Fiscal Federalism– Principles, Practices and Challenges: An Overview

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Design of fiscal constitution: centralized vs decentralized expenditures

- Central planning
- Uniformity
- Redistribution
- Economies of scale
- Risk sharing
- Internal common market
- Regional equity
- Harmonization of expenditures
- Avoidance of race towards bottom
- Avoidance of self-defeating investment promotion
- Rules driven top-down accountability

- Local participatory planning
- Diversity consistent with local preferences
- Incentives for competitive and innovative service delivery
- Better quality, quantity and access of public services
- Lower agency costs
- Bottom-up Fiscal and political accountability
- Restraints against corruption and rent seeking
- Constraints on government size
- But soft budget constraints possible
Design of Fiscal Constitution:
Centralization vs Decentralization of taxing powers

- Efficiency in collection
- Lower compliance costs
- Encourages factor mobility for internal common market
- Wasteful tax competition avoided
- Discourages shifting tax burden to non-residents
- Fiscal inequity avoided

- Fiscal accountability
- Better administration of taxes on immobile factors
- Better use of fees and charges
- Reduced corruption
Forms of Fiscal Constitutions

- Unitary (148 countries) - China
- Federal (45 countries)
  - Dual Federalism
    - Layer cake – Mexico, Malaysia, Russia
    - Coordinate authority – Australia, Canada, India, Pakistan, USA
  - Cooperative Federalism
    - Interdependent spheres – Germany, South Africa (unitary)
    - Marble cake- e.g. Belgium (territorial -3 and linguistic-4)
    - Independent spheres - Brazil
  - Competitive Federalism
- Confederal : EU
Asymmetric Federalism

• Some members are less equal than others: Chechnya in Russia

• Some members are more equal than others: Sabah and Sarawak in Malaysia, Quebec in Canada

• Choice to be unequal or more equal than others: Opting-in and Opting out options. Canada, Spanish agreements, Russia, European Union (treaty exceptions for UK and Denmark)
Not all federal countries are decentralized and not all unitary countries are centralized.

<table>
<thead>
<tr>
<th>Country</th>
<th>Subnational / National Revenues</th>
<th>Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>110%</td>
<td>190%</td>
</tr>
<tr>
<td>Germany</td>
<td>42%</td>
<td>56%</td>
</tr>
<tr>
<td>Australia</td>
<td>33%</td>
<td>80%</td>
</tr>
<tr>
<td>Unitary –Europe</td>
<td>11%</td>
<td>27%</td>
</tr>
<tr>
<td>Unitary-Nordic</td>
<td>45%</td>
<td>59%</td>
</tr>
<tr>
<td>Central Europe</td>
<td>18%</td>
<td>25%</td>
</tr>
</tbody>
</table>
Federal Systems and Economic Performance

- Rules of the game are clear and understood by all – delineated scope of authority.
- All agents independent in their spheres – political, fiscal and administrative autonomy. Ability to capture rents locally from local prosperity critical to growth. US/China vs Mexico/Russia
- Institutionalized restraints on unilateralism by any player especially the federal government – to guard against potential for tragic brilliance -India/Mexico/Pakistan vs Canada/Spain
- Internal common market provisions - USA
- Fiscal Responsibility restraints
Theoretical Foundations of Decentralized Fiscal Constitutions

- Principle of Fiscal Equivalence
- Decentralization Theorem
- Subsidiarity principle
Expenditure Assignment Principles

• Efficiency
  – Spatial externalities
  – Economies of scale
  – Administrative and compliance costs
• Fiscal efficiency
• Regional equity
• Redistributive role of the public sector
• Provision of quasi-private goods
• Preservation of internal common market
• Economic stabilization
• Spending power
Assignment of Local Public Services

• Allocation Criteria for provision
  – Economies of scale
  – Economies of scope
  – Benefit-cost spill-outs
  – Political proximity
  – Consumer sovereignty
  – Economic evaluation of sectoral choices
  – Composite

• Allocation criteria for public vs private production
Tax Assignment Principles

- Efficiency of internal common market
- National equity
- Efficiency in tax administration
- Fiscal Need
Major Emerging Challenges to Fiscal Federalism

