

AUTONOMY OR DEPENDENCE: INTERGOVERNMENTAL FINANCIAL RELATIONS IN ELEVEN COUNTRIES¹

By Ronald Watts

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ABSTRACT

This study compares intergovernmental financial arrangements in eleven countries. Five are mature federations (the United States, Switzerland, Canada, Australia and Germany), four are transitional federations (Brazil, India, South Africa and Spain), and two are mature decentralized unitary political systems (Sweden and Japan). The financial arrangements in these eleven countries are compared in terms of the constitutional and political context; the allocation and scope of federal, state and local expenditures and revenues; the nature, role and scope of intergovernmental transfers; systems of tax harmonization and collection; decision-making processes for intergovernmental

financial relations; recent major reform efforts; and identification of distinctive and unique features. The economic and political performance of these eleven financial arrangements is also assessed in terms of a variety of economic and political criteria.

A. INTRODUCTION

1. Focus and Scope of the report

This study follows an earlier study by Professors Robin Boadway and Ronald Watts on behalf of the Institute of Intergovernmental Relations concerning intergovernmental fiscal relations in Canada, the United States and Germany. This new study is intended to supplement the previous one by providing a comparative overview of intergovernmental fiscal relationships in which a further eight countries are included, thus embracing in all eleven countries.

As originally envisaged the additional eight countries that were selected for this study represented: (a) three developed federations and quasi-federations, Switzerland, Australia and Spain; (b) three developing federations and quasi-federations, India, South Africa and Brazil; and (c) two decentralized unitary systems, Sweden and Japan. In terms of their financial arrangements, however, as the study has progressed, it has proved more useful to group them into three slightly different groupings. First is a group of "*mature federations*". Into this group would fall Switzerland (1848) and Australia (1901), both in operation now for more than a century. The three federations considered in the earlier reports, the United States (1789), Canada (1867) and Germany (1949), would for comparative reference fall into the same category making a total of five mature federations. The second group might be called "*transitional federations*". These federations or quasi-federations share a number of similarities, all being federalized more recently and, with the exception of Spain, representing countries with developing economies. In this group would be India (1950), Spain (1978), Brazil (1988) and South Africa (1996). A third category are the two "*mature unitary systems*", Sweden (1523)

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and Japan (1947), with well developed economies.

In the comparative analysis of these eleven cases, the focus will be on those institutional features that affect the way in which revenue and expenditures are allocated among different levels of government, the role and nature of intergovernmental transfers, the nature and extent of tax harmonization or competition, and other key elements of intergovernmental financial relationships. This review will take account of major recent reform efforts over the past five to ten years and their effects, and any unique features, including the processes through which decisions on these matters are arrived at. The analysis will further explain how each country's institutional features have reflected its particular historical, geographical, cultural, demographic and economic circumstances. The report will conclude with an assessment of the economic and political performance of these examples in terms of eight criteria: economic efficiency, equity, fiscal management and stabilization policy, autonomy of constituent units, coordination and degree of central influence on states and local governments, transparency and accountability, political stability and adaptability, and the relative significance of their institutions and political culture. The issues considered in this report parallel those in the earlier reports on Canada, the United States and Germany in order to facilitate comparisons of this report with those earlier reports.

2. Introductory Overview of the Eight Additional Countries Studied

For an overview of the three mature federations, Canada, the United States and Germany, the reader is referred to the previous reports in this series. Here, in this section an overview of the eight additional countries included in this study is provided.

(a) Mature federations:

(1) Switzerland (1848):

Switzerland is a long-standing developed multicultural federation marked by a substantial degree of fiscal decentralization and cantonal autonomy.

The Swiss Confederation founded in 1291 existed in various forms until it broke down in the brief Sonderbund civil war of 1847. A new constitution in 1848 converted it into a federation. This constitution was substantially revised in 1874 and 1999, but the most recent revision retained the basic character of the federation, taking the form largely of modernizing the language of the constitution rather than substantially modifying its content.

Switzerland is a small country of some 7 million people and now comprises 26 cantons of which 6 are designated as 'half cantons' in terms of their representation in the Council of States (Ständerat) and in terms of their voting power as cantons in constitutional referendums. Despite its small size, the Swiss federation is notable for its degree of linguistic and religious diversity. Its three official languages (German, French and Italian; a fourth, Romansh, is recognized as a 'national' language) and two dominant faiths (Roman Catholic and Protestant) are the major territorial cleavages. But these cleavages cut across each other territorially. Although the German Swiss continue to dominate in overall numbers and economic power, the fact that among German-speaking cantons some are Roman Catholic and some are Protestant and that among French-speaking cantons also some are Roman Catholic and some are Protestant, means that on different issues cantonal representatives adopt different alignments and coalitions. This has moderated any tendency to the cumulative polarization of differences within the federation.

While under the constitutional distribution of legislative powers a significant proportion are assigned to the federal government there is a general emphasis upon decentralized decision-making and cantonal autonomy. Not only do the unlisted residual powers lie with the cantons but the constitution leaves the federal government highly dependent upon the autonomous cantons for the administration of a large portion of its legislation leading in practice to a high degree of decentralization. Indeed in terms of both governmental revenues and of governmental expenditures, Switzerland and Canada are the two most decentralized contemporary

federations in the world. Furthermore, two other factors contribute to the decentralized character of the Swiss federation. One is the high degree of cantonal consultation that the federal government is required to undertake due both to constitutional requirements and to political tradition. The second is that all federal legislation is subject to check by a referendum if a specified number of citizens petition for it.

Switzerland has had since 1959 a system of equalization transfers to moderate the financial disparities among the cantons. In recent years these have been the source of some controversy leading to the consideration of substantial reforms to the system.

The principle of the separation of powers with fixed-term collegial executive councils has been applied to both levels of government. The Federal Council is a collegial executive body elected by the Swiss federal legislature for a fixed term and composed of seven councilors among whom the Presidency rotates annually. The federal legislature is bicameral composed of the National Council (Nationalrat) and Council of States (Ständerat) with equal powers. In the latter the twenty full cantons have two representatives each and the six half cantons have one each. The electoral system based on proportional representation has resulted in a multiparty system, but the fixed-term executive has provided stability, and the tradition has developed that it should encompass the four major political parties representing an overwhelming majority in the federal legislature. The predominant characteristics of the Swiss political processes have been emphasis upon consultation with all groups, respect for minorities, and decisions based upon compromise and consensus. These processes characteristically have required lengthy deliberations but have received widespread acceptance of decisions once arrived at.

(2) Australia (1901):

Australia is a long-standing developed federation with parliamentary institutions. It has been marked by a considerable emphasis upon uniformity and inter-state equity in its financial equalization arrangements.

The Australian federal constitution of 1901 united a group of self-governing British colonies on the continent. Today, the federation comprises six states (of which the two most populous, New South Wales and Victoria, comprise some 60 percent of the total federal population) plus one capital territory, the vast Northern Territory, and seven small administered territories.

By contrast with Switzerland, Australia has a relatively homogeneous society with a population of about 19 million people mostly descended from British and European settlers. However, the geographic vastness of the continent and the concentrations of population in dispersed state capitals, each serving its own hinterland, have made federation a natural form of political organization.

The founders of the Australian federation rejected the Canadian model which they regarded as having a relatively centralized distribution of powers, and followed instead the American model of enumerating a limited list of federal exclusive powers and a substantial list of concurrent powers, leaving the substantial unspecified residual powers to the state governments. In practice, however, the Australian federation has over time evolved into a relatively more centralized federation, particularly with respect to its financial arrangements. A notably significant feature has been the strong revenue position of the federal government, reinforced by some major High Court rulings. Indeed, the federal government controls about three-quarters of the total federal-state-local revenues. Since the states and local governments are constitutionally responsible for nearly half the total public expenditures, this has required a system of very substantial transfers from the federal to the state governments to close the vertical financial gap. Given a political culture emphasizing uniformity and inter-state equity, Australia since 1933 has been a pioneer among federations in developing formal equalization arrangements. In many respects it has been the model that has most influenced the equalization arrangements adopted in subsequent federations in the developing world. A key institution in the evolution of equalization

arrangements since 1933 has been the Commonwealth Grants Commission.

While adopting a different form of distribution of legislative powers, the Australian federation did follow the Canadian precedent of combining federal with British parliamentary institutions (with cabinets responsible to the legislatures at both federal and state levels). At the same time, unlike Canada, the Australians incorporated a relatively powerful directly elected Senate with equal representation of the states. The impact of the parliamentary system has, however, made the Senate in practice more of a 'party house' than a regional 'state house'. The parliamentary institutions which in practice has led to cabinet dominance within each government have also affected the character of intergovernmental relations with the result that Australia has developed the institutions and processes of 'executive federalism' extensively.

(b) Transitional federations:

(3) India (1950):

The Union of India is a developing country that contains a highly diverse society. The Union has been held together for over half a century within what began as a highly centralized quasi-federation under the constitution of 1950, but which has since then been progressively decentralizing. Today the federation comprises 28 States, 6 Union Territories and one National Capital Territory with a total population of over one billion people.

India is a diverse multilingual society. Hindi, is spoken by some 40 percent of the population but there are some 18 other regional languages recognized as official by the constitution. Between 1956 and 1966 the states were reorganized largely on an ethno-linguistic basis. Since that time there have further adjustments to the boundaries of the constituent units with three new states being created as recently as 2000.

While the founders sought to create a centralized federation to hold this diversity together, the ethno-linguistic basis of many of the states and the powerful forces of regionalism within the India sub-continent have led in

practice to a federation that is only partially centralized and is composed of powerful states. The constitution provides for three exhaustive lists of legislative powers – exclusive federal, exclusive provincial, and concurrent (with federal paramountcy) powers – and for residual powers assigned to the Union government. The major taxing powers are assigned to the Union government, but there is constitutional provision for the sharing of the proceeds of these. Adjustments to these largely unconditional transfers are made on the basis of recommendations from quinquennial Finance Commissions provided for in the constitution. These transfers also include an equalization element.

Formally, the Union government possesses very substantial powers, especially powers of intervention and preemption in emergencies, but it now functions within an ethno-political and multi-party context that requires that those powers be used to preserve federalism in form and spirit. Increasingly, power-sharing as a way of reconciling conflict and the operation of coalition governments encompassing a variety of regional parties at the Union level have come to predominate, despite some imperfections in the process.

The institutions of the Union and state governments are parliamentary in form with the principle of responsible government operating at both levels. The formal head of state is a President elected by an electoral college consisting of the elected members of both houses of parliament and the state legislatures. The formal heads of the states, the governors are appointed by the Union government. But it is the Prime Minister and the Chief Ministers of the States who dominate the political processes.

(4) Spain (1978):

Spain is a developed country which relatively recently adopted a quasi-federal structure. It has been marked by considerable asymmetry in the powers and financial arrangements for its 17 Autonomous Communities.

After some forty years of totalitarian centralization, in 1978 Spain adopted a new constitution establishing a parliamentary democracy. As part of the post-Franco democratization and as a means of balancing powerful regional interests fostered by revived Basque and Catalan nationalism, Spain has pursued a process of regionalization. This led to the development of units called 'Autonomous Communities' of which there are 17 in a country of nearly 40 million.

Although historically a strongly centralized unitary state, Spain has in fact contained considerable diversity. While the political culture of the Castilians has tended to be hierarchical and centralistic, the Argonese, Basques, Catalonians, Galicians, Navarrese and Valencians have each had a strong interest in securing their own cultural identity.

The Spanish response to this situation was the adoption of a constitution in 1978, which although not officially labeled as federal, in fact has virtually all the characteristics normally associated with federation. At the very least it may be called "quasi-federal". Furthermore since its adoption there has been a progressive grant to each region of its own arrangements for autonomy based upon a particular set of compromises negotiated between its regional leadership and the central government. More recently, however, the Madrid government has emphasized that although the different regions are progressing to autonomy at different speeds, ultimately they should become less asymmetrical. As a result of this process since the adoption of the constitution, Spain has moved to a degree of decentralization comparable to those found in developed federations elsewhere. This has, however, been derived less from a constitutional mandate than from party strategies, competition and bargaining within a loose institutional framework.

In practice, the result has been that in the distribution of powers and related financial arrangements there are three groups of Autonomous Communities. The first has been the '*fueros*' (foral) communities, the Basque

Country and Navarra which retain historically significant residual powers and which, unlike the other Communities, have also retained (under the Constitution Additional Provision No. 1) historic tax raising and collecting powers from which a portion is ceded to the central government. Despite this relatively high level of autonomy by Spanish standards, the Basque country has continued to be plagued by relatively intense independist terrorist violence. The other 15 Communities have only limited taxing powers and depend heavily on transfers in the other direction from the central government. This group itself falls broadly into two sub-groups differentiated according to their level of responsibilities. The first, the 'fast track' group (Article 151) Communities including Andalusia, The Canary Islands, Catalonia, Galicia and Valencia, have a high level of responsibilities, including major responsibilities for education and health, and therefore receive a substantially higher level of transfers. The second, the 'slower track' (Article 143) Communities with fewer devolved powers receive substantially less. Nevertheless, as the latter group over time assume greater responsibilities the gap is narrowing. There is also an Inter-Regional Compensation Fund that redistributes funds among regions according to criteria such as population density, relative income, level of unemployment, level of integration, population dispersal and insularity.

The central government is a parliamentary monarchy with the Council of Ministers responsible to the Congress of Deputies, the lower house in the bicameral Cortes. The Senate, the second chamber, consists mainly of directly elected members, but 51 of its 259 members are appointed by the regional legislatures.

The relations between the governments at the national and community level and the degree of asymmetry among the Autonomous Communities continues to undergo a fairly rapid evolution.

(5) Brazil, 1988:

Brazil is a developing Latin America country which during the 19th and 20th centuries alternated between federal and autocratic

regimes. This culminated in a decade of political and fiscal decentralization in the 1970s and 1980s, and a new federal constitution in 1988. In area the fifth largest country in the world, and with a population of more than 170 million inhabitants, the federation encompasses 26 states plus the Federal District of Brasilia. The constitution also provides rules for the management of the over 5,500 autonomous municipalities.

From linguistic, ethnic and cultural standpoints Brazil is relatively homogenous, but its 27 constituent units are marked by great disparities in the distribution of land, population and wealth. Brazil has historically been characterized by major social economic disparities and its pattern of intergovernmental relations, even before the instituting of the federal constitution, had evolved through alternating phases of centralization and decentralization to address these issues. The primary driving force behind the pressure for decentralization during the 1970s and 1980s was the demand from the sub-national governments and provincial elites for a larger share of fiscal revenues.

The 1988 constitution contains detailed provisions about the political, administrative and fiscal organization of the federation. The constitution provides the states with the residuary power and defines areas of concurrent jurisdiction including among others education, health, social assistance and environmental protection. However, the detailed and extensive definition of the federal constitutional powers and its active use of its paramountcy powers in the areas of concurrent jurisdiction, has provided only limited opportunity for the sub-national governments to exercise their legislative powers without federal consent. On the other hand, administrative responsibilities are substantially more decentralized. Sub-national governments (states and municipalities) account for 36 percent of total governmental expenditures (Table 2). With this decentralization has gone a strengthening under the 1988 constitution of the tax bases of the state and municipal governments with the result that own-revenues of the states and local governments account for 70 percent of

their total revenues. This means that the levels of vertical fiscal imbalance are lower than in most federations. Nevertheless, there is a measure of federal transfers, three-fifths of which are unconditional. There is, however, little equalization to correct horizontal imbalances. These financial arrangements have produced two major characteristics: first, intense fiscal competition and a war of tax incentives among most of the states seeking large-scale industrial investment, and second, the continued persistence of sharp disparities of wealth among the states.

The federal institutions have been significantly influenced by the model of the United States with a presidential and bicameral congressional system.

(6) South Africa (1996):

South Africa is a developing country which after the ending of the apartheid regime adopted in 1996 a quasi-federal structure emphasizing three 'spheres of government' – national, provincial and local – within a relatively centralized overall legislative and financial framework.

South Africa has a population of 44 million people of whom 75.2 percent are black, 13.6 percent (composed of Afrikaaners and English-speaking people) are white, 8.6 percent are coloured and 2.6 percent are Indian. But among the black population a variety of languages are spoken leading to the recognition of 11 official languages in the 1996 constitution. Under the constitution nine provinces were established, but unlike most federations with deeply divided societies, these do not coincide with racial or tribal boundaries. This was done in order to avoid emphasizing these divisions.

Federalism has had a highly contested reception in South Africa because apartheid had been justified in part on a federalist rationale. Consequently, the 1996 constitution carefully avoids the label 'federal,' but its characteristics are in fact essentially those of a federation. It may, therefore, appropriately be described as at least 'quasi-federal'. The constitution recognizes not only 'provinces' but 'local governments' as

distinct 'spheres', but consciously rejects the use of the term 'level'. While the constitution formally sets out a substantial area of concurrent jurisdiction and a short list of exclusive provincial powers, the division of powers heavily favours the national government both in the powers assigned to it and in its ability to over-ride the provinces in certain circumstances. The national government is given the power to set national standards and norms and to over-ride provincial standards which may threaten national unity or objectives. The provinces enjoy limited revenue-raising and borrowing powers, and therefore are highly dependent upon transfers from the national government. The constitution does provide for a Finance and Fiscal Commission to make recommendations on these transfers to provide the provinces and local governments with an 'equitable share' of revenues raised nationally. Among the criteria the Commission considers is the need to overcome income inequalities within and among the provinces.

The constitution (chapter 3) emphasizes the principle of 'cooperative government' requiring all spheres of government to exhaust "every reasonable effort to resolve any disputes through intergovernmental negotiation" (s. 41 (3)) and to exhaust all other remedies before approaching a court to resolve a dispute. Nevertheless, there is a Constitutional Court to serve as an ultimate arbiter. In practice, the predominance of the African National Congress (A.N. C.) both in the national government and in all but two provinces has provided the means for coordination through party channels, and indeed for dominance by the central government.

The institutions in the national and provincial spheres, are predominantly parliamentary, although at the national level there is a President who acts both as head of government and head of state. There is a bicameral parliament with a second chamber, the National Council of Provinces, which is composed of representatives both from the provincial legislatures and executives. Its intended function was to ensure that provincial interests are not seriously abrogated by the

central government. In practice, however, its effectiveness in that role has been limited.

