

WORKSHOP C:

Fiscal Federalism and Financial Relations

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INTRODUCTION

The main aim of the workshop on fiscal federalism and financial relations was to discuss and compare the economic, political and legal frameworks of intergovernmental financial relations in the different states at stake, identifying major elements of criticism and suggesting solutions to cope with major problems. With this purpose in mind, the workshop was structured into three parts. In the first part, the experts provided input by focusing on the definition of fiscal federalism and its foundations in order to provide a common level of understanding for the subsequent discussion. In the second part, each participant presented on his / her country of origin following a common set of questions provided by the experts:

1. What type of arrangements has the country adopted to distribute competences and responsibilities in financial and fiscal matters?
2. Which are the major issues at stake in the current debates on the financial system in your country?
3. What type of institutions does your country have to prevent or settle conflicts in financial matters (composition, role, powers ...)? How do they work or how could they work better?

Each presentation was followed by a questions and answers session, in order to identify the major challenges and problems. Finally, in the third part, the discussion aimed at the elaboration of

basic guidelines related to the design of intergovernmental financial relations, to be taken into consideration when it comes to any decentralization process.

DEFINING FISCAL FEDERALISM

The subject of fiscal federalism is a central issue in political agendas and in the academic air due to its importance for the very existence of any federal system. No matter the form decentralization of powers takes, its fiscal dimension is always important and sometimes dominant in determining the outcomes of the entire process.

As in the case of federalism in general, there is no one-size-fits-all model and there is no global agreement on a common definition of fiscal federalism. Furthermore, there are notable differences with regards to the terminology used in the context of fiscal federalism. There are no generally accepted definitions of terms such as "financial relations" or "fiscal arrangements", "fiscal federalism", "fiscal decentralization", "financial regimes" or "financial constitutions" and these terms are sometimes difficult to distinguish. To make things even more complicated, the same terms are usually being applied to political systems that have very few traits in common. They mean different things to different people, depending on their standpoint and background as well as context of reference.

To cope with such great variety, it is thus useful to provide a working definition of "fiscal federalism" as a common frame of reference for discussion. This is of further importance as an essential step to predefine the object to be compared. In this regard, it is worth stressing that the literal meaning of the words "fiscal federalism" could be misleading for an appropriate understanding.

First of all, boundaries of fiscal federalism are hard to draw as we can refer to fiscal federalism even with regard to decentralized systems of government (i. e. quasi-federal states) that are not genuinely federal. Originally, the concept fiscal federalism was associated with the US prototype referring to it as the "assignment

of functions to different levels of government and the appropriate fiscal instruments for carrying out these functions".¹

Moreover, due to the aggregative nature of the American federation, the debate focused primarily on the need to grant certain financial independence to the federal level.² This perspective was only later reversed, when so-called holding-together federations (e. g. Belgium and Spain) or those systems that resulted from a combination of aggregative and devolutionary processes (e. g. India and Canada) were considered. These cases have overall favoured the emancipation of the concept from the US paradigm and in general from the federal state and the wide-spread of the phenomenon worldwide. The result is an inclusive understanding that embraces systems exhibiting features of both federal and unitary states (e. g. the so-called hybrids³) in the analysis.

Hence, fiscal federalism can be referred to cases with very few traits in common, embracing not only in typical (mature) federations like United States, Canada, Switzerland or Australia, but broadly speaking all federal-type systems or generally speaking to all forms of decentralization of powers, as for instance in emerging federations like Spain, South Africa or Ethiopia.

Secondly, notwithstanding the adjective "fiscal" the phenomenon is not strictly (or at least it is not only) related to the tax system. As a matter of fact, fiscal federalism refers more generally to the allocation of powers in financial and fiscal matters and the financial relations among the different tiers of governments of a federal-like system. Although the distribution of taxing powers is one important issue to be addressed, it is not the only one. Furthermore, in the functioning of the different systems there is visible a trend towards centralization of taxing powers at the federal level (with few important exceptions and with great variation from one case to another).

