia's Federation story were not surprised, though they were hopeful in the weeks and months between the end of the Olympics and 1 January 2001—the exact centenary birthday—that some informed commentary would finally emerge.

The more idealistic amongst the small band of Australian Federation aficionados even imagined a genuine if truncated debate on the evolution of their country's original Federation experiment—a necessary, though belated forum on the state of Australian federalism.

Such optimism was naively conceived. Throughout the whole of the last century, the Australian Federation narrative had so few storytellers that there is, now, a dearth of received wisdom. Little wonder, then, that those commentators who emerged between November 2000 and January 2001—from politicians like New South Wales Premier Bob Carr, to historians and even noted authors—could only dance around the edges of a debate Australia has yet to have.

Federalists "shrouded in obscurity"

The Great Federation Silence has its own melancholy story. It was not until well after the conclusion of the Second World War that one or two Australian historians began to comment on the curious Federation history void.

The first of these, the late L. F. Crisp, still arguably our most astute Federation voice, put the problem with characteristic clarity when he wrote, in 1952:

". . . unlike the Americans . . . Australians hold their founding fathers, for all their success, in no special reverence or regard. Many of them are already forgotten. Few are quoted, and then infrequently. . . . Yet there are times when Australians could do with a little more consciousness of their political roots, only to find, when they reach back, that they have cut themselves off by neglect from the facts and spirit of those times".

Sixteen years later, historian Geoffrey McDonald reiterated Crisp's argument, noting simply that "in contrast to the United States, Australians do not remember their federalists: they are shrouded in the obscurity of a forgotten past".

In the decades after these provocative but accurate comments were made, little really changed. Indeed, their essential validity remains. Those of us who have observed, with increasing frustration, the indifference of most fellow Australians when faced with the significance of this unique cultural and political milestone, can scarcely be consoled by recalling that our forebears exhibited the same behaviour.

However, with the fanfare of the centenary now well and truly upon this generation, how does one explain the continuing struggle to secure the Australian public's meaningful participation? What has prevented a long overdue debate on federalism and Federation?

There appear to be at least four reasons.

First, for many Australians, like maverick historian Jonathan King, the process of federating in the 1890s was no struggle-against-the-odds yarn deserving an honourable place in our collective memory. Rather, according to King, it was "the most long drawn-out, no-action talkfest in history. It was riddled with inter-colonial conferences, boring speeches, non-committal committees of inquiry, expensive banquets and long, soporific train journeys back home sleeping off the tax-paid port".

Hardly a scholarly view, this, not one founded on facts, yet one which has certainly found currency in a country where, at the moment, politicians are held in even lower regard than bankers, journalists and used-car salesmen. The recent republic referendum was a casualty of this irrational mindset.

Second, despite the very recent, and mightily welcome, publication of a few excellent books on the Federation saga (works by Helen Irving, John Hirst and

Geoffrey Bolton among them), the telling of the essential narrative has for far too long been extracted from a small number of flawed accounts by long-dead Federation "fathers" such as Alfred Deakin and Bernhard Wise.

Third, as former Australian ambassador Richard Broinowski wrote in a recent letter to the *Canberra Times* newspaper, when we recall key Federation personalities like the then Attorney-General (and later Prime Minister) Billy Hughes, Governor-General Lord Denman and Minister for Territories, King O'Malley, we realise that their well-documented, jaundiced social views helped to shape national aspirations in 1901. They vigorously espoused racism and an aggressive imperialism. The tide is well and truly out on the more virulent Victorian cultural imperatives that motivated a number of our Federation founders.

Fourth and finally, as stated recently by the present Clerk of the Australian Senate, Harry Evans, the commonly held view that Australia has a Westminster system of government is as damaging as it is absurd. Evans regards this "Westminster mantra" cliché as one which many Australian politicians have promulgated because it subtly supports "prime-ministerial absolutism".

For Evans, Australia will only have a worthy debate on the state of its political system when it rejects, once and for all, what Lord Hailsham called the "elective dictatorship" and the "imperial prime-ministership", and it restores the primacy of the system of checks and balances demanded by, and initially achieved by, the Federation founders.