(c) *Mature unitary political systems:*

(7) Sweden (current constitution 1975):

Sweden became independent in 1523 and exemplifies a long-standing developed country with a unitary form of government. However, it is characterized by a high degree of decentralization of welfare services and financial arrangements among its 289 municipal governments and 21 counties. It has a population of about 9 million and its population is relatively homogeneous.

Among unitary political systems, Sweden is marked by a particularly high degree of decentralization. Indeed, in terms of expenditures after transfers the Swedish central government at 54 percent spends less of total combined expenditures than the federations and quasi-federations in the United States, Spain, Austria and Malaysia and about the same proportion as the federations of Australia and India (Table 1). Local governments in Sweden – municipalities and county councils – are assigned all services to the citizens: primary and secondary schools, hospitals, health services, care for the elderly and social assistance. Only police, higher education and the national schemes of old age pension and unemployment benefits remain at the central level. The Swedish intergovernmental fiscal arrangements are sophisticated and have been built on a system of local government that has been in place for over one hundred years. The primary sources of revenue for local government in Sweden are taxes (about two-thirds of the total), grants from the central government (about one-fifth) and user fees (7 percent). There is no property tax. Instead, the primary tax at the local level is a tax on personal income. Local governments set their own tax rates. Municipal and county councils thus enjoy a considerable freedom in deciding on their delivery of services, the financing of these, and their own internal organization. Imbalances between regions are corrected by a system of transfers which are collected and distributed by the central government: municipalities and county councils whose per capita taxable income level is below the national average receive a

grant while those above the average taxable income pay a fee. In addition the local governments receive a block grant from the central government, containing a population-related and age-related portion. Although levying of income tax is highly decentralized, the collection of these taxes on their behalf by the National Tax Administration, and the definition of tax bases by central law has contributed to tax harmonization.

In terms of the organization of central politics, Sweden is a parliamentary democracy with a constitutional monarchy. Although unitary, the constitution establishes the principles of local government. The 1991 *Local Government Act* defined the roles of municipalities, county councils and regions and provided extensive scope for local inhabitants to monitor and influence the local decision-making process. Every municipality and county has a council whose members are elected every four years on the same day as the parliamentary elections.

Among unitary political systems generally, the Nordic countries, of which Sweden is a good example, are unique in the level of autonomy allocated to local governments both for the provision of many public services and for their taxation authority.

(8) Japan (1947):

Japan is a unitary country with one of the most homogeneous populations of any country in the world, but with a considerable administrative and financial decentralization for its 47 prefectures. The population of some 127 million people is concentrated in a relatively small land mass living mostly in four main islands and 4000 smaller islands, but 80 percent of the population and 85 percent of the economic activity is concentrated in the island of Honshu.

The current constitution of Japan was in effect written and imposed by the United States after World War II, coming into effect in 1947. The constitution does make specific provision for local government and the governors of the prefectures are elected. In relation to the 47

prefectures and some 3,250 local governments within them, the Japanese central government is more powerful than would be the case in most federal systems, and this power has been reinforced by making the lower government levels financially dependent on the centre. Nevertheless, not unlike Sweden, local governments in Japan are responsible for a major share of public spending. Their responsibilities include national land conservation and development expenditure, education expenditure, police and fire brigades, social welfare, sanitation and general administration amounting in 2001 to 62 percent of combined total public expenditures. But, unlike Sweden, the ultimate control of the central government is ensured by a provision in the *Local Autonomy Law* (article 150) that states that the chief executives of the local authority act as agents of the central government to deliver prescribed functions, and makes provision for *mandamus* proceedings allowing the central government to direct local governments to carry out certain activities.

Furthermore, the dominance of the central government is reinforced by the centralization of finances. The constitution establishes the Diet's control over the imposing of taxes and the expenditure of funds. In the Japanese fiscal system, while the majority of expenditures are done at the local level, only a very limited autonomy is available to local governments in their spending decisions, and on the revenue side decentralization is limited and the authority of tax base and rate determination lies with the central government. Because local government expenditures constitute approximately 62 percent of all government expenditures but local tax revenue constitutes only about 42 percent of all government revenues (Table 2), the central government through its transfers plays an important role in helping local governments meet their budgetary needs. As a result transfers form a much higher proportion of local government revenues than in Sweden. Moreover, about two-fifths of these take the form of conditional or specific purpose grants which further limits the autonomy of prefectures and local governments. There is an equalization component in the allocation of the unconditional

transfers which are distributed according to a uniform formula based on basic financial need and basic financial capacity.

Under the 1947 constitution, the Emperor of Japan serves as the “symbol of state” but has no formal governmental power. Effective national executive power lies with the Prime Minister and cabinet who depend on the confidence of the House of Representatives to remain in power. The national Diet is bicameral. The second chamber is the House of Councillors elected on the basis of open list proportional representation from prefectural electoral districts. However, the House of Representatives takes precedence over it. Local authorities have elected assemblies and elected chief executive officers. For most of the period since 1947 (the main exception being 1993-6) the dominant party in the national Diet and government has been the Liberal Democratic Party and the political struggles have been as much between different factions within that party as between parties.

B. A COMPARATIVE REVIEW OF SIGNIFICANT FEATURES OF THE FINANCIAL ARRANGEMENTS IN THE ELEVEN COUNTRIES

1. The Context for Intergovernmental Financial Relations

(i) *Significant historical geographic, cultural, demographic, and economic features affecting financial arrangements:*

Underlying the political and constitutional context for intergovernmental financial arrangements in federal, quasi-federal and decentralized unitary political systems are the similarities and differences in the character of their societies. The historical background is significant, for instance. The longevity of the mature federations such as the United States (1789), Switzerland (1848), Canada (1867), Australia (1901) and Germany (1949) means that these federations have had the opportunity to develop over more than half a century and in four of these over a century, experience in the handling of intergovernmental financial relations and to evolve and modify these in the light of that experience. The same could be said of the mature decentralized unitary systems, Sweden

and Japan. On the other hand, among the transitional federations, only India has had a half century of experience and the other three, Spain (1978), Brazil (1988), and South Africa (1996) have had their current constitutional and financial arrangements in place for only three decades or less. This has enabled some innovations, but the pattern is less settled. Furthermore, in most of them, concern about the fragility of the federal union has led (with the exception of Brazil) at least initially to a greater concentration of powers and finances in the central governments (see for instance Table 1 at end of this report).

Geography has also had a significant impact. Most of the federations considered in this and the previous studies have been extensive in territory or population. The only significant exception among these federations is Switzerland, with a population of only seven million people, but the mountainous topography of Switzerland has divided these people by distributing them in pockets in their distinct valleys. Sweden and Japan are geographically more compact than most of the federations and in both their populations are relatively concentrated in a few urban centres rather than dispersed.

Cultural and demographic factors have also been significant. Japan has one of the most homogeneous populations in the world due to an absolute prohibition on immigration,² and Sweden, while less so, in comparative terms also has a relatively homogeneous population. The federations both mature and transitional are generally marked by considerably more internal cultural diversity. Some such as the United States, Germany, Australia and Brazil are fundamentally mono-national in having a dominant national group, but nevertheless contain considerable cultural diversity as a result of extensive immigration. Others such as Switzerland, Canada, India, Spain and South Africa are marked by much sharper linguistic, religious and racial differences in their

² Richard L. Carson, *Comparative Economic Systems, Volume 2; Transition and Capitalist Alternatives*, 2nd ed. (New York: M.E. Sharpe, 1998), pp. 133.

composition and could even be described as multi-national federations. In the case of the first three this has led to considerably more decentralization of constitutional and financial powers, whereas in the two more recent examples, Spain and South Africa, fears of disunity have produced considerable resistance to decentralist pressures and a tendency to insist on retaining strong central powers.

The economic character has also been a significant factor. The existence of different regional economies, especially in countries with continental scope, has helped to reinforce federalization in many instances. Where the market economy has been prevalent this has also contributed to this trend, although in those more recent federations where the emphasis upon economic planning has been strong, as in the early years in India and South Africa, this has led to a much greater emphasis upon providing the central government as the primary planning body with strong financial powers.

(ii) The Constitutional and Political Context:

(a) Features shared in common among the federations:

Six of the countries examined in this study are federations or quasi-federations that share certain features in common with the three federations studied in the previous reports. All nine incorporate the major characteristics of a federation: the establishment of two or more orders of government each acting directly on citizens, rather than indirectly through another sphere of government; a formal constitutional distribution of areas of exclusive and shared (concurrent) legislative and executive authority ensuring at least some areas of genuine constitutional autonomy for each government; a constitutional allocation of revenue resources for each order of government; provision for the designated representation of distinct regional units within the federal policy-making institutions, including usually a federal second legislative chamber designed specifically for this among its functions; a supreme written constitution not unilaterally amendable by either order of government but requiring the assent of the federal legislature and of a significant proportion of the constituent units through their

legislatures, representatives of their governments, or by referendums; an umpire in the form of a Supreme Court or a Constitutional Court to rule on constitutional disputes between governments; and processes and institutions to facilitate intergovernmental collaboration for these areas where governmental responsibilities are shared or inevitably overlap.

Among the common constitutional and political features shared by these mature and transitional federations are number which particularly have an impact on the financial arrangements. First, is the constitutional distribution of expenditure responsibilities and revenue sources. In each case the distribution of legislative and executive authority defined in the constitution has established the scope of expenditure responsibilities that each government in response to political circumstances may undertake. At the same time, in all five mature and four transitional federations, the constitution has also defined for each order of government their financial resources from taxation, borrowing, commercial activities or intergovernmental transfers. In all these federations, either explicitly or implicitly, there is also provision of a "federal spending power," unlimited in certain cases but with limits in others, enabling the federal government to spend its money through transfers on areas of responsibility that normally fall within state jurisdiction.³

Second, although the degree of intergovernmental interdependence varies in the nine federations, common to all is the inevitable existence of some degree of interdependence arising from areas of shared jurisdiction or overlaps in jurisdiction. This interdependence has had important implications for the intergovernmental financial arrangements. For instance, issues of harmonization of taxes and their collection arise. In addition attention has had to be directed in each of them to the correction of vertical (federal-state-local) and horizontal (state-state) imbalances where the

³ Throughout this report, the generic term "states" has been used to cover also "provinces," "cantons" and "autonomous communities."

expenditure responsibilities of each government are not matched by its constitutionally allocated revenue resources. These arise for two reasons. First they arise because in all nine federations there has been a tendency for the major taxing fields to be assigned constitutionally to the federal governments because these taxes are important instruments for affecting and regulating the economy and for performing a redistributive role. Second, there has been a general tendency to assign constitutionally to the states more substantial expenditure responsibilities in the interest of more effective administrative decentralization or to meet political pressures from the states seeking to maintain their distinctiveness. Indeed, in all nine federations provision has had to be made, either constitutionally mandated as in Switzerland, Germany, India, Brazil and South Africa, or by governmental action as in the United States, Canada, Australia, and Spain, for financial transfers from the federal government to the state governments to correct these imbalances. The scope and form of these transfers has varied and will be analysed later in this report.

Third, in virtually all these federations there have been political pressures for state consultation and participation in federal decisions about financial arrangements and transfers. These pressures have arisen because no matter how carefully the original designers of the federation have attempted to match the revenue resources and expenditure responsibilities to each other, over time the significance of different taxes has changed and the costs and scope of expenditure responsibilities have varied in unforeseen ways. Consequently, all these federations have found the need to make adjustments from time to time. This has invariably raised the issue of the appropriate processes and institutions for making these adjustments and the concerns in each federation of the state governments that their autonomy should not be undermined by unilateral federal government action. The actual form and character of the manner in which such issues have been negotiated or dealt with in these federations has varied considerably, however, as will be noted later in this report.

Fourth, common to all nine federations has been the supremacy of the constitution and the role of the courts and the rule of law as the basic context within which the federal financial arrangements have operated. Although invariably the taxing, borrowing and other revenue raising authority of the various governments have been constitutionally specified (either explicitly or through the assigned residual authority), in some cases, most notably in the United States, Canada, Australia, and Spain, only the major expenditure and revenue responsibilities are constitutionally allocated, and much of the arrangements for intergovernmental financial transfers has been left to governmental practice. In other cases such as Switzerland, Germany, India, Brazil and South Africa, the constitution goes into considerable detail about the arrangements for shared tax proceeds and for transfers between governments. But in all nine federations it is the constitution that provides the ultimate framework within which the intergovernmental financial arrangements operate and are adjusted, and in ensuring this, the courts and the principle of the rule of law have been crucial elements in providing the basic framework.

(b) Significant Differences Among Federations in the Constitutional and Political Context.

While as noted above the three federations reported on previously and the six mature and transitional federations being analysed in this report have broad similarities in sharing the fundamental characteristics of federal systems and hence in the issues of federal finance that they have faced, there have at the same time been significant variations among them in their political and constitutional contexts.

First, there is the distinction between “federations” and “quasi-federations.”⁴ The former terminology refers to those political systems which have all the characteristics normally associated with the definition of a federation. “Quasi-federations” refers to political

⁴ R.L. Watts *Comparing Federal Systems*, 2nd ed. (Montreal and Kingston: McGill-Queen’s University Press, 1999), pp. 7-14.

systems which are predominantly federations in their constitutions and operation, but which may have some overriding federal government powers more typical of a unitary system. Such hybrids occur because statesmen are often more interested in pragmatic political solutions than in theoretical purity. The five mature federations, the United States, Canada and Germany considered in the previous reports and Switzerland and Australia in this all now belong in the former category. In the case of Canada, its original constitution contained some quasi-federal features,⁵ but these have fallen into disuse in the past half-century, and so the operation of the federation is now fully federal in practice.

Among the four transitional federations, however, quasi-federal features have been notable. Indeed three of them, India, Spain and South Africa, while predominantly federal in their institutional character, have avoided describing themselves in their constitutions as federal. The Indian constitution (1950) describes the polity as a “Union of States” and includes a set of emergency powers⁶ enabling the Union government in emergencies to completely override the state governments, and the use of these powers has not been infrequent. However, the tendency to invoke them has more recently been declining. Spain too, to emphasize its devolutionary and indissoluble character avoids the label “federation” in its constitution, the central government retains extensive powers, and the constitutional provisions for the devolution of powers to the Autonomous Community emphasize that this delegation in no way implies a ceding of central sovereignty. However, it has most of the institutional features that mark a federation. In South Africa, because the previous apartheid had been justified in part on a federalist rationale and because of fears that federalization would restrict the central government’s capacity to implement and consolidate the processes of democratic reform

⁵ For example the federal powers of reservation and disallowance of provincial legislation and the federal declaratory power (Constitution Act 1867, sections 90 and 92(10)).

⁶ Constitution of India (1950), articles 250, 352-360.

and reconstruction, the “federal” terminology was avoided in the new 1996 constitution. Analysis of its institutions, however, indicates that in character it is essentially federal, although relatively centralized and including central legislative powers to override provincial legislation under specified conditions, a clearly quasi-federal feature.⁷ In these three transitional quasi-federations, the constitutional emphasis was upon giving their central governments sufficient power to preserve the federation against dissolution during the transitional period. A corollary of this has been that in their financial arrangements, revenue raising powers were correspondingly concentrated in the central government even though expenditure responsibilities were more considerably devolved.

Among the transitional federations Brazil provides a contrast. The 1988 constitution expressly defines Brazil as the “Federative Republic of Brazil,” and although the definition of central constitutional powers is detailed and extensive,⁸ there is no provision for central powers to override state legislation. In these circumstances, the institutional arrangements and current government practices of Brazilian fiscal federalism are complex but are characterized by a great deal of sub-national government autonomy.

Variations in a number of other features in the political and constitutional context of these federations and quasi-federations have had implications for their intergovernmental financial arrangements.

(1) The number and character of the constituent units. There is a considerable range. The United States has 50 states (plus 2 federacies, 3 local home rule territories, 3 unincorporated territories, and 130 Native American dependent nations), India 28 states and 7 territories, Brazil 26 states and one federal capital district, Switzerland 26 relatively small

⁷ The Constitution of the Republic of South Africa 1996, section 146(2) and (3).

⁸ This is discussed further later. See for instance Table 1.

cantons, Spain 17 Autonomous Communities, Germany 16 Laender, Canada 10 provinces and 3 territories, South Africa 9 provinces and Australia 6 states (plus 1 territory, 1 capital territory and 7 administered territories). This means that the average scale of operation at the state level in federations varies enormously (as well as varying within each federation) and this affects their capacity to undertake not only legislative and administrative responsibilities but also to take on fiscal and expenditure responsibilities. To emphasize the point, California in terms of wealth would rank in terms of GDP among the top ten independent countries within the world. Uttar Pradesh the largest Indian state has a population over 140 millions. By contrast, Appenzel-Inner Rhodes, the smallest Swiss canton has a population of only 14,000. Furthermore, the degree of variation in size of states within a federation which ranges from a ratio of 343:1 in India to 13:1 in Australia has implications for the horizontal fiscal imbalances likely to result.

(2) Differences in the constitutional status of local governments. The constitutional status of local government as a third order of government, distinct from the federal and state orders, has varied in these federations and this has had an impact upon the financial arrangements affecting local governments. In three of the mature federations, the United States, Canada and Australia, local governments have not been formally recognized in the constitution as a separate order of government, local governments being placed in each as subordinate units under the jurisdiction of state and provincial governments. In the cases of Switzerland and Germany their constitutions make explicit references to local government as a third order. In the former the autonomy of the Municipalities is “guaranteed within the limits fixed by cantonal law,” and the financial provisions in the constitution recognize their existence. In the latter the guarantee of local self-government extends to “the bases of financial autonomy.”⁹ Among the transitional federations and quasi-

⁹ The Federal Constitution of the Swiss Confederation, 1999, arts. 50, 128 and 129; Basic Law for the Federal Republic of Germany art.28.

federations, local government is recognized as a distinct order of government in the Indian, Brazilian and South African constitutions with quite detailed provisions.¹⁰ In all three cases transfers from the central government are a major source of local finances. The Spanish constitution also formally recognizes local governments, in this case involving two tiers, some 50 provinces and over 8000 municipalities, both pre-existing the creation of the 17 Autonomous Communities.¹¹ Although the constitution declares that these provinces and communities within the Autonomous Communities “shall enjoy self-government for the management of their respective interests,” unlike the three other transitional federations there is little detail in the constitution about them. It was left to a central government law in 1985 to reorganize and democratize local administration. This law sets out the jurisdiction of local governments may delegate additional powers to the municipalities. Because of the degree of authority that has been devolved by the central government to the Autonomous Communities, local institutions tend to be politically dependent on these Autonomous Communities, but they remain to a large extent financially dependent upon the central government.