- Shifting Sands in Division of Fiscal Powers- Globalization and Information Revolution and their discontents
  - Towards an hour glass model of federalism
  - New vision of local governance
  - Widening economic and fiscal divide within nations
- Fiscal prudence and fiscal discipline under fend for yourself federalism
- Securing economic union – challenges and risks
  - Burden sharing or dividing the spoils
  - Building partnerships or transfer dependencies
  - Bridging economic divide within nations
  - Beggar thy neighbor policies - race to bottom
- Fragmentation of Internal Common Market
- Failure to create incentives for responsive, responsible and accountable governance
A rising tide of global and local governance – why?

• A nation state is too large to address small things in life and too small to address large things.
Globalization: Challenges for multi-centered governance

- Diffusion of authority to multiple centers within and beyond nation state
- Emerging source of conflict within nations
- Internationalization of cities and regions
- Information revolution empowers citizens and weakens authoritative controls
- Knowledge rather than resource base as a source of international competitiveness
Globalization

- Social policy fall-outs
- Economic policy fall-outs
- Requires a major reorientation of national government role away from municipal/local services but more intensive role in education and training
Globalization: urgent steps

- To bring global institutional evolution in step with the pace of globalization
- Development of national strategies for economic and social risk management
- Periodic review of jurisdictional assignments
Rearrangements: Globalization, Centralization and Localization

- **Beyond Nation States**: Macro stabilization, Regulation of financial transactions, corporate taxation, international trade, global environment, telecommunications, international migration, international standards, anti-money laundering, fight against corruption and terrorism

- **Centralization**: Social and environmental policy through international agreements. Skills enhancement for international competitiveness. Oversight and technical assistance.

- **Localization/privatization**: All local functions
Diminishing relevance of states

• Shifting of powers beyond nation states and to local governments and a new role for federal government.
• Federal government carving a larger role in shared rule: Brazil, Canada, USA, Germany, India, Malaysia
• Federal debt finance through reduced fiscal transfers: Canada
• Federal direct relationship with local governments: Brazil, Canada, USA
• Federal direct role in state affairs: India
Localization/Decentralization: Recent trends

- Increase in number of countries from 140 in 1975 to 193 in 2006 with 60% of the population under democratic rule.
- In LDCs sub-national expenditures as % of total public sector expenditures rose from 12% to 23% during 1980-1999. More than half of education and health expenditures at sub-national levels.
- In LDCs sub-national revenues as a % of total public sector revenues increased from 10% to 15% over the period 1980-1999.
- Decrease in both revenue autonomy and expenditure autonomy of sub-national
Emerging Vision of Local Government: 20th versus 21st century

- Residuality principle
- Ultra vires
- Focus on government
- Agent of central/provincial governments
- Accountable to higher governments only
- Direct provider
- Dependent on central directives
- Rules driven, bureaucratic, technocratic
- Exclusive with elite capture
- Overcomes market failures
- Boxed in a centralized system

- Subsidiarity principle
- Community governance
- Focus on governance
- Primary agent for citizens and gatekeeper for shared rule
- Accountable to voters
- Network facilitator
- Autonomous
- Managerial flexibility and accountability for results, strengthens voice, choice and exit.
- Inclusive and participatory
- Overcomes market and government failures
- Global and local connectivity
**FIGURE. Local Expenditures as a Share of National GDP**

*Source: Calculated based on World Development Indicators Online (WDI), Government Finance Statistics, Chapter 2 – 11 (this book).*
Economic divide within nations

Fiscal Federalism As a Bane for Fiscal Prudence

• Agency problems with incomplete contracts and undefined property rights (taxing, spending and regulation)

• Intergovernmental bargaining with high transaction costs.