A great silence

A bare handful of writers has advanced an opinion on the state of federalism in Australia *ca.* 2000. We might now legitimately talk of the *Great Federalism Silence* down under. We seem to have lost contact with its roots and realities.

While the best of the "ABCs of Federation" summaries were produced, predictably, by two of Federation's most knowledgeable contemporary historians, based on their books—Helen Irving, drawing on her *To Constitute a Nation: A Cultural History of Australia's Constitution* (Cambridge University Press, 1999) and John Hirst, excerpting from his *The Sentimental National: The Making of the Australian Commonwealth* (Oxford University Press, 2000)—the most engaging contribution in this category for me came from Paul Kelly, the *Australian* newspaper's International Editor.

Consistently the most incisive journalist in the country during the republican referendum campaign, Kelly in his article entitled "Practical, visionary, enduring"—which ran in the *Australian* on 30–31 December 2000—wrote in some detail about the importance of the 1901–14 period to the consolidation of Australian federalism.

It was, Kelly wrote, "a vigorous phase of national-building". More importantly, he took Australia's best known historian Manning Clark to task for his dismissive attitude towards Federation. Clark regarded Federation as a disappointment because "the bourgeoisie had triumphed". Kelly in turn takes issue with Clark, maintaining that "the centenary . . . has bequeathed a wiser assessment".

Certainly the scope of Kelly's contribution sharply contrasts those contemporaneous articles which pursued issues more pertinent to the immediate present rather than try and relate the complexities of the past to a vision of the future.

The limited intellectual and imaginative range of the majority of centenary retrospects only served to highlight those accounts which went an extra yard or two.

One of these was controversial historian Geoffrey Blainey. While it must be said that Blainey largely took the safe option, saying that Australia remains "a place of enormous hope and opportunity" and that it has much to celebrate, he did advance his opinion on the federalism question: for a democratic country occupying a huge area, "the federal system is the best-known solution". Blainey's most contentious point he saved for last: "There is a case for each major region possessing its own state government. The sad fact is that the newest state in Australia is Queensland, created more than 140 years ago".

No commentator that I have come across has yet accepted the challenge of responding to Blainey's speculative suggestion, but a few at least advanced opinions on the federalism debate in this country.

The "beginning of an argument"

Australian leader writer Mike Steketee put the case that while Australia's democracy is "one of the most enduring in the world", this "does not make it an efficient system of government, with the Constitution bequeathing a bugger's muddle of overlapping and divided federal and state responsibilities. Anachronisms and contradictions . . . remain to be resolved". What a pity Steketee did not expand on the "bugger's muddle" that everyone knows to exist in Australia.

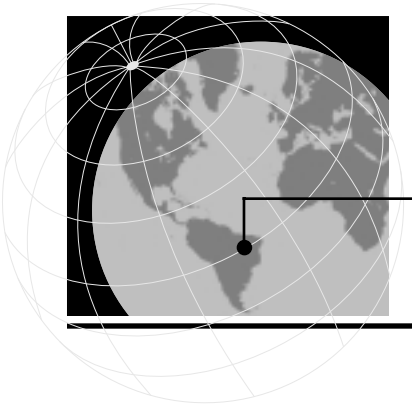
Even more's the pity that the Federation experts called on to comment at the centenary abrogated their responsibilities, and generally chose to 'dumb down' their message.

Federalism is the debate that Australia has yet to have.

Perhaps the wisest words on the Federation instinct came from one of Australia's wisest citizens: our finest living novelist David Malouf. In a typically thoughtful piece, published in the *Australian* on New Year's Day, Malouf began by stating that "Federation was the beginning of an argument about what sort of nation we were to be. . . ." It was a theme worked up by a few commentators. Unlike all the rest, however, Malouf could deftly embrace the Olympic experience within his grasp of Federation and its history:

> . . . the Sydney Olympics really was the apotheosis of Australia's national achievement and the revelation, to ourselves as much as to others, of an achieved national style. That was, in many ways, our real celebration of Federation.

As Australia debates its distinctive system of federalism, in the twenty-first century, it is to be hoped that the participating politicians can bring a similarly imaginative grasp to the table.



Brazil: tax reform and the "fiscal war" in the federation

BY *RICARDO VARSANO*

The stabilization and opening of the Brazilian economy in the nineties, together with changes in international relations that we've come to call globalization, radically modified the economic setting where Brazilian firms operate.