(3) Differences in constitutional allocation of expenditure and revenue responsibilities. All the federations and quasi-federations have a formal constitutional distribution of the legislative and executive authority to the different levels of government. These in effect define the expenditure responsibilities and revenue raising powers of each order of government. But there is considerable variation among federations in the form and scope of this constitutional distribution, thus leading to considerable differences in the allocation of expenditure and revenue functions. The three

¹⁰ Constitution of India, 73rd and 74th Amendment Acts 1992, inserting Part IX (arts. 243-243,0) and Part IXA (arts. 243, P-243, 2g); Constitution of Brazil 1988, art. 29; Constitution of South Africa 1996, chapter 7 (arts. 151-64) and Schedule 4 Part B.

¹¹ Constitution of Spain, 1978, art. 137.

federations considered in the earlier reports exhibited three different patterns.

In the United States the constitution identified a very limited list of exclusive powers, a considerable list of areas of shared (concurrent) jurisdiction where federal law prevailed over state law in cases of conflict, and a substantial number of residual authority where exclusive jurisdiction remained with the states. Canada adopted in effect a three-list approach: the constitution listed specifically areas of exclusive federal jurisdiction, concurrent jurisdiction with federal paramountcy in most cases, and a list of exclusive provincial powers, with the remaining limited areas of residual jurisdiction being assigned to the central government.¹² Germany broadly followed the United States pattern of identifying exclusive federal and concurrent legislative lists with residual power to the states, but transformed the arrangement by making the two lists much more extensive and the scope of residual state authority therefore very much more limited, and by assigning to the states administrative responsibility for all federal legislation in the concurrent domain.

These three examples have each influenced the arrangements in the additional six federations and quasi-federations considered in this study. The United States model has been influential in Australia, Switzerland and Brazil although with considerable modification in the latter two. Australia followed the American model quite closely. In Switzerland, this basic form came to be substantially modified over time such that in the new 1999 constitution there are extensive constitutional provisions defining what aspects in each specific functional area should be performed exclusively by the federal government, exclusively by the cantons, or shared.¹³ Thus, in explicitly defining the scope not only of federal but of cantonal jurisdiction it has come functionally to operate more like the

Canadian allocation of powers, except that the areas of explicitly shared jurisdiction are more extensive. Brazil ostensibly followed the United States model except that the definition of exclusive federal and of concurrent jurisdiction spelled out is more extensive and in much more detail (articles 20-24) shrinking the areas of residual exclusive state jurisdiction. Several powers that should be exercised in common by the central, state and municipal governments are identified (article 23), and detailed rules for the management of the over 5500 municipalities are included (article 29). The taxing powers and financial arrangements for states and municipalities are also explicitly set out (articles 153-59).

Two federations, India and South Africa followed more closely the Canadian model of identifying three extensive lists of jurisdiction with the remaining residual authority being assigned to the central government. They have differed from the Canadian model in three respects, however. First, in both the area of concurrent jurisdiction is much more extensive. Second, following the German model, most federal legislation in the area of concurrent jurisdiction is administered by the states or provinces thus differentiating greater administrative decentralization from the legislative decentralization. Third (as noted above) both recognize constitutionally the specific powers of the local governments. It is worth noting that this general pattern has emerged more often in the devolutionary creation of federations, whereas the United States model has been followed more often where federations have been created by aggregating previously independent units. But while the American model of broad residual authority appears to emphasize the retained powers of the states, it should be noted that in practice, particularly in the evolution of federations such as the United States and Australia, because the state powers are not enumerated in the constitution the courts have tended to interpret the “implied” federal powers broadly at the expense of the states. By contrast, in those instances where exclusive state powers have been explicitly listed, as in the Canadian and Indian cases, these have provided the courts

¹² In one area of concurrent jurisdiction provincial law prevails over federal law: old age pensions (Constitution Act 1867 as amended by the Constitution Act 1964).

¹³ Constitution of Switzerland 1999, arts. 42-135.

with a counterbalancing ground for protecting state powers. Thus, over time, the United States and Australia which when originally established were more decentralized than Canada and India, have evolved now to become more centralized than the latter pair. The impact of these different arrangements upon financial relationships is illustrated in a later section in the discussion of expenditures and revenues in these federations (see Table 1).

The pattern of the distribution of legislative and executive authority in Spain also involves the definition of exclusive federal, exclusive Autonomous Community powers and shared powers, with residual authority remaining with the central government. But the pattern in Spain has some unique aspects influenced by its progressively devolutionary character and by the asymmetrical paths for this devolution provided in the Constitution.¹⁴ Accession to autonomy has been regarded as a voluntary right and the constitution identifies three paths by which a territory can acquire autonomy. The constitution specifies some exclusive powers of the Autonomous Communities (art. 148) and the extensive exclusive powers of the central government (art. 149), but mechanisms have been provided (art. 150) for the delegation of some exclusive central governments powers and the transfer of financial resources to fund these powers.

While Spain carries asymmetry among its constituent units further than any other federation in this study, some degree of asymmetry should be noted in at least two other cases considered in this report. In Canada and India there have been some elements of asymmetry in the allocation of powers to the states, and these have had implications for the financial arrangements.¹⁵

¹⁴ Constitution of Spain 1978, arts. 137, 143, 151; Additional Provision No. 1 and Transitory Provision No. 2.

¹⁵ R.L. Watts, "Asymmetrical decentralization: functional or dysfunctional," Ottawa: Forum of Federations, 2000, www.forumfed.org.

(4) State inputs to federal decisions. As in the three federations previously reported upon, there have been strong political pressures for state consultation and participation in federal decisions about financial arrangements and transfers in the additional six federations and quasi-federations considered in this report. This has occurred because no matter how carefully the designers of the federation have attempted to match the revenue resources with expenditure responsibilities, over time the costs and scope of expenditure responsibilities and the significance of different taxes have varied in unforeseen ways. Consequently, all these federations, even the relatively new ones have had to develop appropriate processes and institutions for making these changes, taking account of the concerns of state governments that the decisions should not be taken simply unilaterally by the federal government but should involve the participation of state governments. The actual way such adjustments have been handled has taken two broad patterns. Following Australia's pioneering efforts, India and South Africa have also established independent commissions to recommend adjustments in the allocation of tax shares and transfers both between federal and state governments and among the states. In the three other federations federal-state negotiations have become a regular feature, assisted from time to time by advice from ad hoc commissions. These processes are discussed more fully below.

(5) Differences in political dynamics. Differences in the form of the central institutions in each federation have affected the political dynamics in the making of financial policies at the federal level. The United States presidential-congressional institutions with the separation of executive and legislative powers and the checks and balances between them has been followed only in Brazil. The Canadian fusion of executive and legislative powers in parliamentary institutions is also found in Australia, India and Spain. South Africa has adopted a presidential-parliamentary hybrid, but its practices and dynamics are closer to the parliamentary model. Switzerland developed its own unique institutions which emphasize the separation of the executive and legislature in a way

distinctively different from that in the United States. In Switzerland, at both levels of government, the executive is a collegial body elected by the legislative but for a fixed term. This provides a set of checks and balances which rely heavily upon coalition politics. While all these federations have directly or indirectly elected representation (or combinations of both) as a feature of their federal second chambers, only South Africa has followed (but with significant modifications) the German example of establishing a federal second chamber in which state or provincial delegates serve as such in the deliberations of that chamber. This has created an interlocking intergovernmental character to the deliberations on matters affecting intergovernmental fiscal issues.

(6) Differences in degrees of interdependence and coordination. In previous reports it was noted that in the United States, the diffused, complex and relatively uncoordinated character of intergovernmental relationships generally has led to a complex financial interdependence based on a variety of ad hoc arrangements, while in Germany the closely interlocked legislative and administrative responsibilities of two orders of government and the focal role of the Bundesrat as an intergovernmental institution has led to a much more systematic financial interdependence between levels of government. Canada has differed from both. The dynamics of “executive federalism” have produced a considerably more systematic system of program and equalization transfers than in the United States while achieving a substantially more decentralized set of financial arrangements than those in Germany.

In this respect the parliamentary federations, Australia and India, have resembled most Canada, but their use of regular independent finance commissions to guide adjustments has led to a more systematic set of arrangements. Brazil and South Africa have each resembled more the different models on which they have based their institutions, the United States and Germany. Switzerland with its unique executive and legislative institutions, and its emphasis upon cantonal and local autonomy, has exhibited

a deliberately consultative process of intergovernmental financial relations. In Spain the dominant characteristics of these processes has been the relative dominance of a central government which nevertheless, has found it necessary to accommodate sub-nationalisms by intergovernmental negotiations producing asymmetrical results.

(7) Mechanisms for dispute resolution. Intergovernmental financial issues do not often lend themselves well to settlement by courts and judicial processes. Common, therefore, to all federations has been tendency to rely more upon intergovernmental negotiations for the resolution of disputes in this area. Nevertheless, federations are fundamentally constitutional systems upheld by courts enforcing the rule of constitutional law as the supreme law. Thus, with the exception of Switzerland, in the other federations ultimately it has been the Constitutional Courts or Supreme Courts that have been the final arbiters in disputes over the financial arrangements. This has been the case not only in the three federations considered in the previous reports, but in this additional set of federations. Indeed, in Australia some of the most important High Court rulings have related to intergovernmental financial issues. In this respect Switzerland is unique, however. The Federal Tribunal may rule on the validity of cantonal laws but not of federal laws. The validity of federal laws is determined instead through the processes of the legislative referendum, and this has been an important factor in the transfer of some taxing powers to the federal government.

(c) Decentralized unitary systems: the differences and similarities in their political and constitutional contexts:

Sweden and Japan are both unitary systems, but as we shall see in more detail later, both are highly decentralized. Indeed measured in terms of expenditure it could be argued that they are as, or more, decentralized than the United States, Australia, Spain or Brazil. What distinguishes them from the federations or quasi-federations considered in the previous reports and this report is not the degree of decentralization, but that their autonomy is not constitutionally guaranteed. In the federations ultimately the

constituent units derive their authority and autonomy, not from the central government but from a constitution which is not unilaterally amendable by the central government or legislature. In decentralized unitary systems such as Sweden and Japan there may even be a constitutional basis for local autonomy, but ultimately, since that constitution can be amended unilaterally by the central government, the local governments are subordinate. This is a difference of fundamental constitutional significance.

Unitary political systems vary, of course, enormously in terms of their degree of decentralization. Sweden and Japan represent two of the most decentralized unitary systems in the world, and therefore, it is of note that in many respects, although not constitutionally guaranteed, their financial arrangements are similar to those in federations and quasi-federations. In each there is a definition, either by constitutional or statutory law of the expenditure responsibilities and revenue sources available to their local governments. In each it has been necessary (although to sharply differing degrees) to supplement local own source revenues with transfers from the central government to close the gap between expenditure requirements and revenue resources and to equalize disparities among local governments. In each it has been necessary to adjust these arrangements from time to time. In each, as in the federations and quasi-federations, these arrangements have had to accommodate pressures from local communities for self-government and autonomy.

There are, however, two significant differences from the situation in the federations and quasi-federations. One is that (whether the third (local) sphere is constitutionally recognized or not) in federations federal, state and local governments in practice represent three distinct spheres each involving particular financial issues. In these unitary systems there may be several hierarchical tiers of local government, but basically they represent two orders of government: the central government and the subordinate local governments. The second is that while the consideration of federal-state

financial relations deal with some 6 to 50 constituent units, the federal-local financial relations deal with some 310 units of local government in Sweden¹⁶ and over 3000 units of local government in Japan.¹⁷ Consequently, the relative bargaining power of these individual local governments in relation to the central government is much weaker than in the case of the states within the federations.

There are differences too in the political contexts of regional and local government in Sweden and Japan. The former has a relatively small population of 9 million whereas Japan has a population of over 127 million which explains why it has required many more units of regional and local government. In Sweden the first legislation on local government was in 1862 and this long historical tradition was reinforced by their expanded role in the provision of social services in the mid-twentieth century. Japan's system of prefectures and local governments was largely the product of post World War II reconstruction under the influence the postwar American occupation. Furthermore, whereas in Sweden, the primary emphasis for local government has been local self-rule and autonomy, in Japan local government has been looked upon more as providing units for delegated administration with local governments serving as agents of the central government in the delivery of prescribed functions.

2. Allocation of Federal, State and Local Revenues and Expenditures

As in the cases of the three federations previously reported on, all eight of the mature and transitional federations and the two decentralized unitary systems covered in this report involve a degree of decentralization of fiscal responsibilities, but the extent and manner of this decentralization has varied considerably. In this report we consider in turn the assignment of expenditure and revenue responsibilities, then the vertical and horizontal imbalances to which these give use.

¹⁶ Actually 289 municipal governments, 18 county councils, 2 regions and the municipality of Gotland.

¹⁷ 47 prefectures and 3,250 local governments

(i) *Expenditures*

As in Canada, the United States and Germany, in the eight federations and two decentralized unitary countries that this report focuses on, state and local governments perform a range of important functions, and these determine the proportion of total government expenditures for which they are responsible. In the case of the federations these are largely defined by the exclusive and concurrent jurisdictions set out in their constitutions and in the case of the unitary systems in large measure by central legislation. Tables 1 and 2 include a listing of the current proportions of total (federal-state-local) expenditure in these countries performed by the central governments (second column, Table 1) and by the states and local governments (second column, Table 2). Two points stand out clearly.

First, in all of these countries there is an extensive devolution of expenditure responsibilities. State and local expenditures (after transfers) range from just 46 percent (Australia and United States) to 68 percent (Switzerland) in the mature federations, and slightly less from 36 percent (Brazil) to 55 percent (India) in the transitional federations. Strikingly, the decentralization of expenditures in the mature unitary systems is comparable in Japan (62 percent) and Sweden (46 percent). Major fields of central expenditure generally have been foreign affairs, defence, international trade, immigration, major transportation and communications infrastructure, and currency. Typical fields of state and local expenditure have been health, education (except post-secondary education), local transportation and infrastructure, water, sewage, housing, community services, and delivery of social services. Expenditures in health, education and social services, however, are often shared with the central government, and in Brazil this has gone so far that almost every area of governmental activity is shared across all three levels of government. The reasons for this decentralization of expenditures have been two-fold. One has been to meet the differences in preferences of citizens in different regions. The second has been to achieve administrative efficiency. Indeed, in the transitional federations

pressures from the World Bank and the IMF urging improved decentralization have in recent years been an important factor. It is noteworthy here, that with the exception of Brazil, the Russian Federation emerges in expenditure terms as less decentralized than all the others, including the unitary systems.

The second point, is that while all these examples are marked by decentralization of expenditure responsibilities there is a significant range of variations. The full range of variations in percentage of total governmental expenditures carried out by the state and local governments ranges from about one-third in Brazil to two thirds in Switzerland (Table 2). This variation can usually be attributed to the social, political and constitutional context described earlier. It is no accident that among the mature federations multilingual Switzerland and binational Canada, and among the transitional federations, India with its complex cultural variety, are among the least centralized.

It should be noted that tabulating relative expenditures of levels of government does not, of course, give a full picture of the level of self-rule. In most cases where legislative and administrative responsibilities coincide it does provide a significant indicator. In others, however, such as Germany and modeled on it, South Africa, where the substantial expenditure relates to the constitutionally mandated state and local administration of central legislation this does represent a limitation upon state autonomy not revealed by the expenditure figures.

In the previous reports the issue of the federal spending power was raised. This is the constitutional power given to federal governments to spend money (usually by conditional transfers to other levels of government) in areas of exclusive state or local constitutional jurisdiction. It was noted in the previous reports that the federal governments in both the United States and Canada (although it is a controversial issue in the latter) have this power, but that in Germany it can only be exercised by the support of a majority in the Bundesrat (a federal second chamber composed of instructed delegates of the state governments).

In all the federations and unitary systems considered here the federal government has been granted that power explicitly (for instance in Australia, India and Spain without reservations) with two exceptions.¹⁸ In South Africa, following to some extent the German model, the National Council of the Provinces (NCDP) has an opportunity under articles 75 and 76 to express its views, although unlike the German example it has no veto over money bills. In Switzerland, both long-held traditions and the constitutional provisions referring to collaboration between the federal and cantonal governments (articles 44-46) have led to the avoidance of unilateral federal decisions in federal spending in areas of cantonal jurisdiction.

(ii) *Revenues*

The allocation of own-source revenues for federal, state and local governments is also set out in Tables 1 and 2 above (first column). Here too, two striking patterns emerge. First differences in the range of revenue-raising powers granted to each order of government are even more pronounced than in the case of expenditures. This was true not only of the three federations reported on previously, but is even more the case when the additional two mature federations, four transitional federations, and two decentralized unitary systems are included for consideration. In terms of own source revenues in the mature federations Australia is more centralized than Canada, the United States and Germany and Switzerland is more decentralized, thus widening the range to between 69 and 40 percent. Generally the transitional federations as a group are substantially more centralized in terms of own-source revenues ranging between 95 percent in South Africa to 66 percent in India. Surprisingly the mature unitary systems are in terms of own-source revenues substantially more decentralized than all the transitional federations and fall close to the median point among mature federations. The emphasis upon central concentration of revenue-raising powers among the transitional

federations is possibly attributable to the influence of Keynesian theories concerning economic stability and development prevalent at the time they adopted their federal structures.

A second feature which emerges clearly from comparing the two columns in Table 1 is that in every one of the five mature federations, four transitional federations, and two mature unitary systems there has been a much greater central concentration of revenue-raising powers than of expenditure responsibilities. Generally there has been a tendency to concentrate such major taxing powers as corporate taxes, personal income taxes, customs and excise taxes, and various sales and consumption taxes in the central governments. Corporate income taxes have most often come under federal jurisdiction because corporations in earning their income tend to cross the boundaries of the internal regional units, and the location of their headquarters does not necessarily reflect the geographical sources of their income. Personal income taxes may be more directly attributed to location of residences and therefore is often an area shared by federal and state governments, although in some, including Australia, India and South Africa it has been exclusively federal. Customs and excise taxes have almost always been placed under federal jurisdiction in the interests of ensuring an effective internal customs and economic union. Sales and consumption taxes are areas which in many federations both federal and state governments have shared, but even where this has been the case, the federal governments have tended to predominate because of the federal power to preempt an area of concurrent jurisdiction.