Having said that, the overarching idea is that fiscal federalism refers in very general terms to "the public finances of the various orders of government in a federal-type system", including the

analysis of "the respective roles and interaction of governments [...] with a particular focus on the raising, borrowing and spending of revenue".⁴ The examination thus includes the allocation of taxing, borrowing, and spending powers, embracing both regulatory and revenue responsibilities.

In addition, emphasis is given to "the respective roles and interactions of governments" redirecting the attention beyond the mere allocation of powers and responsibilities in order to take into consideration the functioning of the system by means of intergovernmental relations. This enrichment is connected to the theory of federalism as a process and appears to be particularly appropriate for addressing the phenomenon and its causes.⁵ At the same time, it is shown to be indispensable for understanding how different systems actually work.

Such a conceptual framework results in an inclusive spectrum of analysis that makes it feasible to embrace highly diverse and heterogeneous systems (like the cases presented in the workshop). The natural starting point of the analysis therefore is the existence of two or more orders of government and a vertical distribution of powers and responsibilities.

COMMON FOUNDATIONS IN FISCAL FEDERALISM

Although with great variation, all cases rest on the same common foundations. These key aspects include in particular:

1. The spending powers to carry out public functions each entity is vested with, with a focus on the following questions: who is responsible for which expenditures? How are they assigned among all tiers?
2. The revenue responsibilities, including both the (legislative) power to tax and the power over revenue. The legislative power to tax involves decisions not only on who is in charge to tax and what can be taxed, but also how to share such powers among the different tiers of government. One could refer to this category in terms of tax-base sharing schemes. Once decided on who

is responsible for tax-raising and how taxing powers are shared among the different levels, another key-issue concerns the vertical and horizontal distribution of the revenue, i. e. the revenue-sharing scheme. This is typically done by addressing the following questions: How does intergovernmental distribution of revenue work? How is revenue shared vertically among the different levels as well as horizontally that is among the entities belonging to the same level? Looking at the existing case studies, two major patterns can be detected: tax-revenue sharing arrangements and / or equalization schemes (or transfers in a broader sense). These are flows of money distributed on the basis of different criteria or a combination thereof, like the derivation principle, but also others such as population, fiscal capacity (the lower the fiscal capacity, the higher the amount of equalization transfers), or spending needs.

3. The borrowing powers – that is the distribution of this power and the limitations each entity undergoes. Who can borrow? How much freedom do subnational governments have in this respect?
4. The institutional dimension: who decides on all this? How does the decision making process look like? This is of relevance as financial relations are necessarily an area of cooperation and conflict, including not only conflicts with regards to the distribution of powers but specifically related to redistribution of funds which ultimately affects the stability of a political system. This applies to all decentralized systems, even the most homogeneous ones (i. e. Germany).

Each intergovernmental system of finance results from the combination of all these key aspects. In theory, the option in favour of a certain combination or another depends (or should depend on) on the aims pursued, but in practice it appears to be the product of political bargaining and compromise. However, it appears that each system is always the outcome of a balance between financial

autonomy and thus responsibility and differentiation (i. e. taxing powers), on the one hand, and equality and solidarity (i. e. the scope of equalization or transfers with a redistributive aim), on the other hand. The precise term of such a trade-off and the related question whether a breakpoint exists depend on too many variables to permit any easy generalization. A case-study approach has thus always to be central in any investigation.

BASIC GUIDELINES FOR THE DESIGN OF "FISCAL FEDERALISM"

During the presentations, the great variation among the different case-studies under discussion quickly became apparent. The participants' countries of origin are in very different stages of reform and differ significantly with regards to the degree of decentralisation. In some countries decentralization is being discussed, in others reforms have been adopted but remain to be implemented. In many of them decentralization is much more similar to a deconcentration of administrative powers and functions to the local level. Few cases can actually be traced back to quasi-federal systems.

Against the background of this great variety, the third part of the workshop has been devoted to the identification of some general and basic guidelines to be followed in the allocation of financial and fiscal powers and in the structuring of institutions to prevent and to cope with conflicts.