The current challenge is to reform the tax system, which is inadequate to the new circumstances faced by the country.

The Brazilian tax system suffers from four major plagues:

- cumulative taxation (which causes economic inefficiency and loss of competitiveness);
- too much evasion (the results of which are often fiscal inequity and unfair competition);
- excessive complexity (bringing in its wake awkward administration and high compliance cost);
- and "fiscal war" (which causes a misallocation of resources and unrest in the federation).

Virtually all recent works on tax competition in federations conclude that the last-named practice is pernicious. And there is ample evidence that the Brazilian fiscal war is wreaking havoc on state financing, and disturbing harmony and cooperation in the federation.

An unequal federation

Income disparities among Brazilian states are quite large. Per capita GDP of the Southeast region is more than threefold that of the Northeast, and per capita GDP of the richest state, São Paulo, is sevenfold that of the poorest, Tocantins.

When you take that into account, it's reasonable that state governments should pursue decentralized industrial policies. They have the legitimate goal of expanding their own production, employment levels, and income.

And, of course, from the standpoint of any particular state, granting *fiscal incentives* to attract and keep investment seems worthwhile.

If we assume that companies benefiting from such incentives would not otherwise choose to locate their businesses in the state offering the tax breaks—then the incentives don't really cause losses in tax revenue.

Plus, aside from their direct impact on production and employment, newly attracted firms bring additional economic activity, creating still more jobs and income, and, of course, tax revenue.

If this were the whole story, state tax incentives would be a valuable development tool.

But, when the successful experience in one state is imitated by others, destructive *fiscal war* starts.

The dynamics of fiscal war

One of the features of fiscal war is that, in effect, it tends to engulf all the players. Firms benefiting from fiscal incentives are conferred an advantage in relation to competitors located in other states. These competitors often threaten to move into the state granting the incentive unless a similar benefit is offered in the state where they are located.

Soon, to avoid the risk, all states engage in the war.

When fiscal war is pervasive, large firms are able to promote a kind of auction to select locations for their plants, in an attempt to get additional incentives. They may even choose a location and simulate the auction just to get a better deal from the chosen state.

And, as it becomes more difficult to attract new investors, state incentive policies become more aggressive. This includes sending government officials to other states in order to entice firms into relocation.

Conflict in the federation is exacerbated.

As the practice spreads out, its efficacy fades. Revenue goes down in all states. And, since taxes have been equally reduced everywhere, states ultimately lose the power to induce relocation of production. When the process reaches this stage, firms tend to choose their locations considering only market and production conditions.

Pressed by larger spending and reduced tax revenue, the financially weaker states, which are the less developed, become unable to provide services and public works necessary to attract new investments from the private sector.

At the final stages of the fiscal war, the more developed states win all the battles. Disparities—already very large in the case of Brazil—naturally tend to increase.

Preventing fiscal war

The practice of states reducing the value-added tax to attract new investments has been unlawful since 1975 (except in cases where the intended reduction is approved by all states). Yet the law has been disregarded and the fiscal war has intensified in recent years.

A change in interstate trade taxation rules may provide the result that the law was not able to bring about.

Almost all firms attracted to a state by tax incentives have the bulk of their markets elsewhere. Were these firms located in one European Union country and their markets in another, governments would not be able to grant value-added tax incentives—because the tax rate on exports from one member country to another is zero.

But in Brazil, interstate sales are taxed at a positive rate under the state value-added tax, known as the ICMS. Interstate taxation provides the base for the incentive, which consists of a disguised refund of ICMS dues, generally in the form of a zero or low interest long-term loan.

One way of undercutting this practice would be to assign revenue arising from interstate trade to the state of *destination* of goods rather than the state where goods are made. This would limit the value of tax incentives to attract investments. They would only work to the extent that the goods produced in a given state were sold in that same state.

Adoption of this *destination principle* would also improve revenue prospects of less developed states, where consumption tends to be larger than production. And it would solve some other problems that stem from current interstate tax procedures.

On the other hand, implementing the destination principle by zero-rating the tax on interstate sales, as in the European Union, would exacerbate some of the other major shortcomings of the value-added tax system in Brazil, such as excessive evasion and costly unfair competition.