Two factors have been particularly influential in creating this general pattern. One, already noted above, was the influence of Keynesian theories regarding economic stabilization and development prevalent not only at the time most of the newer transitional federations were established, but also in the mature federations, most notably in Australia, at the time that many of the current federal fiscal arrangements were developed. Those theories were less influential in Switzerland and Germany and have to some degree lost their

¹⁸ R. L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, 1999).

influence now in such federations as Canada. A second factor, which still holds force, is that where the federal government is expected to serve a redistributive role, this is facilitated by a concentration of financial resources in the federal government. This has been an especially powerful argument where regional disparities have been particularly sharp, as has been the case in most of the transitional federations, and in those countries where there has been a strong emphasis upon inter-regional and inter-personal equity as in Australia and Germany.

Another important source of revenue open to governments at all levels in all the cases considered here has been the operation of public enterprises and corporations, the profits of which may serve as a source of governmental income. The emphasis in the past decade upon “privatization” as part of fostering a market economy, has imposed a limit, however, on the extent to which this can be a source of revenues supplementing those from taxation.

Public borrowing can also be an important source of governmental revenue, especially for capital purposes. In many federations, this is a source open to both levels of government. However, concerns about the possible impact upon federal credit-worthiness of borrowing by the states has led in some of the more recent federations to placing foreign borrowing under exclusive federal jurisdiction, India being an example. Spain and South Africa have gone even further in requiring that all public borrowing by constituent units either be approved by the federal government or follow strict federal guidelines. Of the mature federations, the only one to have placed limits on state borrowing has been Australia which in 1927, early in its history, established an arrangement whereby all major public borrowing by both levels of government is coordinated by the binding decisions of an intergovernmental Loan Council. In the early post World War II years, despite a voting rule what required the consent of at least two of the six states it proved a powerful device for central control of state borrowing when the federal government underwrote all public borrowing, but in recent years the greater reliance upon the

market has diminished the Council’s role and influence.

(iii) Extent and character of resulting vertical imbalances

Comparison of the own-source revenues (i.e. before transfers) and of expenditures (after transfers) in Table 2 (third column in the table) reveals that in all five mature federations, four transitional federations and two decentralized unitary systems there is a vertical imbalance in which state and local expenditures exceed their own source revenues (before central transfers of shared taxes and grants) by a significant amount. These are most significant in South Africa (45 percent of all combined federal-state-local expenditures), Spain (32 percent), Germany (27 percent), and India 21 (percent). With the exception of Brazil (5 percent), the vertical imbalances are generally larger in the transitional federations than in the mature federations, although they are significant in all federations in both groups. Interestingly the vertical gaps in Japan (20 percent) and Sweden (3 percent) are generally less than in the transitional federations. The Russian case is not the subject of this report but is included in Tables 1 and 2 for comparative reference.

The main reason for these vertical imbalances lies in the preceding summary of the allocation of own source revenues and of expenditure responsibilities outlined in the two preceding sections. First, it has usually been found desirable to allocate the major taxing powers to the central governments because they are closely related to central policies for stabilization, development, and regional redistribution within an economic union, while some of the most expensive expenditure responsibilities, such as health, education and social services have usually been considered best administered and delivered on a state and local basis where differing regional and local circumstances can be taken into account. A second reason is that generally the tax sources assigned to the central governments have had more growth potential than those typically assigned to state and particularly local governments. It is also noteworthy that the biggest vertical gaps have occurred in those

federations such as Germany among the mature federations and South Africa among the transitional federations where a large portion of state expenditures represent constitutionally mandated devolved administration of federal legislation.

Vertical fiscal imbalances can potentially be corrected as long as the state and local governments have adequate own-source revenue-raising discretion. Among the mature federations the Swiss and Canadian, and to a lesser degree the United States and Australia state and local governments have considerable discretion to raise their own-source revenues, but in all these cases, and more particularly where the vertical gaps are largest, such solutions may moderate the problem but be incapable of correcting it totally. In the transitional federations where the vertical imbalance is generally considerably larger and the state and local constitutionally assigned taxing powers more restricted, such solutions are totally beyond reach. In the unitary systems, where ultimately the central government determines the taxing powers delegated to the local governments there are also limits to such self-correction. Consequently, in all these political systems it has been found necessary to provide for intergovernmental transfers to correct or moderate the vertical fiscal imbalances.

(iv) Extent and character of resulting horizontal imbalances

Horizontal imbalances represent a second kind of imbalance which tends to arise where fiscal responsibilities are distributed between levels of government. The vertical imbalances refer to the 'expenditure-own-source revenue gaps' relating to all state and local governments as a group compared to central governments. But the revenue capacities for the same taxes and the expenditure costs for the provision of the same services inevitably varies from state to state and locality to locality. Horizontal imbalances, therefore, occur when the revenue capacities of different states vary so that they are not able to provide their citizens with services at the same level on the basis of comparable tax levels. In addition to horizontal revenue

imbalances among states, there can be inter-state imbalances on the expenditure side due to differences in the 'expenditure needs' of different constituent units. These arise from variations in sociodemographic characteristics of their populations such as population dispersion, urbanization, social composition and age structure, and the cost of providing services affected by such factors as the scale of public administration and the physical and economic environment.

Horizontal fiscal imbalances are even more difficult than vertical imbalances to resolve by leaving them to be self-corrected by individual state and local governments action. If one state has less fiscal capacity than another, it will not be able to provide comparable public services at comparable tax rates. The result as noted in our previous report comparing Canada, the United States and Germany, would be either a violation of horizontal equity (with identical citizens in different states being treated differentially by the government sector), or an inefficient allocation across states (with businesses and individuals having a purely fiscal incentive to locate in states with higher fiscal capacities). Consequently, this provides a motivation in most federations and decentralized unitary systems for differential transfers from the central to the state governments.

3. The Nature, Role and Scope of Intergovernmental Transfers

(i) Importance, scale and nature of transfers

In order to correct these vertical and horizontal imbalances all the federations and decentralized unitary systems reviewed here have had arrangements for financial transfers from one level of government to another. The relative size and structures of these transfers has differed considerably, but they have served a crucial role in the intergovernmental financial arrangements. Because central governments, as already noted, have controlled the major tax sources, adjustments have usually taken the form of financial transfers to the states, although occasionally they have taken the form of some state transfers to central governments or for equalization purposes of inter-state transfers. In

most cases there have also been transfers from the states to local governments, and in some but not all federations and all unitary systems of transfers direct from the central governments to local governments. Table 4 (first column) gives an indication of the significance of total central transfers to correct both vertical and horizontal imbalances as a portion of the total constituent unit revenues and hence the resulting state and local government dependence on transfers. These percentages are indeed very substantial although they vary greatly from country to country. Germany (43.8 percent) and Australia (45.3 percent) are the highest and Canada (19.8 percent) the lowest among the mature federations. The corresponding dependence of states on transfers has generally been much higher still in the transitional federations: 96.1 percent in South Africa, 72.8 percent in Spain, 46.0 percent in India, and the lowest, 30.0 percent in Brazil. Interestingly the corresponding figure in the mature decentralized unitary systems is more akin to those in the mature federations: 37.2 percent in Japan, and 15.8 percent in Sweden, the lowest of all these countries.

The central financial transfers to the states have generally taken one or more of three forms. The first is revenue sharing, i.e. shares of the proceeds from specified central taxes. The second is unconditional grants. The third is conditional grants for specific purposes requiring the recipient governments to meet certain conditions or to match from their own revenues the central grants. The extent to which each of these has been used has varied considerably.

Revenue sharing has proved a relatively widespread device, although among the three federations studied in previous reports only in Germany has this been extensively used. There, however, as a result of constitutional stipulations, revenue from the central income taxes, corporation and turnover taxes are shared between the governments of the Federation and Laender (art. 106(3-3)), and revenue from a range of smaller central taxes such as property, inheritance, beer and gambling taxes accrue totally to the Laender (art. 106(2)). Furthermore,

a share of the central income tax, and real property and business, and local excise taxes accrues to local governments (art. 106(5-6)). These are unconditional transfers. In Switzerland, the constitution (art 128(3)) stipulates that 30 percent of the proceeds of the federal personal income tax shall, based on derivation, accrue to the cantons unconditionally. The constitution (art. 131) also provides that one-tenth of the net yield on the federal tax on distilled spirits shall be credited to the cantons to fight the causes and effects of addiction. In addition, as a product of history and much political negotiation, 10 percent from the federal withholding taxes (half on a per capita basis and half based on an index of cantonal financial capacity), up to 12 percent of the custom duties on fuel (42 percent on the index basis) and two-thirds of the earnings of the Swiss National Bank (three-eighths on the index go to the cantons.¹⁹ Sharing of specific central taxes was not an element of the Australian financial arrangements until very recently, but when the Commonwealth government in 2000 ushered in a new Goods and Services Tax (in form a VAT) it was with the commitment that all the proceeds would be transferred unconditionally to the states as the source for all equalization adjustments. Thus, of the five mature federations, three, Germany, Switzerland and Australia, now use revenue sharing of central taxes as one element of the transfers to correct financial imbalances.

In the transitional federations, this mode of transfer has been a significant feature in the intergovernmental financial arrangements in all four countries. In India, under the constitution some duties are levied by the central government but are entirely collected and appropriated by the states (art. 268: stamp duties and duties on medicinal and toilet preparations), some taxes are both levied and collected by the central government but the proceeds are assigned to those states in which they have been levied (art.

¹⁹ R. Bird and A.V. Tarasov, *Closing the Gap: Fiscal Imbalances and Intergovernmental Transfers in Development Federations* (Georgia State University, International Studies Program, Working Paper 02-02, 2002, p.21.

269: taxes on sale and purchases of goods), and some taxes are levied and collected by the central government, but the proceeds are distributed between the central and state governments (art. 270). Into this latter category originally came taxes on income other than agricultural income. This category was expanded by the Constitution (Eightieth Amendment) Act, 2000, section 3, to include all taxes and duties on the Union list except those referred to in Articles 268 and 269 and surcharges on a limited range of central duties and taxes. Where central tax revenues are shared, the portion to be shared and the distribution among the states is based on the recommendations of the constitutionally mandated quinquennial Finance Commissions.²⁰ Thus, from the beginning revenue sharing of centrally levied taxes has been a major element in the financial arrangements under the constitution and these unconditional transfers have been expanded over time to increase the states' shares.

In Spain too, revenue-sharing has been an important part of the financial arrangements to match the progressive devolution. In the general system applied to all Autonomous Communities (except the two 'foral' Autonomous Communities, the Basque Country and Navarra), shares of central tax proceeds constituted in 1998 about a quarter of central transfers.²¹ Originally this arrangement related to a thirty-percent of personal income tax, but in 2002 this was increased to 33 percent of personal income tax, 35 percent of VAT, 40 percent of the major excise taxes, and all taxes on registration and electricity. By contrast in the two 'foral' Autonomous Communities revenue-sharing has operated in the reverse direction. These Communities enjoy the revenues from the major

taxes and transfer an amount to the central government in order to finance the services the latter carries out within their territory.²² In Brazil 45 percent of the revenues from the two most important taxes are transferred unconditionally to the states and municipalities. The states receive 21.5 percent and local governments 22.5 percent of the shares from the federal income tax and from the federal tax on industrial products. In addition smaller amounts of these central taxes are set apart for regional funds and compensation for export exemption. There is also sharing of state tax proceeds between state and local governments. In South Africa revenue-sharing of central taxes has been applied not to specific taxes but to all central taxes proceeds. The constitution, article 214, provides for the 'equitable division' of all revenue raised nationally both among the national, provincial and local spheres of government and individually among the provinces and among the local governments and municipalities. This allocation is made by the central government after consultation with the provinces, local government organization and the Financial and Fiscal Commission and after a top slice (23.1 percent of the total in 2000) has been deducted to cover debt service costs, a contingency reserve, donor-financed spending and funding allocated to a skills development levy grant scheme. In 1999 47.2 percent of the remaining resources comprised the national equitable share, the provincial share was 51.9 percent, and local government received 1.0 percent. Thus under this revenue-sharing arrangement in South Africa, revenue raising is highly centralized, but a substantial portion of government spending occurs in the provincial and local spheres.²³

Of the two unitary political systems the vertical fiscal imbalance is much greater in Japan and the central transfers there also include a local share of central government taxes. In 2001 the central government transferred

²⁰ Twelfth Finance Commission, *Fifty Years of Fiscal Federalism: Finance Commissions of India* (New Delhi: 2003).

²¹ A Castells, "The Role of Intergovernmental Finance in Achieving Diversity and Cohesion: The Case of Spain" in R. Bird and T. Stauffer (eds), *Intergovernmental Fiscal Relations in Fragmented Societies* (Bâle: Helbing + Liechtenhahn, 2001), pp. 90-1.

²² *Ibid.*, p. 90.

²³ C. Murray, "Building Unity Through Transformation: Intergovernmental Fiscal Relations in South Africa" in Bird and Stauffer (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies*, op. cit., p. 516.

unconditionally from funds derived this way 14.3 percent of total national revenue and this represented about 21 percent of total local government resources (after transfers).²⁴ By contrast, in Sweden, where their own taxes are the primary source of revenue for local government (about 67 percent of the total) the device of revenue-sharing of central taxes has not been used, the other major sources of local government finance being user fees and central grants.²⁵

Because in many of these cases revenue-sharing of central tax proceeds has been constitutionally mandated, some analysts classify them as a form of state revenues rather than as a transfer. However, that can be misleading for, unlike their own taxes and user fees, the states have no control of the size of the revenues they will receive from revenue sharing. The size of the proceeds the states receive in this way are determined by the rates and levels of central taxation. They are therefore better classified as transfers which in most cases are unconditional. They therefore share the benefits unconditional central grants, but have the further advantage that instead of being determined at a fixed amount by the central government, are based on a specified share of major taxes and therefore have growth potential as the economy grows. That helps to explain why they have been so widely used as one element to reduce intergovernmental fiscal imbalances.

A totally different form of transfer used as at least one element in the total scheme of intergovernmental financial transfers has been the use of conditional grants. These are central transfers to state and local governments which have conditions attached to them so that the central government may influence or even control how they are spent. The issue of conditionality is often a contentious one in federations. Many of the important public services whose provision is decentralized to the state level may also be important from a wider

federal point of view. In such cases, conditionality applied to transfers is one means by which a federal government can induce the states to design their programs in a way that contributes to federal equity and efficiency objectives. One argument in support of conditional transfers has particularly tended to dominate discussion of the subject in the United States. This, based on the principle of financial responsibility and accountability, is that the federal government that has the nasty task of raising the funds by taxation, should in the interests of accountability to the tax payer, control and set the conditions for the use of these funds by the states. The conditions may take the form of requiring specific criteria to be met or of matching by the recipient governments of the central financial contributions to those programs. This “golden lead” as it has been referred to in Germany, may however undermine the autonomy of the states and local governments if conditional grants constitute a high proportion of the transfers and hence a significant portion of state or local revenues. In such situations a heavy dependence upon conditional transfers may distort state expenditures and priorities in areas of primarily state responsibility. Ultimately, most federations have had to draw a balance between the legitimate aim of the central government to achieve its objectives, and the possibility that such conditionality will have too intrusive and distorting an effect on state priorities and policies and detract from the accountability of state and local governments to the needs and desires of their own particular citizens.

Where that balance has been found has varied among the nine federations and two decentralized unitary systems listed in Tables 3 and 4. Here it is noteworthy that in terms of the percentage of total central transfers represented by conditional grants, the mature federations as a group have generally relied more on conditional transfers than have the transitional federations. Nevertheless, of the mature federations Canada has relied least on these. Transitional federations as a group, with the exception of Spain, have tended to rely less on conditional transfers and more on unconditional shares of central revenue sources. The two

²⁴ Government of Japan, Ministry of Finance, Budget Bureau “Understanding the Japanese Budget, 2003”.

²⁵ Institute on Governance, *Intergovernmental Fiscal Relationships: Case Study #1: Sweden*

unitary countries contrast with each other, with Japan relying much more heavily on conditional transfers.

While on the subject of the distinction between unconditional and conditional grants, it is important to note that there have been differing degrees of conditionality in those federations employing conditional transfers. For instance, most of the conditional grants in the United States, Australia and Germany have embodied precise and strict conditions or matching requirements imposed on the recipient governments. In Canada this was also the case up to 1977, but when the Established Programs Financing (EPF) replaced the previous shared-cost arrangement for health and post-secondary education, these became block grants with only broad conditions applied to health transfers and no conditions to those for post-secondary education. Subsequently, when these were modified in 1996-7 into the Canada Health and Social Transfers (CHST) in support of health, post-secondary education, and social services, because of the broad and largely unenforced conditions specified these transfers verged on the unconditional. Nevertheless, for the purposes of Table 3 and 4 of this study they have been classified as conditional transfers, thus bringing conditional transfers to 43.6 percent of all central transfers and 15.8 percent of total provincial revenues. Given the almost unconditional nature of CHST transfers which provide the provinces with considerable independence in the size and design of their social programs, if all CHST transfers were classed as unconditional, then the respective figures for Tables 3 and 4 would be radically altered, conditional grants becoming 4.3 percent of all central transfers and 0.9 percent of total provincial revenues, much the lowest among all the countries considered in this study.

A third approach would be to break down the proportion of CHST transfers in Canada notionally for health and social welfare (where there are some very broad conditions aimed at minimum national standards), and for post-secondary education (where there are no conditions), classifying the former as conditional (even though the conditions for these are very

general) and the latter as unconditional. If applied in Tables 3 and 4 this would produce figures of the order of 33 for percentage of central transfers that are conditional and of 12 for percentage of provincial revenues constituted by conditional transfers. However, since the CHST transfers are a single block grant, which since 1999 has been an equal per capita grant to the provinces, any such breakdown would be based purely on notional assumptions about the percentages of these transfers applied to the different categories. The essential comparative point to be emphasized here is that the category of conditional grants noted in Tables 3 and 4 may itself embrace a considerable range from grants with very precise conditions to block grants with conditions so general that they may verge on unconditional.