• Tragedy of commons with universalism and pork-barrel politics
Fiscal federalism as a boon for fiscal prudence

- Federal policy as an insurance against asymmetric regional shocks.
- Non-cooperative collusive behavior not in regional interest
- Variety of federal instruments and Institutions of IGFR
- Regional stabilization with “rainy day umbrellas”
- Federal systems – better adapted to deal with universalism
Fiscal Policy Coordination in Mature Federations

- Institutions of IGFR: executive and/or legislative federalism
- Diversity of coordinating mechanisms and experiences – Australia, Canada and Germany
- Formal (constitutional or legislated) and informal fiscal rules (Brazil – a success story)
Lessons on Fiscal Rules

- Fiscal rules are neither necessary nor sufficient for fiscal discipline.
- Fiscal rules can be useful for fiscal retrenchment under multi-party coalitions or but not required for successful consolidation under a single party majority rule (Canada, UK, Australia).
- Fiscal rules may impede countercyclical fiscal policy.
- Fiscal rules should apply to budgetary outcomes and not projections.
- Fiscal rules more appropriate for local governments.
- Enforcement by an independent body desirable.
Ensuring Fiscal Discipline

• Governments at all levels made to face financial consequences of their decisions
  – Requirements for maintaining positive net worth and commercial audit
  – Fiscal rules and gatekeeper committees
  – Independent central bank with price stability mandate
  – Integrity and independence of financial markets
Fiscal discipline

- No bailouts
- Increased reliance on own revenues
- Reduced reliance on revenue sharing
- De-linking fiscal transfers from input controls and linking transfers with accountability for service delivery performance
- Tax decentralization as a pre-requisite for sub-national credit market access

• Consensus on roles and limits of all governments and periodic reviews
Perceptions on intergovernmental finance are generally negative

- **Federal/Central View**: Giving money and power to sub-national governments is like giving whiskey and car keys to teenagers.
- **Provincial and Local View**: We need more grant monies to demonstrate that “money does not buy anything”.
- **Citizens**: The magical art of passing money from one government to another and seeing it vanish in thin air.
Ironically these perceptions are well grounded in reality in LDCs

- Primary focus on dividing the spoils
- **Passing the buck transfers** – revenue sharing with multiple factors (Brazil, Argentina, India, RSA, Philippines and more)
- **Asking for more trouble grants** – deficit grants (China, Hungary, India, and more)
- **Pork barrel transfers or political bribes** (Brazil, India, Pakistan, USA e.g. $200m bridge to nowhere in Alaska)
- **Command and control transfers** (most countries)
- **Overall:** Intergovernmental finance is the dominant source of revenue but creates perverse incentives for fiscal management and accountability
From Dividing the Spoils to Creating An Enabling Environment for Responsive and Accountable Local Governance

- Tax Decentralization
- **Output based fiscal transfers**
  - *operating*
  - *capital*
- **Fiscal equalization transfers**
- Responsible borrowing
Instruments of intergovernmental finance

• Unconditional vs conditional transfers  
  – Unconditional: preserving local autonomy and enhancing inter-jurisdictional equity  
  – Conditional: providing incentives to undertake specific activities

• Conditional Transfers  
  – matching vs non-matching  
  – open-ended vs. closed-ended matching  
  – Input based conditionality vs output based conditionality  
  – Input based conditionality often intrusive and unproductive. Output based conditionality can advance grantor’s objectives while preserving local autonomy
## Traditional versus Output-based grants -1

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Traditional grant</th>
<th>Output-based grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objective</td>
<td>Spending levels</td>
<td>Quality and access to public services</td>
</tr>
<tr>
<td>Design</td>
<td>complex</td>
<td>Simple and transparent</td>
</tr>
<tr>
<td>Eligibility</td>
<td>Government</td>
<td>Provides through government</td>
</tr>
<tr>
<td>conditions</td>
<td>inputs</td>
<td>outputs</td>
</tr>
<tr>
<td>Allocation</td>
<td>Project proposal</td>
<td>Service population</td>
</tr>
</tbody>
</table>
### Traditional versus Output-based grants -2

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Traditional grant</th>
<th>Output-based grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compliance</td>
<td>Inspections and audits</td>
<td>Client feedback. Comparison with base year</td>
</tr>
<tr>
<td>Penalties</td>
<td>Audit observations</td>
<td>Public censure, voice and exit</td>
</tr>
<tr>
<td>Managerial flexibility</td>
<td>None</td>
<td>Absolute</td>
</tr>
<tr>
<td>LG Autonomy</td>
<td>Little</td>
<td>High</td>
</tr>
<tr>
<td>Transparency</td>
<td>Little</td>
<td>High</td>
</tr>
</tbody>
</table>
## Traditional versus Output-based grants -3