This has been done by addressing and discussing the key aspects illustrated above, focusing in particular on the following three elements: the allocation of taxing powers and of tax-revenue (1); fiscal equalization (2); and, finally, the institutions created to prevent and solve conflicts (3).

1. Taxation, tax autonomy, tax sharing

This paragraph is dedicated to the "tax assignment problem" and includes decisions with regard to both the allocation of taxing powers and of tax-revenue. Although there is no one-size-fit-all solution, combining the theories on fiscal federalism and the existing case-

studies the ideal distribution of competences in tax matters should be structured on a three-level-base, taking into consideration the following recommendations:

Local level:	<ul style="list-style-type: none"> • own tax sources, but overall limited autonomy • right on inventing (local) taxes • user charges • access to income and (local) business taxes
State / province:	<ul style="list-style-type: none"> • access to personal and corporate income tax and to general consumption tax (within limits!)
Central government:	<ul style="list-style-type: none"> • taxes with redistributive effects should be the responsibility of this level of government • competence of harmonization of decentralized tax bases and types of tax rates, and thus avoidance of overburden of vertical tax rates • responsibilities of internalization of tax externalities

2. Fiscal equalization (formula based, sufficient volume and transparency, distributive aspects)

This paragraph provides general recommendations on the design of fiscal equalization mechanisms, providing insights into the fundamental elements to be addressed related to the implementation of equalization schemes. The main pillars of fiscal equalization can be summarized as follows:

- Vertical supplement of state / provincial and local tax revenues;
- Horizontal equalization of fiscal capacities and financial needs;
- Country-wide harmonization of infrastructure.

The main challenge is that fiscal equalization has to find an appropriate balance between autonomy claims and solidarity concerns and thus is inextricably linked with the context of reference.

This idea has to be reflected in its structure, that is all entities shall have sufficient and adequate resources, but within limits. Otherwise, the incentives to make use of the assigned taxing powers would be completely lost. The following general recommendations thus apply:

- Base redistribution of resource on a rationale formula (i. e. indicators / criteria equal to all);
- Ensure an adequate balance of unconditioned and specific purpose grants, in order not to nullify spending autonomy;
- Provide appropriate incentives in favour of efficiency and economic growth (e. g. putting quantitative limits to equalization or granting a partial equalization, for instance including in the equalization system only certain revenue and not all revenue at disposal);
- Reduce the implementation gaps (i. e. the system in its functioning has to be the result of the rules and not of concurrent political bargains).

3. Institutions and conflict prevention (and resolution)

Against the background of a broad understanding of fiscal federalism in a sense that includes the dynamic dimension referable to intergovernmental relations, the institutional component is crucial. The structure and functioning of institutions are determinant for the system as a whole and play a great role when it comes to prevention and resolution of conflicts. Beyond the general considerations that have been discussed in the workshop specifically dedicated to intergovernmental relations (see Workshop A), when it comes to fiscal and financial matters the following additional recommendations apply:

- Strengthening of the relationship between citizens and the respective layers of government, in order to foster political accountability and activate democratic control;
- Improving subnational capacities of tax administration;
- Providing adequate incentives for the prevention of state and local corruption and determining credible sanctions in case of violations;

- Ensuring the formal inclusion of academic advisors and / or experts (finance commission, periodic evaluation, recommendation of tax sharing formulas);
- Establishing a body where all layers of government are represented, in favour of a multi-level consistency of the system.

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NOTES

- ¹ See Oates, Wallace E.: An Essay on Fiscal Federalism, in: Journal of Economic Literature 3/1999, pp. 1120–1149.
- ² See Hamilton, Alexander: Federalists no 30-36, in: The Federalist Papers, by Alexander Hamilton, James Madison, and John Jay, New York 1788.
- ³ See Watts, Ronald L.: Comparing federal Systems in the 1990s, Kingston 1996.
- ⁴ Anderson, George: Fiscal Federalism, Oxford, 2. Aufl., 2010.
- ⁵ See Friedrich, Carl Joachim: Federal constitutional theory and emergent proposals, in: Federalism. Mature and emergent, ed. by Arthur W. MacMahon, New York 1962, p. 528 ff.