A better solution would be one in which the destination principle is implemented with the use of similar rates for taxation of both *out* of state and *intra*state sales.

Tax reform as a constitutional matter

Changing the Brazilian tax system is an extremely difficult task.

Since the republic was proclaimed and federalism adopted, in 1889, all Brazilian constitutions have indicated which taxes may be levied by each level of government. And, since 1965, constitutional provisions have also defined the general characteristics, or even the details, of many taxes.

So, in order to change the structure of the tax system and even the features of certain taxes (the ICMS among them), a *constitutional amendment* is required.

Approval of an amendment proposal demands hard political negotiation within the course of a long and complex legislative procedure.

A proposal to amend the constitution, presented to one of the Houses of Congress, must first be submitted to its Constitution and Justice Committee in order to have its constitutionality certified.

(Yes, in Brazil, a constitutional amendment may be *unconstitutional!*)

Next, a special committee, specifically appointed to perform this task, analyzes its merits. The committee may accept, reject or modify the proposal. If approved, the original or modified version advances to the plenary, where it may be further altered.

Approval by the House requires favorable votes of at least 3/5 of its members in each of two ballots. The approved terms of the proposal, which may be utterly different from the original, are then presented to the other House where a similar procedure takes place. If modified, the proposal is sent back to the former House for a final round of political negotiation.

An attempt at reform

A constitutional tax reform process was put in motion in 1995, soon after discontinued, then reinstated in 1999.

The main targets of the tax reform proposal were federal cascading taxes, (excellent sources of both revenue and distortions of all kind) and the ICMS, so intricate a tax that few realize it is—or was originally—a value-added tax (VAT).

The reform proposal recommends:

- substituting the ICMS, the existent municipal tax on services (a "turnover tax") and the federal tax on industrialized goods (a partial VAT) with a "dual VAT";
- replacing the federal cascading taxes with a non-cumulative tax;
- and implementing a version of the "destination principle" for interstate trade mentioned above.

Reform on hold

The proposal, discussed throughout 1999, received 35 favorable votes out of a total of 36 in the special committee constituted to study it. Nonetheless it has been strongly opposed by the Ministry of Finance and by some state governments, especially by those intensely engaged in fiscal war.

Such opposition, which means the proposal would hardly have any chance of approval in the plenary of the House of Representatives (and even less chance yet in the Senate!), stopped it in its course and reopened the discussion.

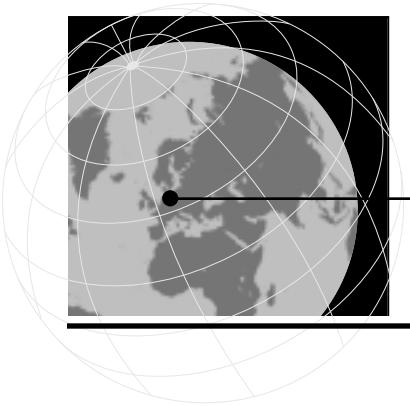
A tripartite commission—with representatives of Congress, federal and state governments—was formed in an attempt to reach an agreement about the content of the tax reform.

But, by March 2000, a deadlock was finally declared, the proposal was sent to the plenary, and the legislative procedure suspended. The 1999 tax reform proposal is now lying, maybe forever, inside some drawer at National Congress.

* * *

This does not mean that Brazilian tax reform has reached the end of its journey. Those familiar with the stops and starts of past reform processes would bet this is just another delay. They believe that the process will be resumed, maybe as soon as the first half of 2001.

The sooner the better, because if tax reform is stalled it means not only that fiscal war will continue upsetting federative relations, but also that investment will remain below its potential level and economic growth will be sluggish.



The German Constitutional Court takes on the principle of 'solidarity'

BY *PAUL BERND SPAHN*

A little more than two years ago three Southern states (Baden-Württemberg, Bavaria, and Hessen) launched a constitutional challenge to the system of intergovernmental fiscal arrangements in Germany.

Their quarrel with the system of interstate equalization was that it redistributes wealth to an excessive degree and creates negative incentives.

In its ruling of November 11, 1999 the German Constitutional Court declared the equalization law to be "transitory", and ruled that it should be phased out as of the 1st of January 2005.