<table>
<thead>
<tr>
<th>Criterion</th>
<th>Traditional grant</th>
<th>Output-based grant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Focus</td>
<td>Internal</td>
<td>External</td>
</tr>
<tr>
<td>Accountability</td>
<td>Top down input based</td>
<td>Bottom up, results based</td>
</tr>
</tbody>
</table>
## Performance Budgeting Results Chain
Application in Education

<table>
<thead>
<tr>
<th>Program objectives</th>
<th>Inputs</th>
<th>Intermediate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improve quantity, quality, and access to education services</td>
<td>Educational spending by age, sex, urban/rural; spending by level; teachers, staff, facilities, tools, books</td>
<td>Enrollments, student-teacher ratio, class size</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Outputs</th>
<th>Outcomes</th>
<th>Impact</th>
<th>Reach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Achievement scores, graduation rates, drop-out rates</td>
<td>Literacy rates, supply of skilled professionals</td>
<td>Informed citizenry, civic engagement, enhanced international competitiveness</td>
<td>Winners and losers from government programs</td>
</tr>
</tbody>
</table>
An example: A performance oriented education grant to set national minimum standards and encourage competition and innovation and citizen empowerment

- **Allocation basis among local governments**: school age children (ages 6-17)
- **Distribution to providers**: equal per pupil to both government and private schools
- **Conditions**: Universal access to all, private school admissions on merit regardless of parents’ income, improvements in school achievement scores, graduation and drop out rates, no condition on spending
- **Penalties**: public censure, reduction of grant funds
- **Incentives for cost efficiency**: retention of savings
<table>
<thead>
<tr>
<th>Objective</th>
<th>Grant Design</th>
<th>Better Practices</th>
<th>Practices to Avoid</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal Gap</td>
<td>Reassign, tax base sharing</td>
<td>Canada</td>
<td>Deficit grants, tax by tax sharing</td>
</tr>
<tr>
<td>Regional fiscal disparities</td>
<td>Fiscal capacity equalization (FCE)</td>
<td>FCE with an explicit standard as in Canada, Germany, Denmark</td>
<td>General revenue sharing with multiple factors, Fiscal eq. with a fixed pool as in Australia, China</td>
</tr>
<tr>
<td>Setting national minimum standard</td>
<td>Block transfers, conditions on service standards</td>
<td>Ex-Indo. roads and education, Chile, Brazil</td>
<td>Conditions on spending</td>
</tr>
<tr>
<td>Benefit spillovers</td>
<td>Matching grant</td>
<td>S. Africa teaching hospitals</td>
<td></td>
</tr>
<tr>
<td>Influencing local priorities</td>
<td>Open-ended matching</td>
<td>Canada social assistance</td>
<td>Ad hoc grants</td>
</tr>
</tbody>
</table>
Conditional transfers with conditions on spending impair recipient’s autonomy without furthering grantor’s objectives
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, Morris, Finance Canada, Dafflon, Lotz, Shah, Spahn & Werner*)

  ◆ **Paternal**: Australia (fiscal capacity plus fiscal needs) and Canada (fiscal capacity only)

  ◆ **Solidarity, Fraternal or Robin Hood**: Germany (fiscal capacity)

  ◆ **Mixed**: Switzerland, Sweden, Denmark

◆ **Practices to avoid**: General revenue sharing with multiple factors e.g. practices in Brazil, India and South Africa.
Equalization programs are concerned with inter-jurisdictional equity (horizontal fiscal equity) not with interpersonal equity (vertical equity)