The proportion of total state or local revenue made up by central conditional transfers provides one significant measure of the financial constraints upon the genuine autonomy of these governments. Table 4 indicates the degree of dependence of states in different countries by indicating the extent to which all central transfers (first column) and conditional transfers (second column) constitute an element of their total revenues from all sources. Significantly as a group the transitional federations by comparison are more dependent on central transfers, but with the exception of Spain are generally less dependent upon conditional transfers. Indeed, apart from Spain, the two federations in which conditional transfers constitute the largest portion of their total revenues are the United States and Australia. The constituent units in Sweden, Brazil, and if the CHST transfers are essentially unconditional, Canada, have the least dependence on conditional transfers. Particularly striking is the South African case in which the provinces are the most highly dependent on central transfers, but the proportion of these which is conditional is relatively low.

A third element often found in intergovernmental financial arrangements is the use of unconditional grants. These, like most cases of central revenue-sharing, are unconditional, but unlike tax revenue-sharing

their amounts are unrelated to the specific or general proceeds from central taxes. These amounts are in some cases determined by the central government at its discretion, in other cases by intergovernmental negotiation, and in yet others on the advice of intergovernmental or independence finance commissions. Reliance on this form of transfer has usually occurred where there has been concern that conditional transfers would undermine the autonomy of the states and local governments. One area where unconditional grants have been frequently employed has been for equalization purposes intended to adjust the general revenues of different states to correct horizontal imbalances. Among the mature federations unconditional grants have been used most extensively in Canada, Australia (until replaced by revenue sharing of the GST), and India (Finance Commission application of article 275 in the constitution).

(ii) Transfers to correct vertical fiscal imbalances

The third column in Table 2 indicates the extent of the vertical fiscal imbalances in the nine federations and two decentralized unitary systems. The first column of Table 4 sets out the total of transfers – shared central revenues, conditional grants and conditional grants, combined in different proportions in each case – from the central to the state and local governments as a proportion of total state revenues. This gives a further idea of the need for and form of the combined unconditional and conditional vertical transfers in each country.

(iii) Transfers to correct horizontal imbalances: extent and character

As noted in our previous report comparing Canada, the United States and Germany, it is somewhat artificial to distinguish precisely transfers to correct vertical fiscal imbalances and those that correct horizontal ones. Indeed, among the nine federations and two decentralized unitary systems only four have attempted to meet equalization needs primarily through equalization schemes distinct from the other transfers. Australia from 1933 to 1973 had a separate systematic scheme of equalization grants but in 1973 this was replaced by the

application of state relativities to the transfers aimed at correcting vertical financial imbalances. Canada has had a system of distinct formal equalization grants since 1957. Germany since the inception of the federation in 1949 has had a formal equalization scheme distinct from other intergovernmental transfers. Sweden in 1996 introduced a new formal system of equalization grants. But even in these countries where the equalization arrangements are relatively distinct, the transfers intended primarily to deal with vertical imbalances may also have a redistributive effect among the constituent units when they are allocated in equal per capita terms or on the basis of expenditure needs. Apart from these four cases, the other countries which have formal equalization schemes (and the United States is the only one not to have a formal equalization scheme) meet these objectives not by separate grants from the transfers correcting vertical imbalance, but by an equalization adjustment to the vertical transfers.

The importance of a major element of “equalization” in intergovernmental financial transfers arises from the widely held view in most countries that all citizens wherever they live should be entitled to comparable services without having to be subject to excessively different tax rates. The need for such transfers has arisen in most federations and decentralized unitary systems from a recognition that disparities in wealth among internal regions are likely to have a corrosive effect on internal cohesion. Indeed it is for this reason that in most European federations equalization schemes have been labelled “solidarity transfers.”

The arrangements for removing or reducing horizontal imbalances are set out in summary form in Table 5. Several points are especially noteworthy. First, in all these federations and decentralized unitary systems horizontal financial imbalances have been significant, and hence in all, except the United States but including the decentralized unitary systems, provision for some form of systematic financial equalization by means of intergovernmental transfers has been found not only to be desirable but politically necessary.

Second in the case of federations, in most of them some specific provision has been included in the constitution itself for the principle of financial equalization. Among examples are Switzerland, Canada, Germany, India and South Africa. In the interests of flexibility, details about processes for implementation and about criteria and formulae for equalization have normally not been embodied in the constitution, however. These have usually been left to be worked out by intergovernmental negotiation or by independent advisory commissions.

Third, the extent and impact of the equalization element in intergovernmental transfers has varied considerably. All of the countries reviewed here, except the United States, have some formal equalization scheme, but the scope of such transfers has varied. Some such as Australia, Germany, India and South Africa have gone the furthest in attempting to correct horizontal disparities. Canada, Switzerland, Sweden and Japan, while making significant efforts have not gone so far. Spain and Brazil have gone the least distance in attempting to close the horizontal disparities.

Fourth, the form of the equalization element in the arrangements for intergovernmental transfers has varied considerably. In many it has taken the form primarily of varying the basic vertical transfers – revenue-sharing, unconditional grants and sometimes also the conditional grant schemes – to apply redistributive equalizing criteria to their allocation among states. On the other hand, in some cases, notably Australia up to 1973, Canada, Germany and Sweden separate stand-alone unconditional equalization grants from the central government or horizontal intergovernmental payments have been the methods adopted to reduce the horizontal financial imbalances.

Fifth, in most cases equalization has been effected through proportionately larger central transfers to the poorer states without penalizing the wealthier ones. In two cases, Germany and Sweden, however, the primary mode of equalization has involved inter-state transfers. The German and Swedish schemes involve a

fund in which the payments to the poorer states are provided by reductions to the revenues of the wealthier states. Such schemes by emphasizing the reductions suffered by the wealthier units tend to be politically more contentious. In both cases these are supplemented by additional central transfers, in the German case per capita payments from the Value Added Tax, to contribute further to equalization.

Sixth, while in some federations and most notably Canada, the federal attempt to correct horizontal imbalances through federal equalization payments has focused primarily on adjusting for differences in the revenue capacities of the provinces, others and most notably Australia, India, Spain, South Africa and Japan have based their equalization on the assessment of *both* revenue capacities *and* expenditure needs.

Seventh, there has also been a variation between those political systems in which equalization adjustments have been based on an established formula and those based on the recommendations of a standing or quinquennial independent advisory commission, as occurs in Australia, India, South Africa and Sweden. Such commissions themselves may use a variety of formulae to arrive at their recommendations. In the former case the formula for distributed used may be set out in the constitution (rarely because of the need for periodic adjustment), may be arrived at by intergovernmental agreement as in Switzerland, Canada, Germany, Spain and Brazil (although in some cases the federal government dominates these negotiations), or may simply be imposed by the central government as in Japan.

Eighth, the criteria and the relative weights given to them in the formulae for distribution used in the determination of the equalization element of transfers have varied from country to country to take account of different particular circumstances and differing political pressures for equity.

Ninth, it might be expected that the more decentralization there is the more it is likely that disparities among constituent units will be

significant and therefore that there will be a greater pressure for equalizing mechanisms. Experience indicates otherwise. Indeed, where the greater decentralization reflects a higher degree of social and cultural diversity and fragmentation, as in Canada and Switzerland, the stronger have been the pressures for regional distinctiveness, autonomy, resistance to dependency upon federal funding aimed at inducing more uniformity. It is significant that both Germany and Australia with the predominant emphasis on uniformity and equity in their societies, have gone to much greater lengths towards realizing full equalization than have Canada and Switzerland. In the latter cases the pressures for equalization have been counterbalanced to some degree by a greater emphasis upon preserving their diversity and provincial or cantonal autonomy and initiative.

Tenth, most federations have recognized that due to changing values of revenue sources and of costs of expenditure responsibilities over time, regular processes for the systematic review and adjustment of financial equalization arrangements are necessary. These recognize that the essence of federalism is not in static structures but in the dynamic processes of evolving intergovernmental relations responding to changing circumstances.

4. Systems of tax harmonization and collection:

(i) Extent of tax harmonization:

In federations where different orders of government have their own substantial taxing powers an issue which often comes to the fore is the desirability of some harmonization of their taxes in order to minimize the harmful effects of excessive tax competition between governments. The three mature federations considered in the previous reports, Germany, Canada and the United States all had very different forms and degrees of tax harmonization. In Germany where the states have been largely financed by sharing of central revenues, all the major taxes (comprising some two-thirds of taxes raised in the federation) are subject to a single federal tax law and therefore are fully harmonised. In Canada where the major broad-based taxes are

co-occupied by both the federal and provincial levels of government, there are varying degrees of tax harmonization. For personal income tax which is the largest source of revenue for both levels of government nine of the ten provinces have tax collection agreements with the federal government whereby the federal government collects on their behalf the different levels of taxes levied by the provinces (on a harmonized base). There is also a similar corporate income tax collection agreement. Most other major taxes are not harmonized in Canada. Four of the provinces do harmonize their taxes with the federal GST (i.e. VAT) and in the case of Quebec it acts as a collection agency for both the federal and provincial VATs. In the United States, there is no formal system of tax harmonization. Personal and income taxes are occupied independently by the federal and state governments, although some states choose to piggyback on the federal tax system by using the federal tax base and in some cases even the federal rate structure. The lack of harmonization does give rise to some inefficiencies and also some instances of double taxation or of non-taxation of some portion of incomes.

Among the additional countries considered in this report the concentration of taxing powers in the central governments and the heavy reliance for state revenues upon shared revenues from central taxes means that, as in Germany, so in Australia, India, Spain, South Africa and Japan the need to harmonize taxation by governments at different levels has not been a major issue. This is further reinforced in Spain by the *Autonomous Communities Finance Act* which imposes severe limits on double taxation when the Autonomous Communities do exercise the limited powers of taxation bestowed upon them by the constitution. It is also worth noting that when the Conference of State Finance Ministers in India agreed in 2003 that all the States and Union Territories would introduce a VAT, it was agreed that every state legislation on VAT should have a minimum set of common features based on a model VAT bill.

The pattern is different in Switzerland Brazil and Sweden, where both levels of share significant taxing powers. In Switzerland, a

federal Tax Harmonization Law which came into effect in 1993 harmonizes the tax bases for personal and corporate income taxes but does not harmonize tax rates, schedules and personal allowances. This has facilitated the collection by the cantons of the direct taxes levied by the federal government. In Sweden the pattern is similar with local authorities setting the tax rate for income tax and central law defining the tax base, but in this case it is the central government that is responsible for its collection. The one other country where both the federal and state governments exercise considerable taxing powers is Brazil, but in this case there has been little successful tax harmonization.

(ii) *Extent of tax competition:*

The degree of intergovernmental tax competition has depended largely on the extent to which tax harmonization has been lacking. In those cases where the major taxing powers have been concentrated in the central governments and states or local governments have depended heavily upon central revenue-sharing, this has reduced the scope for tax competition. On the other hand, in those countries where the different levels of government levy major taxes, but tax harmonization arrangements have been implemented, either by intergovernmental agreement (e.g. Canada and India) or by central legislation (e.g. Switzerland and Sweden) the harmful effects of excessive tax competition have been moderated. At the same time, the Swiss authorities have considered that some inter-cantonal tax competition, kept within bounds, outweighs the negative effects of overly constraining cantonal choice of tax structure.²⁶

The effects of intergovernmental tax competition have been most apparent in the United States and Brazil, particularly in the latter. One of the greatest problems of Brazilian federalism has been intense “fiscal war” among most of the states for large-scale industrial investment. The “war of tax incentives” arising from the attempt to attract investment has led to a misallocation of resources and contributed to

unrest in the more backward regions.²⁷ This example suggests that unbridled intergovernmental tax competition can be extremely harmful.

5. Decision-making processes for intergovernmental fiscal relations:

(i) *Formal and informal institutions and processes:*

Because, as already noted, the relative values of revenue resources and expenditure responsibilities change over time, federations and decentralized unitary systems have found it necessary to establish institutions and processes to facilitate regular or periodic adjustments to the intergovernmental financial arrangements. Table 6 summarizes the arenas in which these issues have been dealt with in the different countries referred to in this study.

In some cases formal institutions and process have been specified in the constitution itself. Germany, India and South Africa represent examples of this. In other cases quite elaborate formal institutions and processes have been established by intergovernmental agreement. Australia has been a pioneer in this respect, but Canada also provides an example. In some cases formal institutions have been established by federal law as in Spain and Sweden. In many cases there has been a mixture of these processes – establishment by the constitution and also by intergovernmental agreement – for establishing formal institutions dealing with intergovernmental financial issues as exemplified in India and South Africa. In India the Finance Commission (FFC) and the Interstate Council were provided for in the constitution, but the National Development Council (an intergovernmental body to oversee economic planning) evolved by intergovernmental consensus, and the Planning Commission was established by the Union government. In South Africa, the National Council of the Provinces and the Financial and Fiscal Commission are both constitutional

²⁶ D. Carey, K. Gordon and P. Thalmann, *Tax Reform in Switzerland* (OECD Economics Department Working Paper No. 222, 1999), p. 6.

²⁷ J. Serra and J.R.R. Afonso, *New Economic and Fiscal Federalism: the Brazilian Case* (Ottawa: Forum of Federations, undated), p. 336.

bodies, but the Budget Council (composed of the Minister of Finance, the Executive Council members responsible for finance in the provinces and the chairman of the FFC) and the Budget Forum (made up of the Budget Council and local government representatives) are intergovernmental bodies established under the central Intergovernmental Fiscal Relations Act, 1997. These are supplemented by the MinMecs (sectoral intergovernmental ministerial councils) and the Technical MinMecs (sectoral intergovernmental councils of senior officials).

In addition to the variety of constitutional and other formal institutions and processes dealing with intergovernmental financial issues, in most of these countries there has been extensive intergovernmental consultation and negotiation on issues related to the federal financial arrangements.

In terms of the institutions and processes for adjusting issues of federal finance, five distinct patterns can be identified. In Australia, India and South Africa, although varying in precise form, expert commissions established by the central government (quinquennially in the case of India) have been entrusted with the primary task of determining distributive formulae for allocations among the states, and in the case of India and South Africa also with recommending the overall state share to be drawn from central revenues. In India, the unconditional allocations of the Finance Commission are also supplemented by the substantial central transfers of conditional grants in support of the Five Year Plans of the Planning Commission. But as the contrasting experience of Australia and India on the one hand, and of South Africa on the other, shows, the establishment of the independence of the commission and the tradition of government acceptance of its recommendations in the former has been crucial to their effectiveness. In the case of South Africa, the treatment of the commission as a purely advisory body has limited its influence.

A second pattern has been the operation of an intergovernmental council composed of central and state representatives to negotiate arrangements, although implementation may

require central legislation. In different forms Canada, Germany and Spain provide examples of this pattern, as does Australia insofar as an intergovernmental ministerial council establishes by agreement the framework within which the Commonwealth Grants Commission operates.

A third pattern is exemplified by the United States, Brazil and Japan where grants to the states or local governments are determined by the federal government with representatives of the states or local governments performing the role largely of lobbying the members of the central legislature. In Brazil there is an intergovernmental National Council for Fiscal Policy (CONFAZ) to coordinate the fiscal and tax policies of the states, but it appears to perform largely formal functions. The general lack of institutional mechanisms to facilitate intergovernmental cooperation has resulted in a patchwork of public policies.

Switzerland, as is so often the case, provides a fourth somewhat unique pattern. In some respects its particular form of the separation of powers within both levels of government resembles the United States. But in other respects, arising both from its traditions of extensive intergovernmental consultation and the provisions in the constitution of 1999 for intergovernmental cooperation it differs significantly. There is extensive consultation between the Federal Council (i.e. the federal executive) and the Conference of Cantonal Governments and action has usually required a broad consensus.

A fifth pattern relates particularly to the decentralized unitary systems. In both Sweden and Japan, ultimately it is central legislation which determines the overall pattern and devolution in the financial arrangements, although in both local interests have a considerable influence on these decisions. In the case of Sweden an Equalization Commission has also been created to implement the equalization arrangements.

(ii) *Degree of central government dominance of the intergovernmental processes:*

The adoption of a federal political system has usually been aimed at the dual objectives of promoting both unity and diversity by achieving a balance between the institutions of shared rule and those of territorial self-rule in the constituent states. An important question therefore is the degree to which the decision-making processes for intergovernmental financial relations contribute to that balance or distort it by making either level of government dominant in the processes. Given the general tendency in the examples reviewed in this study to concentrate the taxing powers and revenue resources in their central governments, it is important to consider whether in such cases this has *in practice* undermined the federal balance. In considering this question it is important to distinguish between the allocation of constitutional and legal authority on the one hand and the extent to which in practice both levels of government exert a significant influence upon the key decisions.

In many cases it may appear that the concentration of major taxing powers, the ultimate legal authority for decisions in the adjustment of intergovernmental financial arrangements, and the use of the federal spending power to employ extensive conditional transfers places the central government in a relatively dominant position. Indeed, this could be said, although in vary degrees, of most of the countries reviewed in this study. This apparent pattern is most acute in the cases of South Africa, Spain and Japan. However, even in these examples and certainly in most of the others, in practice there have been strong political dynamics inducing central governments to be sensitive to state and local concerns. This is illustrated by the importance of intergovernmental negotiation and agreement in the deliberations affecting the financial arrangements in most cases, particularly in Switzerland, Canada, Australia, Germany and India, and even in Spain, South Africa and Sweden.

6. Major Recent Reform Efforts

While intergovernmental financial arrangements in federations and decentralized unitary systems are constantly in evolution under the pressures of changing economic and political circumstances, it is noteworthy that in the past five to ten years there have been some important major reform efforts in many of the countries examined for this report.

Among the five mature federations perhaps the most significant efforts have occurred in Germany, Switzerland and Australia. A thorough and substantial reform of German federalism has been on the agenda during the past decade. The Länder, particularly the wealthier ones, have been pushing for a more “competitive federalism” instead of the current interlocking “participatory federalism”.²⁸ In relation to issues of federal finance this has involved two thrusts. One is the demand of the Länder for an increase of their autonomous competencies and finances, combined with the reduction of federal government activities, especially in the fields of concurrent legislative powers. Second has been the pressure from the stronger Länder, as the net payers, for a new equalization scheme to reduce their burden. To date, although there have been some adjustments to the financial arrangements, these have been modest. On the broader issue of reducing the degree of intergovernment interlocking entanglement, a “Commission for the Modernization of Federalism”, composed of 16 representatives representing one for each Land and 16 from the federal government, was recently been established. Its mandate included an examination of the financial relations between the federal government, the Länder and the communes. This attempt at a fundamental review has, however, run into difficulties that have led to the suspension of its work.