The Court's verdict has given some support to an in-depth revision of the general philosophy of the German Constitution, and spurred farther-reaching discussions of intergovernmental fiscal relations.

This conflict on equalization is effectively a dispute over how far Germany should go to practice what Europeans call "interregional solidarity".

Can this "solidarity" be promoted without generating negative incentive effects?

The Court did not answer this question but took a formal approach to the *technical* aspects of the intergovernmental fiscal machinery.

Mechanisms for sharing the wealth in the German federation

In order to assess the Court's ruling, it is essential to have a basic understanding of intergovernmental fiscal relations in Germany (see box below).

Considering that income taxes are shared among tiers in fixed proportions, a balance between the states and the federal government (vertical fiscal balance) is mainly achieved by varying the states' share of the value-added tax. This is based on federal legislation, with the cooperation of states through the *Bundesrat* (the second chamber of the German parliament, consisting of appointed representatives of the state governments).

On the basis of an assumed fiscal balance among tiers of government, *horizontal fiscal balance* among states is then realized in three steps:

- the regional apportionment of the value-added tax;
- an interregional redistribution scheme;
- asymmetrical federal grants.

The Constitutional Court found that there is a lack of clear criteria for defining how wealth should be redistributed between

How the German fiscal constitution works

The almost complete lack of policy discretion of lower-level governments, and the inability of states to use their own tax instruments has promoted revenue sharing and intergovernmental transfers for fostering national homogeneity in Germany.

Taxes are basically uniform and their proceeds are often jointly appropriated among layers of government. This is true for about 75 percent of total revenue. Revenues from exclusive (but uniform) state taxes are only 4.4 percent of total tax. The sharing formulae are designed to balance fiscal resources between layers of government (vertical equalization), and to level out differences of regional tax potentials (horizontal equalization).

The constitution presumes that it is possible to define "necessary expenditures" at both levels and to achieve a "fair compensation" between them.

As regards the assignment of income taxes, the constitution is extremely rigid: half of the revenue falls to the federation, the other half to the states (with some participation of municipalities). The horizontal allocation follows the residence principle (with formula apportionment for the corporate income tax). "Fair compensation" between layers of government is primarily achieved through the vertical splitting of the turnover tax (VAT). Its allocation is governed by a federal law requiring the consent of the Bundesrat.

Vertical equalization was last revised in 1992 when the Eastern states were included in intergovernmental fiscal arrangements (taking effect in 1996). As a consequence, the states' shares of the VAT have considerably increased reflecting the need to reach consensus with the Western states. At present the federal share of the VAT is 50.5 percent.

The horizontal equalization mechanism consists of three stages:

At a first level, *the horizontal allotment of the VAT has a strong equalization element. Three quarters of the states' share are apportioned on population. Another quarter is reserved for states considered to be "financially frail". They receive supplementary transfers from the VAT to bring their fiscal potential per capita up to at least 92 percent of the average.*

At a second level, *there is a specific horizontal equalization scheme* (Finanzausgleich). *Regional equalization is arranged among states in a "brotherly" fashion. The "rich" states compensate the "poor" through financial transfers. The focus is on taxable capacity (as in Canada), with little or no concern for specific burdens.*

At a third level, *there are asymmetrical vertical grants: so-called supplementary federal grants. Such transfers have been widely used after unification—previously they were insignificant. In particular, "gap-filling grants" have been introduced that guarantee at least 99.5 percent of the average fiscal capacity for all states. Moreover, nine states out of sixteen receive federal grants to relieve the costs of "political management", and the new Eastern states (as well as some Western counterparts) receive federal grants in compensation for "special burdens".*

jurisdictions. And it requested greater transparency for fiscal equalization, both among the states and between the states and the federal government.

Vertical equalization

Regarding the sharing of resources between the federal level and the states, the constitution demands a definition of "necessary expenditures" at each level of government, and a "fair compensation" among jurisdictions. The Court deems this to be possible on the basis of objective statistical data and medium-term planning.

Unfortunately, this is likely to be an illusion.