- **Australia**: capacity to provide services at the same standard with same revenue effort and same operational efficiency
- **Canada**: “reasonably comparable levels of public services at reasonably comparable levels of taxation across provinces”
- **Germany**: “to equalize the differences in financial capacity of states”
- **Switzerland**: “to provide minimum acceptable levels of certain public services without much heavier tax burdens in some cantons than others”.
<table>
<thead>
<tr>
<th>Fiscal Equalization Program</th>
<th>Australia</th>
<th>Canada</th>
<th>Germany</th>
<th>Switzerland</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Status</td>
<td>Federal Law</td>
<td>Constitution</td>
<td>Constitution</td>
<td>Constitution</td>
</tr>
<tr>
<td>Paternal or Solidarity</td>
<td>Paternal</td>
<td>Paternal</td>
<td>Solidarity</td>
<td>Mixed</td>
</tr>
<tr>
<td>Total Pool determination</td>
<td>Ad hoc</td>
<td>Formula</td>
<td>Formula</td>
<td>Ad hoc</td>
</tr>
<tr>
<td>Allocation</td>
<td>Formula</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, Actual Revenues</td>
<td>Yes, major macro tax bases</td>
</tr>
<tr>
<td>Fiscal Equalization Program</td>
<td>Australia</td>
<td>Canada</td>
<td>Germany</td>
<td>Switzerland</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-----------</td>
<td>--------</td>
<td>---------</td>
<td>-------------</td>
</tr>
<tr>
<td>Fiscal Need Equalization</td>
<td>Yes</td>
<td>No</td>
<td>No (only pop size and density)</td>
<td>some</td>
</tr>
<tr>
<td>Program Complexity</td>
<td>High</td>
<td>Low</td>
<td>Low</td>
<td>Medium</td>
</tr>
<tr>
<td>Political Consensus</td>
<td>No?</td>
<td>Yes (?)</td>
<td>Yes (?)</td>
<td>Yes</td>
</tr>
<tr>
<td>Who recommends</td>
<td>Independent agency</td>
<td>Intergov. Committees</td>
<td>Solidarity pact II</td>
<td>Federal Government</td>
</tr>
<tr>
<td>Sunset clause</td>
<td>no</td>
<td>Yes (5 years)</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Dispute resolution</td>
<td>Supreme court</td>
<td>Supreme Court</td>
<td>Constitutional court</td>
<td>Supreme court</td>
</tr>
</tbody>
</table>
Fiscal Transfers: Negative Lessons or Practices to Avoid

- General revenue sharing with multiple factors
- Deficit grants
- Fiscal Effort Provisions
- Input or process based or ad hoc grants
- Capital grants without assurance for upkeep
- Negotiated or discretionary transfers
- One size does not fit all
Fiscal Transfers: Positive Lessons or Practices to Strive For

• K.I.S. (keep it simple)
• Focus on single objective
• Introduce sunset clause
• Output based conditional transfers with citizens’ evaluations
• Fiscal capacity equalization to a defined standard
• Political consensus on the standard of equalization
• Institutional arrangements for broad based consultation
Bridging the economic divide within nations: lessons from experience

- Centralized fiscal systems not conducive to reducing regional disparities
- Regional disparities more pronounced in countries with interventionist regional policies
- Subnational political autonomy creates political pressures against inequitable development
- Regional convergence largely attributable to removing distortions in economy
- National minimum standards of public services important for factors, goods and services mobility.
- National minimum standards through output grants, equalization and credit market access.
A race to the bottom

• Internal barriers to mobility
• Regulatory impediments for non-residents
• Degradation of quality of life
• Under-provision of merit goods and social policy fallout
• Wasteful tax and expenditure competition
• Pork barrel politics
Securing an economic union

- Preservation of internal common market through constitutional guarantees
- Tax coordination for taxes on mobile basis
- Setting national minimum standards through conditional block transfers
- Regional fiscal equity through equalization transfers
- Protecting David from Goliath
- Facilitating local access to credit
- Central role in social risk management
- Mitigating adverse consequences of globalization
Fiscal system design issues to deal with commitment problems

Fundamental elements:

• direct democracy
• governing for results (New Public Management Framework)
• home rule
Are there options feasible?

- This is a chapter from the past history of mature federations but is it relevant for the 21st century?
- Globalization and information revolution makes it possible but path dependency makes it infeasible?
- Is there a political will? Absolutely not.
- **Conclusion:** Reform is eternal, we do not always succeed but we must keep trying.