Long-standing as the Swiss federation has been, reform of the constitution and of intergovernmental finance have been major

²⁸ See, for instance, R. Hrbek, “Germany” in A.L. Griffiths, ed., *Handbook of Federal Countries* (Ottawa: McGill-Queen’s University Press for the Forum of Federations, 2002), p. 155.

issues in recent years. In April 1999, three decades of sporadic efforts to achieve a comprehensive revision of the Swiss constitution, last totally revised in 1874, culminated in the approval in a referendum of the total revision of the constitution. Although a total revision, the draft avoided substantial and controversial reforms. It took the form largely of clarifying and modernizing the language rather than the content of the constitution. Nevertheless, it lays out the basis of the intergovernmental financial arrangements (articles 126-135), emphasizing both the elements of cantonal autonomy and of intergovernmental interdependence and cooperation. It also includes reference to the principle of financial equalization among cantons. Discussion of further reform to the actual details of the equalization system has continued and is the subject of considerable debate.

In Australia, the past decade has also seen considerable major reform. Most notable was the tax reform of 2000 in which the federal government created a new VAT tax, the Goods and Services Tax (GST), with the commitment that all the proceeds would go to the states as the basis for unconditional equalized transfers. Thus the previous unconditional equalized grants were now replaced by a tax that will grow with the economy as the basis for the equalized transfers. The Commonwealth Grants Commission has the responsibility to make recommendations on the state relativities. The arrangements are subject to overview by a federal-state ministerial council including approval of changes to the rates. In sum, this arrangement has delivered a significant reform, shoring up the financial security of the states, reducing inefficiency in the tax system by the removal of some minor state taxes, and introducing a unique degree of co-decision to the fiscal arrangements and tax policy.

The transitional federations, although some of them were established quite recently, have also seen some major reforms to their financial arrangements. India has seen four significant developments. The first was the coming into force in 1993 of the 73rd and 74th constitutional amendments giving local governments, the

panchayats and the municipalities, constitutional status. Not only were certain powers transferred from the states, but provision was made for State Finance Commissions and for the principles on which adequate financial resources would be transferred to the panchayats and the municipalities. The second was the 80th amendment of the constitution in 2000 which, following the recommendations of the Eleventh Finance Commission, put the sharing of central taxes with the states on a new level. Where previously only certain specified central tax proceeds were shared, henceforth virtually all central taxes (with only a few minor exceptions) were to be shared on the basis of quinquennial Finance Commission recommendations. Third, in order to address the growing debt burden of the states and supplement the efforts of the states in evolving their Medium Term Fiscal Reform Program (MTFRP), a Debt Swap Scheme facilitated by the Union government was formulated in 2003. Fourth, at the Conference of State Finance Ministers held in 2002, a final decision was taken that all States and Union Territories would introduce a VAT with a minimum set of common features in 2003.

In Spain there was a reassignment of state taxing powers between 1997 and 2002 in order to give greater taxing powers to the Autonomous Communities and make them more accountable to the taxpayers for their expenditures. Although the Autonomous Communities still rely mainly on central transfers, their taxation powers were substantially increased and their financial dependence was moderated. The reforms, while described as “ceded taxes”, in fact represented the ceding of the proceeds from certain central taxes with the Autonomous Communities being given power to regulate some of these taxes – mainly tax brackets, tax rates, and some tax credits. In reality what had been a form of grants become a form of tax sharing.²⁹

By comparison with some of the other examples, the recent efforts to reform the

²⁹ V.R. Almendral, “The Asymmetric Distribution of Taxing Powers in the Spanish State of Autonomies: the Common System and the Foral Regimes,” *Regional and Federal Studies*, 13(4), 2003, 52-6.

financial arrangements have been more modest in Brazil. The federal government did in 2000 send to Congress a Fiscal Responsibility Law (modelled on the Fiscal Responsibility Act of New Zealand) which imposed maximum limits on the debts and personnel outlays of the federal government, the states and the municipalities. Two other reforms have had some impact on intergovernmental relations. The first was a constitutional amendment in 1996 which created a fiscal fund (called FUNDEF), composed of state and municipal revenues, to finance in redistributive (per capita) terms, the basic public educational systems. The second was in the health sector where the federal government has recently instituted a fund that provides direct monetary transfers based on per capita criteria for basic municipal health programs.

Since the new South African constitution came into effect only in 1996, the major efforts there have been on implementation rather than immediate reform. These have included a Provincial Tax Regulation Process Act in 2002 which enables provinces to impose new taxes, subject to approval by the national government. Provinces are now in a better position to address the central government's general aim of reducing poverty, vulnerability and inequality. Indeed, their budgets have reflected a strong alignment to nationally agreed government priorities.

The decentralized unitary regimes have also seen some efforts at financial reform. In Sweden, the proportion of conditional central grants was reduced in 1991 so that two-thirds of the grants would be unconditional. The new unconditional grant was to be distributed according to three factors: revenue equalization, structural cost equalization, and a supplement for population reduction. There were some criticisms of the new mechanism on the lack of "teeth" to the revenue equalization component and on the difficulty in understanding the structural cost equalization component.³⁰ In 1996, a new equalization scheme was adopted, based on three elements: a population-based

³⁰ Institute of Governance, *Intergovernmental Fiscal Relationships*, Case Study #1: Sweden.

grant, revenue equalization, and cost equalization.

In Japan a Decentralization Promotion Law came into effect in 2000. Its purpose was to clarify the roles of central and local governments and minimize central involvement in areas of local jurisdiction. The objective was to encourage local governments to carry out their administration more independently so that their operations will fit better the actual conditions of particular local sectors.³¹

7. Identification of Distinctive and Unique Features

These federations and decentralized unitary systems have had in common issues such as the appropriate revenue and expenditure allocation among governments, dealing with vertical and horizontal imbalances by various forms of transfer including in most cases systematic equalization programs, some effort to avoid harmful tax competition, and formal and informal institutions and processes for intergovernmental consultation and cooperation. Nevertheless, each has displayed some distinctiveness and even uniqueness in its intergovernmental financial arrangements.

Among the mature federations, the United States stands out for its lack of any systematic equalization scheme and for its total dependence upon conditional grants in the transfers from the federal to the state governments. In relation to the latter, this has led one American critic to describe the result as "coercive federalism".³²

Canada has been distinctive for the relatively strong taxing powers of the provinces and the largely unconditional nature of federal transfers in recent years, making it one of the

³¹ Government of Japan, Ministry of Public Management, Home Affairs, Posts and Telecommunications, Local Administration Bureau, "Local Administration," accessed from Ministry official website: www.soumu.go.jp/english/c-gyousei/index.html.

³² J. Kincaid, "From Cooperative to Coercive Federalism," *The Annals of the American Academy of Political Social Science*, vol. 509, May 1990, pp. 139-52.

most decentralized federations (next to Switzerland) in the world. The processes of adaptation have relied primarily upon inter-executive negotiation, “executive federalism,” but these processes have had no constitutional or statutory basis, depending largely on pragmatic evolution.

Germany, on the other hand, has had an interlocking federal-state system of financial relationships with a heavy reliance upon revenue-sharing of central taxes. Furthermore, its closely tied executive federalism based on the Bundesrat as a constitutionally mandated focal point, has provided a whole range of intergovernmental institutions and processes governing the financial relationships among the governments.

Switzerland stands out as the most decentralized federation in terms of allocation of revenues and expenditures. It is also distinctive as a federation where the predominance of the processes of direct democracy has both reinforced cantonal autonomy and yet enabled extensive federal, cantonal and local involvement in almost every sphere of public policy.

Among mature federations Australia is at the other extreme, with the highest concentration of taxing powers in the federal government. Particularly distinctive has been the degree to which the processes of “executive federalism” have been embodied in a range of formal institutions such as the Loan Council and the Commonwealth Grants Commission created quite early on, and more recently the intergovernmental Council of Australian Governments (COAG) overseeing and coordinating the operation of up to thirty formal sectoral Ministerial Councils. In the realm of formal equalization arrangements, Australia, and particularly its Commonwealth Grants Commission, have played a pioneering role whose example has been followed and adapted in a number of later federations.

Among the transitional federations India has the most fully developed financial relations with prominent elements being the heavy and

expanded reliance upon revenue-sharing of centrally levied taxes and the role of the quinquennial Finance Commissions. The general acceptance of their recommendations has shaped not only the equalization among states, but has gone beyond the functions of the Australian Grants Commission in making recommendations on the overall share of the central revenue pool that should be allocated to the states as a group.³³

The most distinctive and unique feature of the Spanish federal financial arrangements is of course their asymmetry in relation to different Autonomous Communities. To begin with there are the special arrangements relating to the “foral” regimes in the Basque Country and Navarre whereby for historic reasons they collect all taxes within their territory (except customs duties) and remit a share to the central government for the estimated services provided in the region by the central government. Even among the “Common” regime for the other Autonomous Communities, where the main process is one of transfers from the central government, there are differences between the “slow track” Autonomous Communities and the “fast track” Communities in which devolution and correspondingly the size of financial transfers is greater.

Among the transitional federations, Brazil stands in contrast because of the lack of federal-state financial coordination and the intensity of the interstate tax competition often described as “tax wars”.

By contrast, in South Africa the overwhelming emphasis has been upon “co-operative governance”. The arrangements have all the trappings of a federal distribution of revenues and expenditures and of intergovernmental consultative bodies, and even a constitutionally mandated independent Finance and Fiscal Commission. But under these constitutional provisions lies the overwhelming centralization of own-source revenues and the

³³ See for instance, The Twelfth Finance Commission, *Fifty years of Fiscal Federalism: Finance Commissions of India* (New Delhi: 2003).

predominant influence of the central leadership of the African National Conference which so far has held overwhelming sway in the central government and seven of the nine provinces.

Sweden and Japan stand out from the other examples because, although in many respects there is a comparable degree of decentralization, this is not guaranteed constitutionally due to the unitary character of their regimes. Nevertheless, among unitary regimes Sweden, like the other Nordic countries, is unique in the level of autonomy allocated to local governments. Local governments are responsible for the provision of many public services and have significant taxation authority including local income taxation. This has helped to keep vertical imbalances at a low level. In addition to playing a relatively minor role in local public finance, central government grants are largely provided unconditionally, further strengthening local autonomy. Sweden has also provided an example of effective cooperation and negotiation between central and local government thanks in large part to the non-dependence of the Local Government Associations.³⁴

In Japan the degree of expenditure decentralization is in fact considerably more extensive than in Sweden, but the dependence of local governments upon transfers from the central government is much greater and the tendency for the central government to be directive is also much greater. As Mochida and Lotz put it, "The issue for Japan is not so much to change/enlarge the expenditure assignments themselves, but to redefine responsibilities for designing, implementing, and financing these assignments."³⁵

C. EVALUATION OF ECONOMIC AND POLITICAL PERFORMANCE

1. The Criteria:

In assessing the operation of fiscal federalism in these federations a number of

criteria need to be taken into account: economic efficiency, equity, effective fiscal management and stabilization policy, the relative autonomy of the constituent units, the degree of intergovernmental coordination and of central influence on the states and local governments, the transparency and democratic accountability of decision-making, the influence on political stability and adaptability, and the relative significance of institutions and of political culture. The individual federations and decentralized unitary systems will each be briefly examined in turn in relation to these criteria. Included in this review will be the three mature federations, Canada, the United States, and Germany, but the reader's attention is drawn to the much more extensive discussion of the lessons to be drawn from them in the previous comparative report on them.³⁶

Each of these criteria is important but the emphasis placed upon each and the balance struck among these criteria has varied in the nine federations and two decentralized unitary systems.

Economic efficiency relates to the extent to which the specific decentralized fiscal arrangements have contributed to the improvement of economic efficiency or have compromised the efficiency of the federal economy as a whole. As a concept it encompasses efficiency in the allocation of public and private resources as well as efficiency in the provision of government services.

Equity in a federal setting relates to the achievement of the objectives of equality of opportunity and of economic security (social insurance) for citizens throughout the federation, wherever they live, through the provision of public services, as well as the purely redistributive objective of equality of outcomes.

Fiscal management and stabilization policy refers to the extent to which the allocation of

³⁴ Mochida and Lotze, "Fiscal Federalism in Practice, the Nordic Countries and Japan", *The Journal of Economics*, vol. 64 (4), 1999, p. 83.

³⁵ *Ibid.*, p. 59.

³⁶ R. Boadway and R.L. Watts, *Fiscal Federalism in Canada, the United States, and Germany: Final Report* (Kingston: Institute of Intergovernmental Relations June 2001) pp. 32-55.

taxing powers has facilitated or hindered the management of the economy to achieve stabilization policies.

Autonomy of the constituent units relates to the degree of freedom from external control by other governments experiences by governments within the polity. This is important because an authentic federal system involves a combination of shared rule for certain specified purposes through a common government *and* self-rule for certain specified purposes by the governments of the constituent units. In such a context, the extent to which the financial arrangements contribute to the genuine autonomy of the governments of the constituent units in their areas of constitutional responsibility or constrains such autonomy gives an indication of the degree to which the political system is in practice genuinely federal. The extent to which the constituent units have access to own-source revenues or are dependent upon transfers from the central government, and furthermore the extent to which these transfers are generally unconditional or conditional may seriously affect their degree of autonomy.

The degree of coordination and of central influence upon states and local governments is important because of the unavoidable interdependence and overlaps in the responsibilities of governments in any system of divided jurisdiction and decentralization. The effectiveness of the machinery and processes for intergovernmental cooperation in financial matters is therefore particularly significant but the degree to which the central government dominates these processes or proceeds unilaterally may undermine the autonomy of the states and local governments.

Transparency and democratic accountability of decision-making is important because an underlying principle of democratic representative government is that elected and appointed officials should be ultimately responsible to the citizens for their actions. This means that decisions about the fiscal arrangements should involve processes by which those making the decisions are publicly and legally accountable. A precondition for this is

“transparency” which refers to the degree to which decisions taken by governments are clearly open to public scrutiny. For democratic public control to operate effectively, the governmental, including intergovernmental, processes must be easily understood by the public.

Political stability and adaptability are both important. Political stability relates to the extent to which the processes of intergovernmental fiscal relations are carried out with a minimum of conflict and have a stabilizing influence on the operation and development of the country. A closely related consideration is the ability of the fiscal arrangements to assist the federation or decentralized unitary system to adapt over time to changing circumstances without destabilizing the polity.

The relative significance of institutions and of political culture refers to relative roles of the institutional structure and of the prevailing culture in shaping the character and operation of the intergovernmental financial arrangements.

2. The mature federations previously reported on: Canada, the United States and Germany:

The financial arrangements in three of the mature federations – Canada, the United States and Germany – were previously reported upon, and therefore the application of the criteria listed above will be only briefly summarized here.³⁷

In relation to the criterion of efficiency, in Germany efficiency in the common market has been virtually guaranteed because economic activity faces common government policies no matter where they locate. The concentration of taxing powers in the central government and funding arrangements that ensure all Länder are able to provide comparable levels of public services at comparable tax rates has ensured this. On the other hand, many of the efficiency advantages of decentralization are foregone by the uniformity of fiscal policies across Länder. Furthermore, inter-Länder competition as a spur to initiative and efficiency is generally lacking. The Canadian case achieves a number of the

³⁷ Ibid.

efficiency advantages of the German one while avoiding some of the major disadvantages. The decentralization of expenditure responsibilities is accompanied in Canada by real discretion for the provinces to tailor their programs to suit the needs and preferences of their constituents. The main issue in the Canadian case is whether there is too much decentralization from the point of view of efficiency. While in some areas of provincial spending, such as health, there is some degree of harmonization, in others which are important for efficiency objectives, such as education, there is virtually none. The United States, like Canada has a considerable degree of financial decentralization. However, some of the advantages of this are undermined by the fact that a substantial proportion of grants from the central government are conditional or are used to impose mandated expenditure programs upon the states. As well, although the tax system is not as decentralized as it is in Canada, there is no explicit system of tax harmonization.

From the point of view of equity objectives, these three federations achieve quite different degrees of redistributive equity. In the case of Germany common standards of equity apply across the federation. The common national system of income and sales taxation and the great lengths to which full equalization has been taken have ensured that full horizontal equity applies nationwide. In Canada, the equalization system goes a considerable way to ensuring that the goal of horizontal equity applies at least in revenue-raising terms. However, the decentralization of major social programs and the relative absence of federal oversight through conditionality of transfers or other means have meant that in practice different standards of equity can apply in different provinces. The United States differs from both the German and Canadian cases. Although the various conditional grant schemes often embody elements intended to achieve equity objectives, the absence of an explicit system of equalization transfers means that there is no systematic attempt to correct horizontal imbalances among the states.

In relation to fiscal management and stabilization policy the concentration of central

taxing powers in Germany leaves the central government there in a stronger position to carry out policies directed to these objectives. On the other hand, in Canada where there was more emphasis on Keynesian policies when they were in their heyday, the greater decentralization of income and corporate taxes placed some limits on these. In the United States too, although to a lesser extent than Canada, sharing of such taxing powers by the states had some effect upon the scope for federal fiscal management and stabilization policy.

There is considerable variation among these three federations in the degree to which constituent units lack their own tax levying powers and are dependent upon transfers from the federal government, particularly conditional transfers, and these have affected the degree of autonomy experienced by the governments of their constituent units. In terms of reliance upon own-source revenues and of predominance of unconditional transfers, the Canadian system of fiscal federalism clearly leaves the provinces with the highest degree of autonomy among these three federations. While the German Länder are dependent upon a higher proportion of intergovernmental transfers than the United States, the lower proportion of conditional transfers and the constitutionally mandated character of the unconditional transfers from shares of federal taxes, the size of which they have some influence over through the Bundesrat, leaves the German Länder with a larger degree of financial autonomy than the states in the United States.

