Lessons from International Practices of Fiscal Equalization Transfers

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Outline

• Rationale for Fiscal Equalization Transfers (FET)
• Principal Approaches to Equalization Transfers
• Constitutional-Legal Framework for FET
• Canada: A Federal Program of Fiscal Capacity Equalization
• Germany: A Solidarity Program of Fiscal Capacity Equalization
• Australia: A Federal Program of Fiscal Capacity and Expenditure Need Equalization
• Sweden and Denmark: Central-local and local-local equalization
• Institutional Arrangements: Alternate Models
• Some Lessons
Why use fiscal equalization transfers?

**REGIONAL FISCAL INEQUITY AND NATIONAL FISCAL INEFFICIENCY ARGUMENT**

**DIFFERENCES IN NET FISCAL BENEFITS ACROSS STATES (NFBs)**

Reasons:

- Differences in access to source-based taxes such as resource revenues and CIT.
- Per capita incomes differ → differential access to PIT and sales tax.
- Fiscal needs different: Proportion of old, young, incidence of disease, terrain factors, etc

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Fiscal Equalization Transfers: Rationale

- Political: Large regional fiscal disparities can be politically divisive. May even create threat of secession. Fiscal equalization grants to create a sense of political unity
- Makes it possible for all citizens to be treated alike regardless of the places of residence. Thereby advances social justice (fiscal equity) and efficiency in market resource allocation (fiscal efficiency).

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Differential net fiscal benefits (NFBs) and implications: An example

Total Income = Private Income + NFBs

Individuals with identical incomes in two states:

<table>
<thead>
<tr>
<th></th>
<th>Rich</th>
<th>Poor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private income</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Tax paid</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td>Per capita exp.</td>
<td>10,000</td>
<td>5,000</td>
</tr>
<tr>
<td>NFB</td>
<td>5,000</td>
<td>0</td>
</tr>
<tr>
<td>Total income</td>
<td>15,000</td>
<td>10,000</td>
</tr>
</tbody>
</table>

→ Fiscally induced migration to RICH state.
→ Inefficient and inequitable resource allocation.
Economic rationale for fiscal equalization transfers (FETs): conclusions

Solution:
◆ Fiscal equalization transfers to eliminate NFBs
◆ Allow replication of financial structure of an unitary state while having decentralized decision making.
◆ Equity and efficiency considerations coincide.

Design of FETs:
◆ Must be inframarginal, i.e., no incentive to change fiscal effort to exploit the system.

Conceptual Approaches to Equalization

• Fiscal Capacity Equalization using
  – Macroeconomic Indicators
  – Representative Tax System
• Fiscal Need Equalization through Representative Expenditure System

Measurement of Fiscal Capacity: Macroeconomic Indicators

• Personal income
• Personal disposable income
• Province/State Gross Domestic Product

A Representative Tax System approach to fiscal capacity equalization

\[
\text{Equalization from revenue source } i = \left(\frac{\text{Per capita potential revenue in all states}_i}{\text{Per capita standardized revenue in All states (i)}} - \frac{\text{Per capita base in state A (i)}}{\text{Per capita own base per capita}}\right)
\]
A Representative Expenditure System approach to Fiscal Need Equalization

**Equalization entitlement from expenditure category i**

*EQUALS*

Per capita potential expenditure of State A for category i based upon own need factors if it had national average fiscal capacity

*MINUS*

Per capita potential expenditure of State A on expenditure category i if it had national average need factors and national average fiscal capacity

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International practices in transfers to reduce regional fiscal disparities

- **Design**: General non-matching fiscal capacity equalization transfers.
- **Better practices**: Fiscal equalization programs (sources of data: CGC, Finance Canada, Lotz, Shah & Spahn)
  - Paternal: Australia (fiscal capacity plus fiscal needs) and Canada (fiscal capacity only)
  - Solidarity, Fraternal or Robin Hood: Germany (fiscal capacity), Sweden, Denmark
- **Practices to avoid**: General revenue sharing with multiple factors e.g. practices in Brazil, India and South Africa.

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<table>
<thead>
<tr>
<th>Fiscal Equalization Program</th>
<th>Australia</th>
<th>Canada</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Status</td>
<td>Law</td>
<td>Constitution</td>
<td>Constitution</td>
</tr>
<tr>
<td>Paternal or Solidarity</td>
<td>Paternal</td>
<td>Paternal</td>
<td>Solidarity</td>
</tr>
<tr>
<td>Total Pool determination</td>
<td>Ad hoc</td>
<td>Formula</td>
<td>Formula</td>
</tr>
<tr>
<td>Allocation</td>
<td>Formula</td>
<td>Formula</td>
<td>Formula</td>
</tr>
<tr>
<td>Fiscal capacity equalization</td>
<td>Yes, RTS</td>
<td>Yes, RTS</td>
<td>Yes, RTS</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Fiscal Need Equalization</td>
</tr>
<tr>
<td>Program Complexity</td>
</tr>
<tr>
<td>Political Consensus</td>
</tr>
<tr>
<td>Who recommends</td>
</tr>
<tr>
<td>Dispute resolution</td>
</tr>
</tbody>
</table>
Federal Fiscal Equalization Program of Canada is enshrined in the constitution

Canada Constitution Act 1982, Article 36.(2)
Parliament and the Government of Canada are committed to the principle of making equalization; payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of services at reasonably comparable levels of taxation.