It is impossible to compare the necessity of national defense at the federal level with education at the state level without relying on value judgments. Objective "needs criteria" are more easily established among entities with *comparable responsibilities* at subnational levels. It is perfectly feasible, for instance, to identify norms to allocate resources among states for primary education (e.g., the number of children of school age, and student-teacher ratios).

In a first reaction (of September 2000) to the ruling of the Court, the federal government has proposed to base the sharing of the value-added tax on the actual budget and financial planning exercise, in which the states are involved regularly. Moreover, the Finance Ministry regards a "law on general standards" redundant for that purpose. The existing machinery of value-added tax sharing would generate similar coverage ratios between "current income" and "necessary expenditure" at each level. It would also ensure fair compensation.

However, the Ministry considers an automatic rebalancing mechanism for the value-added tax share to be useful. But it is unclear how criteria for managing such a mechanism would be determined.

Horizontal equalization among the states

The mainstay of the Court's verdict is on equalization among the states. The German Constitution obliges lawmakers to take measures to equalize the differences in the financial capacity of states. This refers to *actual* financial resources, not to a relationship between revenue and specific expenditure needs.

The Constitution defines a yardstick for equalization between the states by the number of inhabitants.

The Court, in its decision, criticized the existing practice of weighting of population as a method to express specific burdens in certain cases—such as in the case of city states. The Court requested a scientific procedure of balancing, based on accurate data. But neither the federal government nor the states have seen the need to act.

Moreover, the Court questioned elements of "specific burdens" (for instance of harbours) that have crept into the state-to-state equalization system. The Court said they should either be abolished, or applied more generally on the basis of solid statistical criteria.

The Court points to a clear constitutional dilemma here.

On the one hand, the Constitution requests an objective quantitative approach for resource sharing between the federation and the states. (And it should be noted many experts argue such an "objective" approach may be, in fact, unattainable).

On the other hand, it says that population is the *sole criterion* for distributing resources among the states (whereas an approach based on needs could, in principle, be possible).

Given the German tradition, however, it is unlikely that more specific criteria for needs (as in Australia) will be used in the future.

The federal government is indeed prepared to abolish "needs related" elements in its equalization formula—such as the provision for harbours. However, it wants to retain the weighting in favour of city-states, arguing that there are peculiarities to be considered in the formula. Such peculiarities would be based on more reliable and objective criteria in the future.

Moreover, the Court wants "financial capacity"—the sole distribution criterion for equalization among the states—to be understood in a comprehensive way. Not only tax revenue, but also other non-market income of jurisdictions (such as royalties and concession levies) would have to be taken into account. Also municipal financial resources (now counted as elements of the states' financial capacity by only 50 percent) would have to be included *in full.*

The federal government seems to accept the Court's request to calculate the financial ability of states in a comprehensive sense.

But the reaction of the paying states remains to be seen. Some—in particular the richer "challengers"—would likely lose resources if this were done.

Federal intervention

The Court was particularly critical of federal equalizing grants.

It stated clearly that federal grants must remain exceptional and transitory measures to mitigate the financial stress of particular states.

At present, federal grants have a strong equalization effect on fiscal capacity per capita (99.5 percent of the state average for all states). They even have *perverse effects*—in that poorer states may end up at higher capacity levels than the richest ones.

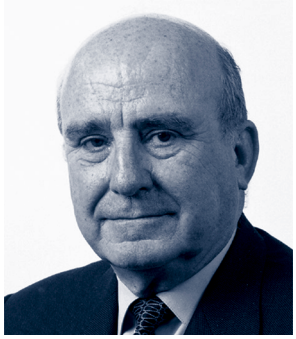
The Court seems to have limited the degree of per-capita equalization to a level of 95 percent of the average. The federal government will therefore have to reduce the number of its grants as well as their magnitude.

In a first reaction, the Federal Finance Ministry has indeed announced that federal grants for relieving the costs of *political management* would no longer be made.

States in a situation of budgetary distress would still receive grants in the future, but only for a limited time—and on a regressive scale. States that are to receive such grants will have to present binding plans for financial reorganization. The federal government and the states will share the burden of such grants in relation to their spending.

Overall, the ruling of the German Constitutional Court will require a *fundamental review* of the existing German equalization law. But German lawmakers are unlikely to allow the existing model to disappear completely. Rather they will likely try to limit the changes, as much as possible, to minor revisions.