In terms of degree of intergovernmental coordination and central influence upon states and local governments, the interlocking nature of decision-making on financial issues in Germany clearly stands out. Indeed some critics have argued that it has been carried to excess and that the resulting "joint decision trap" has reduced autonomy, initiative and freedom of action of governments at all levels.³⁸ At the

³⁸ F. Scharpf, "The Joint Decision Trap: Lessons from German Federalism and European Integration," *Public Administration* 66 (autumn 1988), pp. 238-278.

other extreme is the United States where intergovernmental cooperation, while not insignificant, has largely been of an ad hoc nature focused on specific projects and programs. Mid-way between them comes Canada where the processes of “executive federalism” have led to intense interaction among officials and ministers and even on occasion meetings of first ministers in relation to the financial arrangements between the federal and provincial governments. As a result, while the federal government may on some of these matters have the legal final word and has on occasion even acted unilaterally, in practice the degree of intergovernmental consultation and negotiation has been extensive. Nevertheless, unlike Germany, “executive federalism” is not formally grounded in the Canadian constitution and has on occasion been marked by inadequate collaboration or by federal government unilateralism. Thus, where in Canada there have often been calls for more collaboration and coordination, this contrasts with the calls in Germany for some loosening of the interlocking financial arrangements there in order to introduce larger elements of autonomy, more intergovernmental competitiveness, and clearer transparency and accountability.

In relation to the criteria of transparency and democratic decision-making, the complexity of the diffused system of governmental decision-making and intergovernmental relations in the United States has resulted in a relatively low transparency and public understanding of their financial arrangements. Nevertheless, the reliance upon conditional transfers makes it clear that the responsibility for setting those conditions lies in the Congress and the bargaining “free for all” that takes place there is relatively open to the public to observe. Canada and Germany, unlike the United States, are marked by parliamentary institutions with their executives at each level directly responsible to their respective legislatures. A significant result of this has been the predominance in their intergovernmental relations of negotiations between the executives in processes usually referred to as “executive federalism.” In both cases the complexity of the fiscal relationships, the complicated constitutional law surrounding

the distribution of powers and the exercise of the federal spending power, and the negotiations by the executives usually behind closed doors have meant that there is very little transparency for the citizenry concerning intergovernmental fiscal relations. The primary method for ensuring accountability in both federations is through the traditional conventions of executive responsibility to the legislature within each of the participating governments. The effectiveness of these accountability measures is, however, often undermined by the lack of transparency and clarity concerning the relative roles and responsibility of each government in relation to financing a particular policy or program.

An important consideration in assessing intergovernmental fiscal relations in these countries is the extent to which intergovernmental conflict is minimized and a stabilizing influence is exerted upon the operation and development of the federation. Closely related to and contributing to stability is whether the fiscal arrangements assist the federation to adapt to changing circumstances over time. An obvious measure of political stability in these three federations has been their existence under basically the same constitutional structure: in the United States for nearly 140 years since the conclusion of the Civil War of the 1860s, in Canada for 137 years since the formation of the federation in 1867, and in Germany for 55 years since its post World War II establishment as a federation. On the whole, the fiscal transfers system in the United States has shown a remarkable ability to adapt to changing circumstances over that period. The matrix of interconnections among legislators, administrators and executives in all three levels of government has produced an uncoordinated but flexible system accommodating the variety of regional views in its decision-making processes. The cumulative net effect has been that, despite the rhetoric of noncentralization, the fiscal arrangements in the United States have over time contributed to a progressive and cumulative centralization and relative dominance of the federal government within the federation.

Canada, by contrast, has over much the same time evolved from a relatively centralized federal system to a more decentralized one, and a key element in that trend has been the evolution of its fiscal arrangements. Nevertheless, during the past half century two factors contributing to continued political stability and cohesion have been the consensus in support of a systematic equalization scheme to assist the poorer provinces, and the general federal programs of financial assistance to the provinces in support of health, post-secondary education and social welfare which have contributed to the public's sense of Canada as "a sharing community." Given the difficulties and rigidities of the processes for formal constitutional amendment in Canada, it has been the adjustments in the federal-provincial financial arrangements that have served as the major factor enabling the federation to adapt to changing circumstances.

As in the other two federations, the processes of intergovernmental relations and fiscal arrangements in Germany have had both a stabilizing effect and have facilitated adaptation. For example, the special adjustments to the financial arrangements to assist the new Länder after reunification have played an important role. Despite the current pressures for a significant move towards disentanglement of the financial arrangements between the federal and Land governments, the fact remains that the Federal Republic of Germany over its first fifty-five years has proved both remarkably stable and remarkably adaptable.

In all three federations not only their institutional structures but their political cultures have played an important part in the operation of their intergovernmental financial arrangements. Of the three federations, Germany, for instance, has in relative terms the most homogeneous society and this has been both reflected in and reinforced by its intergovernmental fiscal arrangements. Examples are the emphasis upon equivalence of living conditions throughout the country, the extensive equalization program heavily based on inter-state transfers, and the generally highly integrated, interdependent and indeed interlocked character of its

intergovernmental decision-making and fiscal arrangements. The cultural homogeneity of the United States has been a factor in the relative dominance of the federal government and the acceptance of extensive conditional intergovernmental transfers. But compared to Germany, the emphasis in the United States political culture upon the variety of individual and group interests and upon the diffusion of power upon multiple decision-making centres has meant that, unlike Germany, there is no coordinated overarching system of equalization grants or of intergovernmental financial transfers. There is instead a vast array of uncoordinated intergovernmental transfer programs, each attempting to respond to specific needs and interests. The Canadian political culture, on the other hand, has been characterized by deep linguistic and regional cleavages. These explain the insistence of the provincial governments, and particularly Quebec, on ensuring their autonomy, and hence the trend over time to emphasize their own taxing powers and reliance particularly upon unconditional rather than conditional transfers. Nevertheless, despite the existence of regional and linguistic cleavages there is a high degree of consensus among Canadians on many social values. This has been reflected in the use of transfers by the federal government to assist the development of a set of Canada-wide programs that are accessible to Canadians regardless of where they live, and by a formal program for the systematic equalization of provincial revenues (including Quebec as a major recipient). The largely unconditional or only semi-conditional character of these transfers has at the same time allowed considerable discretion and variety in how the provinces deliver these programs. These examples indicate that each of these three federations in developing its own particular form of fiscal federalism has reflected the distinctive character of its society and political culture.

3. Two additional mature federations: Switzerland and Australia:

In relation to the various criteria, the other two mature federations, Switzerland and Australia, in some respects provide significant contrasts. In terms of economic efficiency Switzerland has emphasized the benefits that

flow from decentralization. Indeed as Table 2 indicates, it is the most decentralized of all the federations in terms both of expenditure and of own-source revenues. The fundamental principle has been that of subsidiarity. Competencies have generally been vested as far as possible at the local and cantonal levels and have been reluctantly transferred to the federal level only when a lower level is no longer in a position to provide a service “efficiently”. Despite or because of this approach, Switzerland has maintained a relatively prosperous economy with one of the highest per capita incomes in the world.

By contrast, in Australia most of the major taxing and revenue sources have been concentrated in the hands of the federal government, its percent of total government revenues being the highest among the mature federations. This has reduced intergovernmental tax competition and provided the federal government with the ability to exert an integrated and coherent economic policy. At the same time on the expenditure side there in Australia is a considerably greater degree of decentralization to obtain benefits from providing the states with considerable room for state initiatives. Unlike the German federation, decentralization on the expenditure side does not consist of administration of federal legislation but represents fields where the states have both legislative and executive responsibility. The considerable dependence on specific purpose conditional grants (Table 4) does, however, provide a source for central influence over state policies.

These two federations also provide contrasts in the degree to which they have emphasized the objective of equity. As in Germany, in Australia there has been a very strong value placed upon the goal of equity and of removing disparities among the states. This led to the first development of an equalization system in any federation in the world in 1933. The Commonwealth Grants Commission now takes into account some 18 revenue categories and some 41 expenditure categories in arriving at its recommendations. Switzerland introduced its first equalization scheme somewhat later in

1959. Because of the moderating impact of the Swiss emphasis upon cantonal autonomy, the Swiss equalization scheme has not been as far reaching in its total scope as those in Australia and Germany, or even that in Canada. Furthermore, the means of achieving equalization has been less systematic, being applied through a number of instruments including revenue sharing, conditional grants, and the cantonal contributions to the federal government’s social expenditures. In this respect Switzerland has been somewhat closer to the pattern in the United States although the approach has been more systematic. Consequently, the need to reform the equalization scheme has come to the fore very recently and has proved a contentious subject.

Fiscal management and stabilization policy as an objective for the federal government has been particularly prominent in Australia, and has been a major factor in the concentration of nearly all the major taxing powers in the federal government. The desirability of a centralized Keynesian approach to issues of fiscal management and stabilization which was so prominent in Australia for a significant period during the twentieth century, was much weaker in Switzerland, however. Consequently, the comparatively strong decentralization of both revenues and expenditures has persisted in Switzerland.

On the issue of autonomy of the constituent units, despite some pressures towards increased central policy-making and revenues during the latter half of the twentieth century, the Swiss cantons have remained fiercely independent in their outlook. As a result, as already noted, Switzerland continues to be the most decentralized federation in the world in terms of the distribution both of own-source revenues and of expenditures (Tables 1 and 2). Even in those considerable areas where the cantons implement federal laws, by contrast with Germany, the cantons are left by virtue of the constitution with a great deal of autonomy and the federal government is required to take into account the financial burden that is associated with implementing federal laws by transferring

sufficient equalized funding.³⁹ In Australia state autonomy has not been revered to the same extent as in Switzerland or Canada. Consequently, the own source revenues of the states are the lowest among the mature federations (Table 2), and the proportion of state revenue received in the form of conditional specific purpose grants is higher than in any other mature federation except the United States (Table 4). Nevertheless, concern for state autonomy has meant that more than half of the federal transfers to the states are unconditional in form (Table 3).

Intergovernmental coordination has been extensive in both federations. Australia since the Loan Council was established in 1927, has gone on to develop one of the most extensive arrays of formal coordinating bodies in any federation. The Council of Australian Governments (COAG) established in 1992 and composed of the leaders of the Commonwealth and state governments and also representatives of local government, usually meets twice a year and oversees the intergovernmental collaborative processes embodied in a wide range of sectoral Ministerial Councils, a number of which have voting rules for decisions. The premiers of the states also meet with each other regularly both to consider inter-state collaboration and to agree upon strategy for their relations with the Commonwealth government. The new equalization arrangements following the introduction of the GST also provide for the Ministerial Council on Commonwealth-State Financial Relations to oversee the work of the Commonwealth Grants Commission and to agree to changes in the rates of the GST. Not infrequently, intergovernmental discussions of financial relations have proved quite contentious, but because of its strong revenue base, ultimately the federal government has

usually carried the day in consultations and collaboration on a wide range of matters. In Switzerland, the fairly recent creation of a Conference of Cantonal Governments has not only provided an instrument for inter-cantonal collaboration but has also facilitated federal-cantonal multilateral deliberations in a federation composed of as many as 26 constituent units. By contrast with Australia, the relatively weaker financial position of the federal government in relation to the cantons, has meant that the federal government has not been in apposition to dominate federal-cantonal financial deliberations.

The financial arrangements in both Australia and Switzerland, because of their complexity, especially in the equalization formulae and indices, have been marked by a lack of transparency for the public at large. Furthermore, because much of the financial arrangements have been worked out in a context of intergovernmental negotiations and bargaining, there clarity has been obscured. In Australia where total transfers have formed such a high percentage of state revenues (highest among the mature federations – see Table 4), this has particularly undermined democratic accountability for the expenditure of these revenues. On the other hand in Switzerland, not only the much lower proportion of cantonal revenues composed of central transfers, but also the impact of the strong traditions of direct democracy at all levels of government, have contributed to a much greater level of democratic accountability regarding financial relationships. Indeed virtually all significant changes in taxing powers have been subject to approval by referendum.

Both federations have exhibited high degrees of both political stability and adaptability. In Switzerland, since the adoption in 1848 of a federal system to replace the previous unstable confederal structure which had culminated in a civil war, Switzerland has shown a remarkable political stability inspite of its deep historic, linguistic and religious diversity. Indeed, it has come to be held up widely as a model of multicultural accommodation. At the same time it has proved

³⁹ A. Linder and A. Vatter, "Institutions and Outcomes of Swiss Federalism: the Role of the Cantons in Swiss Politics," in J.-E. Lane, ed., *The Swiss Labyrinth: Institutions, Outcomes and Redesign* (London: Frank Cass, 2001), pp. 103-4; L. Mader, *Co-ordination of Powers in Federal Systems* (Paper at International Forum on Federalism in Mexico, Vera Cruz, 2001), p. 2.

capable of adaptation. This evolution by piecemeal adaptation is illustrated by the more than one hundred constitutional adjustments, including many on financial matters, made by formal constitutional amendments during the twentieth century, and by the modernization of the federal structure by the total revision in 1999. Australia too has displayed over a century of political stability. However, although having an almost identical procedure for constitutional amendment as Switzerland, the process has proved much more difficult in Australia. Indeed, by contrast with Switzerland over the same century, of 42 proposed constitutional amendments sent to referendum in Australia only 8 received the necessary double majorities for adoption. Nevertheless, the processes of executive federalism have provided an alternative means for some adaptability as illustrated by the implementation of the new GST tax as the pool for equalized transfers to the states.

Many of the differences between Switzerland and Australia in the evolution of their financial arrangements can be attributed as much to differences in their respective political cultures as to their political institutions. The largely egalitarian political culture of Australia has played an important part in the emphasis in its financial arrangements upon centralization facilitating uniform treatment and upon full equalization of both the revenue and expenditure aspects of inter-state disparities. By contrast, in Switzerland its linguistic and religious diversity has fostered an insistence upon decentralization and cantonal autonomy and has moderated the impulse for equalization.

4. The transitional federations: India, Spain, South Africa and Brazil:

Of the group of transitional federations, India, Spain and South Africa have shared some common tendencies, while Brazil is clearly differentiated from the other three. The first three will therefore be reviewed as a group and then Brazil separately.

In relation to the criteria of economic efficiency, India, Spain and South Africa have each on grounds of economic efficiency

concentrated taxing powers in the central government but decentralized expenditure responsibilities to promote efficient delivery of services (Tables 1 and 2). South Africa has carried this to the greatest degree with 95 percent of all revenue sources allocated to the central government, but even India, the least centralized of the transitional federations in this respect, is comparable to the most centralized of the mature federations (Australia) in terms of revenue concentration. Although in India the major taxes are levied and collected by the Union government there is more state tax room than in the other transitional federations. Consequently, some vertical tax overlapping has occurred due to the imposition of state sales taxes on items on which federal excise taxes have been levied, causing some distortions.⁴⁰ These three transitional federations as a group have clearly placed a high priority upon a coherent centralized levying and collection of taxes, and with it the avoidance of intergovernmental tax competition and conflict. This emphasis has been understandable since in each of these cases at the time the federal structure was established there was a severe pressure for rapid economic development to overcome their economic deficiencies. At the same time, the political pressures which made the adoption of federal institutions necessary were easier to accommodate while also giving weight to economic efficiency through the decentralization of expenditure responsibilities. The price of trying to combine these two different forms of economic efficiency for revenue raising and for expenditure responsibilities required, however, the acceptance of substantially larger vertical financial imbalances than in most of the mature federations. This in turn has required for these transitional federations as a group a much higher level of dependency of their states upon transfers from the central government. With this has gone a resulting loss in incentives for responsible spending. In the Indian case a further inefficiency has come from the failure of

⁴⁰ M.G. Rao and N. Singh, *The Assignment of Taxes and Expenditures in India*, Working Paper #435, Department of Economics, University of California, Santa Cruz, 1998, p.17.

coordination among the two important specialized institutions – the Finance Commissions and the Planning Commission – that both play a part in determining the size and form of total central transfers to the states.

In the case of Spain, the economic efficiencies gained from the different allocations of taxing powers and expenditure responsibilities have been moderated by the political necessity of treating the Autonomous Communities asymmetrically, particularly the “foral” cases. For these various reasons, the wide variation in vertical imbalances among the Autonomous Communities have in the end counterbalanced significantly the intended gains in economic efficiency from combining centralized taxation with decentralized expenditure.

In South Africa and India the disparities in wealth among the constituent units have been much deeper than that generally found in the mature federations. Consequently inter-unit equity has been a particular concern. In the case of South Africa, this has been reinforced by the avowed objective of reversing the inequities of the previous apartheid regime in relation to the Bantustans. Consequently, the notion of “equitable shares,” both in vertical and horizontal terms, permeates the constitutional provisions relating to the financial arrangements (article 214), and is set out as an objective for the Financial and Fiscal Commission (art. 214 (2)(d), (e), (f) and (g)). In its operation, the Commission has developed a methodology involving an array of indices to meet this objective (see Table 5). Since the constitution came into effect so recently in 1996, it is too early to judge the degree of success towards meeting this criterion, except to say that a start has been made. In India, too, the disparities in wealth among states are severe and the equalization of state revenues has been a major factor in the recommendations of its Finance Commissions. The criteria they have used have tended to be more general (see Table 5) than the multiple indices used by the Australian Commonwealth Grants Commission since in India the disparities are much wider. In spite of nearly 50 years of equalizing transfers in India,

per capita expenditures still show wide variations. These differences translate into disparities in literacy rates, health indicators and standards of governance.⁴¹ In Spain, where the economic disparities have not been as great to begin with, the revenues per inhabitant of the different Autonomous Communities have been broadly equivalent, and when the European Funds from the European Union are included, the per capita revenues of the poorest Autonomous Communities have been even lifted above those of the wealthiest.⁴²

In these three federations the relative concentration of taxing powers in the central governments has left the levers for fiscal management and stabilization policy clearly with their central governments. In South Africa, for instance, the national Department of Finance has moulded a system of intergovernmental fiscal relations in which, by and large, the provinces are expected to follow the national department’s game plan.⁴³ Some concerns have arisen, however, particularly in India, about the extent to which the largely unconditional nature of the non-plan transfers has permitted states to develop persistent deficits, thus building up a deteriorating debt situation. In Spain, the 1997-2002 financing arrangements for the Autonomous Communities which substituted some lump-sum central transfers by regionally-raised tax revenues was an important step to improving fiscal responsibility at the regional level, but the central government has retained the final decision power on financing the

⁴¹ D.K. Srivastava, “India” in P. Smoke and Y-H Kim (eds.) *Intergovernmental Fiscal Transfers in Asia: Current Practices and Challenges for the Future* (Asian Development Bank), 2001, p.92.

⁴² A. Castells, “The Role of Intergovernmental Finance in Achieving Diversity and Cohesion: The Case of Spain,” in R. Bird and T. Stauffer (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies* (Fribourg: Institute du Fédéralisme, 2001), p. 98.