Federal equalization transfers to provinces:
- Basic principles enshrined in the constitution.
- “Glue that holds the federation together”.
- Considers all provincial-local revenue sources.
- GNP growth rate cap
- Floor: Yearly decline limited to 1.6% of the equalization standard
- Formula determined Level and Allocation

EQUALIZATION PER CAPITA FOR REVENUE SOURCE (i)

\[
\frac{\text{National average tax rate}}{\text{5-provinces}} \times \frac{\text{Per capita in own base}}{\text{province A}} = \frac{\text{Per capita revenue in 5-provinces}}{\text{standardized revenue in province A}}
\]
How Equalization Works

\[ E_a = \left( \frac{R_a}{B_a} - \frac{B_s}{P_s} \right) \times P_a \]

Value of Fiscal Standard Capacity

Federal-Provincial Fiscal Arrangements Committees

- Ministers of Finance and Provincial Treasurers Chaired by the Federal Minister of Finance
- Continuing Committee of Officials on Fiscal and Economic Matters Chaired by the Federal Deputy Minister of Finance
- Sub-committee on Income Taxation
- Fiscal Arrangements Sub-Committee
- Economic and Fiscal Data Sub-Committee
- Working Group on Sales Tax Reform
- Technical Sub-committee on Equalization Implementations
- Technical Sub-committee on Pensions (CPP)

CANADIAN PROGRAM: AN EVALUATION

Merits
- Enduring program of more than 50 years - embodies a consensus view.
- Terms of endearment “glue that holds the federation together.”
- Simple and objective (2 staff members required).
- Allows monitoring of fiscal position of subnational governments.
- Largely free of grantsmanship and strategy.
- Size of pool and allocations determined objectively.

Demerits
- Paternal program with fiscal capacity equalization only
- Neglects other federal programs
- Weak accountability in Atlantic Canada

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Australia

Federal Fiscal Equalization Program in Australia is based upon the Personal Income Tax Sharing Act of the Parliament

“… to enable each state to provide without imposing taxes and charges at levels appreciably different from the level of taxes and charges imposed by the other states, government services at standards not appreciably different from the standards of the government services provided by the other states.”

Section 13(3) of the States (PIT sharing) Amendment Act, 1978.

Total equalization pool is determined arbitrarily outside the formula

- Total equalization pool (G) from 1979 to 2000 = 40% of PIT collections from the previous year
- G from 2001 to present = Total proceeds of the GST (Goods and Services Tax – a general sales tax) for the previous year.

Commonwealth Grants Commission

FISCAL EQUALISATION

THAT EACH STATE SHOULD BE GIVEN THE FINANCIAL CAPACITY TO PROVIDE THE AVERAGE STANDARD OF STATE-TYPE SERVICES, ASSUMING:

- IT OPERATES AT AN AVERAGE LEVEL OF EFFICIENCY; AND
- MAKES THE AVERAGE EFFORT TO RAISE REVENUE FROM ITS OWN SOURCES.
**Commonwealth Grants Commission**

**DISABILITY**

INFLUENCES BEYOND STATES’ CONTROL THAT RESULT IN THEM HAVING:

- TO SPEND DIFFERENT PER CAPITA AMOUNTS TO ACHIEVE THE SAME OBJECTIVE
- DIFFERENT PER CAPITA REVENUES RESULTING FROM THE SAME LEVEL OF EFFORT TO RAISE REVENUE

(they can be either positive or negative)

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**EXPENDITURE NEED FACTORS**

(a) SCALE FACTORS

(b) POPULATION AND RELATED FACTORS
- Dispersion
- Urbanization
- Social composition
- Age structure

(c) ENVIRONMENT FACTORS
- Physical
- Economic

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**ASSESSED GRANT**

\[(B) \text{ EQUALS} \]

**REVENUE NEEDS**

PLUS

**EXPENDITURE NEEDS**

MINUS

**ASSESSED NEEDS MET BY OTHER FEDERAL TRANSFERS**

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**An Example of Expenditure Need Determination in Australia:**

Secondary Education Expenditure Need Factors

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**Table 4 - Government Secondary Education Factors - 1995-96**