In the Germany of the new millennium interregional *solidarity*—the notion that there must be as great a measure of economic equality in the federation as possible—continues to exert a strong hold on the political culture, notwithstanding the stresses of unification.



the Practitioner's page

Llibert Cuatrecasas of Catalonia, an advocate for the regions in the new Europe

Llibert *Cuatrecasas is Secretary-General for European Affairs in the Catalan government, and is based in Barcelona. In this capacity, he is the President of the Council of Europe's Congress of Local and Regional Authorities of Europe. He is also the Vice-President of the Congress' Chamber of Regions.*

Mr. Cuatrecasas presided over the recent Conference of Presidents of Regions with Legislative Power, held in Barcelona in November 2000. **Federations** *spoke with him about the role of regions with legislative power in the new Europe:*

Federations: **What is the Working Group of Regions with Legislative Power?**

Cuatrecasas: It is a working group that was created by the Chamber of Regions of the Congress of Local and Regional Authorities of the Council of Europe. As the European region evolved, it became increasingly clear that the situation of regions with legislative authority was different, legally and politically. This distinct legal situation is seen most clearly perhaps in the case of the European Union.

How do the legal situations of the regions differ?

For regions without legislative authority, the European Union's decisions and directives are immediately binding on member states. The parliaments of these states have no authority to reject these directives because under the treaty of the European Union, its directives apply immediately.

These EU-level decisions apply immediately as well to those regions without legislative authority. The national government makes the laws and then the regions enforce them according to their local powers.

The case of regions with legislative authority is different, especially if these regions have exclusive jurisdiction. In such cases the region, rather than the national government, makes the law to apply an EU decision.

This leads to *de facto* federalism. That is, this hierarchy of regulations affects the three levels: the EU, the nations, and the regions.

Once the working group was created, one of its first tasks was to find out, in the most institutional way possible, the perspective of the regions as a group. This was the reason for this conference.

Do you have some specific objectives for the future?

The Final Declaration of this conference identifies the objectives.

It asks the national governments of Europe to pay more attention to their regions that have legislative authority. It asks the national governments to let them participate fully in the life of the countries.

It also recognizes the diversity of situations. The situation in Germany, Austria or Belgium is not the same as in Italy or Spain.

The next meeting, in the second half of next year, will be held in the French-speaking part of Belgium, and in the meantime the working group can continue to talk about the issues.

Is the Council of Europe becoming irrelevant?

No. It was often said that once the European Union was created, the Council of Europe's work could be phased out. But since the end of a divided Europe and the fall of the Berlin Wall, things have changed substantially.

Today there are 15 countries in the European Union. The Council of Europe has 41 member states and in a few weeks will have 43, with the admission of Armenia and Azerbaijan.

Obviously, these member states of the Council of Europe must adopt all the provisions concerning human rights. But there are other important ones, like cross-border cooperation, the European Charter on Local Autonomy, the draft European Charter on Regional Autonomy approved by the Congress, which we hope will also be ratified.

I would say that the Council of Europe has prepared all these states to effectively implement the principle of subsidiarity, which is much clearer in the rules of the Council of Europe than in those of the European Union itself.

Right after the fall of the Berlin Wall, all the states of Central and Eastern Europe wanted to join the Council of Europe. But to do so, they had to adapt their own structures. Most of them saw fit to regionalize to some degree—like Poland, the Czech Republic and Slovakia, and we could mention several other countries in central and eastern Europe.

Basically, all this is applying the principles of the Council of Europe. All this intergovernmental cooperation, harmonizing legislation and structures,

is an essential precondition so that European Union can be achieved.

Why were the other states chosen to join this working group?

The other states with significant regionalization, like Italy and Spain, are of course aware that they must change some of their own structures to come closer to a clearly federal model.

This kind of federalism must recognize all the diversity that exists in Europe and that no European would want to give up.

Obviously, the system in Germany or Austria, which have highly developed federalism and allow for a variety of situations, is considered by other highly regionalized states as structures from which they can learn about their own unresolved issues.

How do you think globalization and the search for European unity affect how the administrative regions are perceived?

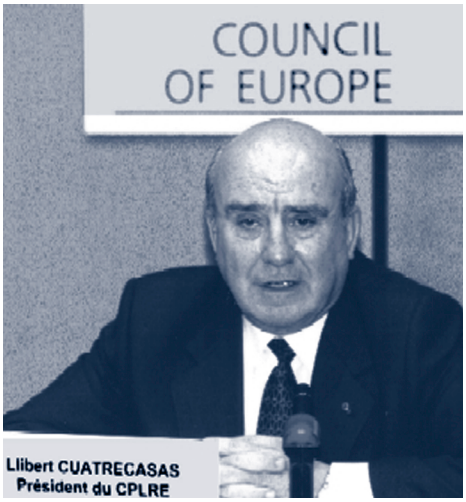
It is hard to answer this question now—this is a decisive moment for the European Community.

Much will depend on how this united Europe is actually built. The German foreign minister always talks about a constitution for Europe. Sooner or later, we will have to face this issue.

It is interesting that those who are most reluctant about the idea of a European constitution are sometimes Germans. Why?

From the Final Declaration of the Conference of Presidents of Regions with Legislative Power:

"We undertake to defend our regional cultural policy and the specific characteristics of some of our regional sectors, in fields such as agriculture, health and education, against the machinery of a global investment policy, in particular, and against any attempts to bring about harmonisation, standardisation, or even uniformity. In global negotiations, Europe must defend its own model, based on regional cultural diversity. However, being aware of the danger of withdrawal into our own identity, and the xenophobia this may entail, we undertake, on the contrary, to develop our specific regional characteristics as the necessary basis for productive exchanges with the rest of the world . . ."



Because they have real power and exclusive authority to develop policies and their own legislation, and since the system for debating legislation in the German federation is already highly structured, they do not want the European Community to take this away from them.

The Germans were very concerned about this for the past year or two, since they already have such a policy development mechanism in which they participate so fully that they are practically assured of supporting what the German federation eventually does.

For the rest, it remains to be seen.

Do you think that the challenges facing European nations are different from those of other nations?

It may be somewhat different because in Europe there has been a longstanding basic movement towards European unity. Nationalism in Europe co-exists with a feeling of European unity.

The nation-state, which arose in the 16th or 17th century, may have fulfilled a worthwhile simplifying function at one time. But now, this system will lead to impoverishment.

I think that the world today is moving towards large markets and anyone who does not participate in a market of at least 300 million people will have trouble defending himself.

Even the United States is a rather small market. In America, they felt the need to create NAFTA, which has been more successful than expected. It's better for Canada, and better for Mexico.

In Latin America, Mercosur has been another attempt that has had some difficulties but has involved a complete change of mentality compared to what existed before between Latin American countries. It has the potential to be a really large market and to organize itself as such, and I believe that they can do it.

Of course, the present situation in Europe is different from other parts of the world, but in the long run it may not be so different if the rest of the world can consolidate more.

Could this type of meeting be replicated elsewhere?

Yes, why not? Because sharing experiences is important. If we Europeans can offer ours as a guide, for example, so could Canada—which is a well-known case—the United States and Latin America.

The President of the EU suggested that a regional system is the wave of the future. Does this imply the dissolution of national governments?

No, I don't think so. If there is a clear distribution of powers, all three levels are necessary. The national government plays an essential role, namely to ensure public safety and the equality of rights and obligations. So it would be hard to eliminate it. In the long run, the European Union may provide these guarantees, but for now this is not how it works.

From the Final Declaration of the Conference of Presidents of Regions with Legislative Power:

"[W]e call on the Committee of Ministers of the Council of Europe to adopt as rapidly as possible the draft European Charter of Regional Self-Government, initiated by its Congress of Local and Regional Authorities of Europe . . . and thereby to recognise the specific status deserved by regions with legislative power . . ."

"We also call . . . for the incorporation into the EU Treaty of the extension of application of the subsidiarity principle to regions with legislative power . . ."

"We also support the claims made by the Committee of the Regions . . . especially the elevation of the Committee of the Regions to be a fully fledged institution of the European Union, the obligation for its members to hold an elected office and the introduction of a right of appeal for the Committee of Regions to the Court of Justice of the European Communities in the event of a failure to respect its prerogatives."