<table>
<thead>
<tr>
<th>Disability Factors</th>
<th>NSW</th>
<th>Vic</th>
<th>Qld</th>
<th>WA</th>
<th>SA</th>
<th>Tas</th>
<th>ACT</th>
<th>NT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dispersion</td>
<td>0.9973</td>
<td>0.9921</td>
<td>1.0093</td>
<td>1.0108</td>
<td>0.9972</td>
<td>0.9952</td>
<td>0.9885</td>
<td>1.0710</td>
</tr>
<tr>
<td>Grade Cost</td>
<td>1.0014</td>
<td>1.0028</td>
<td>0.9966</td>
<td>0.9950</td>
<td>0.9902</td>
<td>0.9998</td>
<td>1.0016</td>
<td>0.9970</td>
</tr>
<tr>
<td>Input Costs</td>
<td>1.0120</td>
<td>0.9950</td>
<td>0.9960</td>
<td>1.0032</td>
<td>0.9910</td>
<td>0.9900</td>
<td>1.0080</td>
<td>0.9340</td>
</tr>
<tr>
<td>Relevant Population</td>
<td>0.9949</td>
<td>0.9874</td>
<td>1.0093</td>
<td>1.1639</td>
<td>0.9479</td>
<td>1.1422</td>
<td>0.9750</td>
<td>1.2226</td>
</tr>
<tr>
<td>Administrative Scale</td>
<td>0.9946</td>
<td>0.9946</td>
<td>0.9946</td>
<td>1.0065</td>
<td>1.0150</td>
<td>1.0304</td>
<td>1.0463</td>
<td>1.1139</td>
</tr>
<tr>
<td>Service Delivery Scale</td>
<td>0.9922</td>
<td>0.9906</td>
<td>1.0031</td>
<td>1.0153</td>
<td>1.0166</td>
<td>1.0380</td>
<td>0.9714</td>
<td>1.1141</td>
</tr>
<tr>
<td>Vandalism &amp; Security</td>
<td>1.0023</td>
<td>1.0023</td>
<td>0.9973</td>
<td>0.9973</td>
<td>0.9973</td>
<td>0.9992</td>
<td>0.9943</td>
<td>0.9923</td>
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<tr>
<td>Cross-border</td>
<td>0.9965</td>
<td>1.0001</td>
<td>1.0001</td>
<td>1.0001</td>
<td>1.0001</td>
<td>1.0001</td>
<td>1.0001</td>
<td>1.0001</td>
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<tr>
<td>Category Disability</td>
<td>0.9692</td>
<td>0.8658</td>
<td>1.0815</td>
<td>1.1941</td>
<td>0.9772</td>
<td>1.1917</td>
<td>1.0440</td>
<td>1.6005</td>
</tr>
</tbody>
</table>
AUSTRALIAN PROGRAM: AN EVALUATION

- Comprehensive yet have some flaws.
- Expenditure need assessment subjective and imprecise.
- Municipal revenues not included.
- Data issues: dated base period.
- Past allocations influence current entitlements.
- Fixed allocation negates open-ended commitment by the Act.
Australian Fiscal Equalisation: As Seen by Rich States

Germany

Source: Paul Bernd Spahn

How does the Finanzausgleich work?

- A fiscal capacity yardstick is defined per capita (national average with modifications)
- Each State’s fiscal capacity per capita is measured against this yardstick
- ‘Poor’ States obtain 95% of fiscal yardstick
- ‘Rich’ States pay in progressive steps
- The Finanzausgleich is a pure horizontal clearing mechanism

'Marginal levy' on State fiscal capacity in excess of average fiscal capacity

The World Bank

TwoRd
Sweden: Fiscal Equalization at the Local Level

- Central transfer to bring all local governments to national average fiscal capacity
- Special grant for population size, composition and location
- Municipalities above 135 percent of the average contribute to the pool.

Denmark: Equalization models and standards

<table>
<thead>
<tr>
<th>Equalization type</th>
<th>Counties</th>
<th>Metropolitan areas</th>
<th>Local Govts.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal capacity</td>
<td>85% Robin Hood</td>
<td>90% Robin Hood</td>
<td>50% central grant</td>
</tr>
<tr>
<td>Fiscal Needs</td>
<td>85% Robin Hood</td>
<td>60% Robin Hood</td>
<td>35% Robin Hood</td>
</tr>
</tbody>
</table>

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Institutional Arrangements for Fiscal Transfers

- Intergovernmental committees: Canada, Germany (with strong role of Bundesrat)
- Intergovernmental cum civil society commissions: Pakistan (limited duration)
- Independent grant commissions: Australia (permanent secretariat), India (limited duration) and South Africa (permanent)

Fiscal Equalization Grants: Some Lessons

- Fiscal capacity equalization with an explicit standard is desirable and do-able in most countries.
- Fiscal need equalization is much more complex – desirable but may not be worth doing. Rough justice may be better than precise justice.
- For local equalization – one size does not fit all.
- Important to have societal consensus on the standard of equalization
- Must have a sunset clause and provision for a review and renewal
- Institutional arrangements for a continuous review and periodic revision