⁴³ C. Murray, “Building Unity Through Transformation: Intergovernmental Fiscal Relations in South Africa,” in R. Bird and T. Stauffer (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies*, (Fribourg: Institute du Fédéralisme, 2001), p.529.

autonomous governments (through the system of grants) and therefore remains largely in control.⁴⁴

As far as autonomy of constituent units is concerned, because of the restricted range of own-source taxing powers and high degree of dependency upon central transfers, the financial autonomy of the constituent units in these federations is much more limited than in the mature federations generally (see tables 2 and 4). To some extent this has been partially mitigated by a heavier reliance on unconditional rather than conditional central transfers, but the more genuine autonomy that comes from substantial own-source revenues whose size is determined by the constituent units has been limited.

In these three federations, there is a considerable degree of coordination of intergovernmental relations, largely in the form of inter-executive consultation and meetings (especially in South Africa), but this has generally been characterized by central government leadership and a top-down approach rather than by a spirit of cooperation among governments of equal status.⁴⁵ While this characterized the situation in India in the early decades after independence, more recently the replacement of Congress Party dominance by coalitions of regional political parties within the Union government has moderated the centralist bias in intergovernmental financial negotiations. In South Africa, on the other hand, the continued overwhelming dominance of the African National Congress at both levels of government and, as the 2004 election has indicated the continued strength of the party's central organization in relation to the political dynamics at all levels shows no sign of weakening. The change of central government in Spain in 2004 may moderate the heavily top-down character of the previous financial arrangements, but it is too early to judge the impact of the change of government in Madrid.

⁴⁴ I.Joumard and A. Varoudikis, *Options for Reforming the Spanish Tax System*, OECD Paper 249, 2000, p.10; 2000, p. 10; Castells, op.cit., p. 98.

⁴⁵ See, for instance, Murray, 2001, op.cit. pp. 530-31.

In relation to fiscal transparency, India has achieved a reasonably high standard.⁴⁶ Particularly noteworthy is the detailed information that is made available in the government budgets and also elsewhere in reports by government ministries and in the audit processes. Nevertheless, the inevitable complexities of the intergovernmental transfer arrangements, and the conflicting impacts of the Finance Commission and Planning Commission processes have complicated the picture. In Spain the different kinds of grant mechanisms, the added complication of the European Funds assisting the poorest Communities, and the different arrangements relating to the 'foral' Communities and the fast and slow-track Communities all contribute to a complicated picture difficult for the public to understand clearly, and they provide fuel for inter-Community grievances and resentments. In South Africa the complexity of the criteria used in its assessments by the Finance and Fiscal Commission has led the Department of Finance to criticize the commission reports as at a "fairly high level of abstraction."⁴⁷ But the resultant sidelining of the commission's recommendations by the Department of Finance, and the fact that the shares allocated to each sphere of government have in the end been based on "a political judgement made by the cabinet"⁴⁸ has contributed to a lack of transparency concerning intergovernmental financial arrangements. The limitations of transparency have affected the degree of democratic accountability in decision-making on financial matters in all three federations, and this lack has been further accentuated at the constituent unit level by their limited own-source revenues and dependency upon central transfers. Recent Indian Finance Commissions have attempted to counteract this by including among their criteria for allocation among the states their fiscal performance (including tax effort and fiscal management). In Spain the

⁴⁶ IMF, 2001, p.8.

⁴⁷ J. Wehner, "Comments on 'Building Unity Through Transformation: Intergovernmental Fiscal Relations in South Africa'" in Brid and Stauffer, op.cit., 2001, pp. 542-3.

⁴⁸ Department of Finance, 1999, p. 258.

substitution of some lump sum central transfers by regionally levied tax revenues was intended to increase the accountability of Communities to their electorates, but the effect has been limited by the continued heavy dependence on central transfers. In South Africa the Fiscal and Financial Commission has held the view that provincial taxing powers are essential if the provincial governments are to be properly accountable,⁴⁹ but taxing powers have nevertheless remained highly centralized.

Despite shortcomings in relation to a number of the criteria reviewed above, these three transitional federations have performed remarkably well in terms of overall political stability and adaptability. This is perhaps clearest in the Indian case. Despite the dire predictions of some of the critics in the early decades, the adaptability of the federal system, enabling the accommodation of its extensive socio-cultural diversities, has enabled the federation to hold together. The states and local governments have come to play an important role, raising some 34 percent of total government revenues and being responsible for some 55 percent of total government expenditures (see Table 2). The increased democratic decentralization which has occurred since the inception of the constitution in 1950 and particularly in the 1990s has provided an important and effective answer to subnational and ethnic conflicts.⁵⁰ In Spain while the asymmetrical devolution has been highly complex, especially in relation to the financial arrangements, they have enabled the promotion of self-government for its minority nations. Public debates on federalism and the nature of the Spanish constitution continue, but at a time when the constitution of 1978 has reached its quarter-century, the Spanish democracy now appears relatively stable, particularly since the ETA ceasefire of 1998 which removed the threat

of secessionist violence from the public sphere. The South African constitution of 1996 is still less than a decade old, and therefore it is clearly too early to talk about long-run political stability and adaptability, but the election of 2004 has provided ample evidence that despite difficult economic circumstances, the Republic has got off to a strong political start.

In these three federal examples institutional structures and the prevailing political culture have both played a part in shaping their federal systems in general and their arrangements governing intergovernmental financial relations. In India the constitutional structure has defined the allocation of taxing powers, arrangements for financial transfers, and the role of the Finance Commission as a constitutional body. At the same time the broad eclectic and pragmatic nature of the underlying Hindu culture has contributed to the adaptation of the institutional structure and its accommodation of the ethnic and linguistic diversity expressed through the states. In Spain, the arrangements in the 1978 constitution provided a process for progressive asymmetrical devolution. But the actual shape in which that devolution has evolved has owed as much to the negotiations among the political leadership at different levels and the degree to which the population has been willing to accept the multi-national character of Spain and the moderate nationalist groups in preference to such extremist groups as ETA. The constitutional structure of South Africa emphasizing “cooperative governance” and its detailed provisions relating to the financial arrangements have clearly been important, but equally important has been the post-apartheid prevailing public emphasis upon “equitable shares” throughout the country. The dominance of the ANC as a party and the national priority it has given both to equity and to fiscal stability has been a major factor in the intergovernmental financial relations.

Among the four transitional federations, Brazil has clearly been an outlier. While also relatively centralized in terms of concentration of taxing powers in the central government – a similar level to India but considerably less than South Africa or Spain (Tables 1 and 2) – it has

⁴⁹ Murray, 2001, op.cit., p.517.

⁵⁰ H. Bhattacharyya, “Federalism, Decentralization and State-Building in India: Aspects of Centre-State Fiscal Relations,” in R. Bird and T. Stauffer, (eds.), *Intergovernmental Fiscal Relations in Fragmented Societies* (Fribourg: Institut du Fédéralisme, 2001), p. 278.

differed in two major respects. First the degree of expenditure decentralization is much less, indeed the lowest of all the countries listed in Tables 1 and 2. Second, this means that the vertical imbalances are much less than in any of the other countries examined in this report (Table 2), and the dependence of the states on central transfers (Table 4) is much less than in any of the other transitional federations (although comparable to the United States and more than is the case in Switzerland or Canada). This has meant that in relation to the criterion of economic efficiency it has moderately achieved the benefits of centralized revenue raising, but in comparison to the other cases far less those of expenditure decentralization. Efficiency has also been hindered by the lack of a clear division of responsibilities across levels of government on health and security issues, education, social welfare, agriculture, food distribution, sanitation, housing and policing. This has led to duplication of spending assignments.⁵¹

A particularly distinctive feature of the Brazilian federation has been the pronounced socio-economic disparities among the sub-national units. These fiscal disparities have hindered the creation of new forms of federative coordination within the decentralized regime. For example, the City Government of Sao Paulo collects more municipal service tax (ISS) than the combined value tax (ICMS) revenues of 17 states.⁵² Given that, unlike the other transitional federations, the states in Brazil receive much smaller proportion of their revenues from central transfers and therefore are much more dependent on their own-source revenues (Table 4), the need to correct of these sharp differences among the states in revenue capacity has continued largely unabated. Brazil's major redistributive program does concentrate on the poorest regions – 85 percent goes to the northeast region⁵³ – but to a

large extent these have been insufficient to reduce the disparities.

With regard to fiscal management and stabilization policy, the federal government does levy personal (IRPF) and corporate (IRPJ) income taxes and a VAT (IPI). It therefore does have major levers for fiscal management and stabilization policy. On the other hand, unlike most of the other transitional federations, it has far less leverage over the taxation levied by the states (including the states' VAT (ICMS) which account for about 25 percent of the total amount of taxes levied in Brazil) and over the expenditures of the states.

In the process of disorganized decentralization that has occurred under the 1988 constitution, the main concern of the states has been upon guaranteeing their tax autonomy, especially in relation to their main tax, the ICMS (a state VAT). The states are responsible for a wide and expanding range of activities and raise significant amounts of revenue themselves. This has given them a wide-ranging budgetary autonomy, and despite numerous federal attempts to restrict their borrowing activities, they have also had access to credit through a wide range of sources and instruments. Important factors have been that the states are well represented in the Senate (whose approval is needed for all legislation) and that the political autonomy of the states and municipal governments is protected by tight constitutional restrictions. Furthermore, the states preside over large, powerful militias that counterbalance the threat of federal intervention. The net effect is that the states and municipalities often behave like predators of a politically weak and wounded federal government.

In Brazil the only institution established to coordinate intergovernmental fiscal relations is the National Council for Fiscal Policy (CONFAZ). Originally established during the military regime to coordinate the fiscal and tax policies of the states, it still operates but today it

⁵¹ OECD, Economic survey: Brazil, 2001, p.145.

⁵² J. Serra and J.R.R. Afonso, *New Economic and Fiscal Federalism: the Brazilian Case*, (Forum of Federations, Ottawa, undated), p.326.

⁵³ A. Shah, "Comment on 'Decentralization and Reform of the State: The Brazilian Federation at the Crossroads,'" in R. Bird and T. Stauffer, eds., *Intergovernmental Fiscal Relations in Fragmented*

Societies (Fribourg: Institut du Fédéralisme, 2001), p. 350.

performs purely formal functions.⁵⁴ Relations between the federal government and the states and municipalities, and between the state governments and their respective municipalities are characterized largely by mutual independence and competition, and the federation lacks effective institutional mechanisms to facilitate cooperative intergovernmental relations. The result is that a distinctive characteristic of the Brazilian has been intergovernmental tax competition which often goes to the length of 'tax warfare'. A high degree of party fragmentation and weak party discipline at the federal level has contributed to producing a relatively weak federal government.

Nevertheless, in 2000 the federal government sent to Congress a Fiscal Responsibility Act inspired by the Fiscal Responsibility Act in New Zealand. This Act introduced new concepts such as responsibility and transparency and was intended to create a responsible fiscal management at all three levels of government. It required all levels of government to formulate and publicize three-year targets, prohibited the federal government from bailing out state and municipal debts, and applied hard sanctions to those responsible for misuse of government funds.

Although the current federal constitution has been in operation for only a decade and a half, in that brief period the tax system seems to have undermined rather than contributed to political stability. It has encouraged 'fiscal warfare' among vertically and horizontally among governments, and this has if anything intensified in recent years.

It would appear that to a considerable extent the institutional structures established by the 1988 constitution have been distorted by the socio-economic pressures that have been inherited from the preceding regimes in Brazil. The major social and economic disparities have created intense inter-state and federal-state rivalries and fiscal competition at the expense of any efforts at coordination.

⁵⁴ Costa, *op. cit.*, p. 50.

5. The decentralized unitary systems: Sweden and Japan:

Both these unitary systems have sought the objective of economic efficiency through substantial decentralization. Indeed, as Tables 1 and 2 indicate, the extent of decentralization has been comparable to that in many federations. The major difference between them and the federations has not been in the degree of decentralization, but rather in the fact that in the federations the decentralized authority of the constituent units is conferred and guaranteed by the constitution rather than by the central government.

In terms of economic efficiency both these decentralized unitary systems have, like the federations, attempted to combine the efficiencies of centralized taxation enabling fiscal management and stabilization policy with the efficiencies to be obtained by decentralized expenditure responsibilities. There is, however, a significant difference between Sweden and Japan. The scope of expenditure that has been decentralized is substantially greater in Japan (Table 2), but the degree of autonomy granted to local governments, especially in terms of own-source revenues, is much greater in Sweden. The OECD has given positive reviews of the Swedish economic reforms of the 1990s, indicating that decentralization has contributed to the long-term economic performance of Sweden.⁵⁵ Japan has been in the midst of a decade of economically troubling times, but there have been some signs in 2004 that its economic performance has begun to pick up. Moreover, despite the problems of the past decade, it should be noted that Japan has remained one of the world's most economically powerful countries, ranking eleventh out of 102 countries in the World Economic Forum's global competitiveness rankings.⁵⁶ At the same time a desire for equity in the provision of public goods has distinguished both Japan and Sweden among decentralized polities.

⁵⁵ OECD, *Economic Surveys 2000-1: Sweden* (Paris: OECD, 2001).

⁵⁶ World Economic Forum, *Global Competitiveness Report 2003-04*.

Sweden has been unique among decentralized unitary systems in the level of autonomy granted to local governments. Local governments are responsible for the provision of many public services and, what is more, have significant taxation authority. This has reduced the vertical fiscal imbalance to the lowest of all eleven countries referred to in this report (Table 2, third column). In addition what limited central grants have been necessary have been largely provided unconditionally, further strengthening local autonomy. This has led Mochida and Lotz to commend highly Sweden's intergovernmental financial arrangements, both for the autonomy they promote and for the transparency and democratic accountability of financial decision-making that these arrangements have achieved. While the Japanese decentralization has in terms of extent gone somewhat further (Table 2, second column), this has not been accompanied by the same degree of local autonomy. Due to the heavy reliance on central tax sharing and grants, central control has reduced local accountability, and the complicated formulae involved in determining local allocations have reduced transparency. This has led Mochida and Lotz to conclude: "The Japanese system seems to attempt to combine North European (i.e. Scandinavian) expenditure decentralization with Continental style centralized methods of financing. This is a problematic match".⁵⁷ The result has been a high degree of central government influence and control over local governments through the financial transfers and subsidies it provides for centrally assigned tasks. In Sweden on the other hand there has not been the same top-down dominance. Due to the relative independence of the Local Government Associations, the relations between central and local government have been characterized more by cooperation and negotiation.⁵⁸

Despite the problems that have been identified, in long-run terms the degree of decentralization implemented in Japan under its post-war constitution appear to have contributed

to its remarkable political stability. In the earlier decades these arrangements also contributed to its adaptability, but in the past decade their bureaucratic character seems to have been a factor blocking responsiveness and fresh initiatives in the face of economic stagnation. Sweden's long history of local decentralization has been a factor in its renowned political stability, but these arrangements have not been inflexible. Not only were there reforms in local governments in 1952 and in 1962-74, but in the 1990s, after a period of poor economic performance in the 1970s and 1980s marked by high inflation, currency crises, and rising public and foreign debt, the significant reforms in the financial decentralization and deregulation of local governments have produced benefits now manifested in improved economic performance.⁵⁹ How much of the political stability and adaptability of these two examples can be attributed to their political institutions and how much to their respective political cultures is difficult to say. In federal systems where the constitutions lay down the specific allocations of powers and finances and established the institutional structures, the modifications of these in practice under the pressures of the prevailing social values illustrates the relative impact of political cultures. In unitary systems where a central government does not have the same constitutional constraints upon it, it is harder to determine the precise extent to which the evolution in political practice is due to the influence of the institutional structure or to the impact of prevailing social values. Over the long course of the evolution of local government and finance in Sweden these arrangements would appear to have influenced and been influenced by the wide public acceptance of the desirability of decentralized and autonomous local government. In Japan, the new institutional structures established in the post-war occupation period clearly represented a break with Japan's past political culture. Those institutions have, however, put down roots and appear to have become widely accepted by the public. The institutions were to some extent the product of

⁵⁷ N. Mochida and J. Lotz, "Fiscal Federalism in Practice: The Nordic Countries and Japan," *The Journal of Economics*, 64(4), 1999, p.61.

⁵⁸ *Ibid.*, p. 83.

⁵⁹ Swedish Institute, "Fact Sheets on Sweden: Local Government in Sweden," 2001.

an occupying power. Nevertheless, in the process of accepting them, after the shock of the way in which the war ended the operation of these institutions has been modified in subtle ways by traditional Japanese values. This explains the complex nuanced relationships between the central and local governments.

D. CONCLUSION

Although there is considerable individual variation the federations and decentralized unitary systems considered in this report fall into two broad groups in terms of their intergovernmental financial relations. In one group, there has been an emphasis upon the economic benefits of relatively centralized revenue-raising combined with substantially more decentralized expenditure responsibilities. With this has gone the need for massive transfers from the central government to correct both the resulting vertical and also the horizontal financial imbalances by means of extensive sharing of the proceeds of central taxes and the use of unconditional and conditional grants. Into this broad group fall Australia and Germany among the mature federations, India, Spain and South Africa among the transitional federations, and Japan among the decentralized unitary systems. The drawback of this approach has been the general dependency of the constituent units upon the central government in order to meet their expenditure needs and the lack of incentives for fiscal responsibility in their operation. To offset these disadvantages there has usually been an attempt to foster state autonomy by an emphasis upon the unconditionality of the central transfers, including in Australia, India and South Africa the use of independent finance commissions. In the case of Germany and South Africa there have been attempts to counter the limited autonomy of the states by giving them some role through such institutions as the Bundesrat and the National Council of the Provinces in the making of central policy that affects the states.

A second broad approach has been to emphasize the importance of a sufficiently substantial allocation of own-source tax and other revenues at the state level to achieve the benefits of autonomy and fiscal responsibility.

This has usually resulted in a narrower vertical financial imbalance to be corrected by a more modest scale of transfers from the central government. With variations, this has been the general pattern in Canada, Switzerland and the United States among the mature federations, Brazil among the transitional federations, and Sweden among the decentralized unitary systems. The disadvantage of this approach is that if there is inadequate intergovernmental cooperation and collaboration it may lead to harmful tax competition between the various governments in the polity. These effects are most apparent in the tax wars occurring in the Brazilian example. In the United States, to recognize the principle of financial responsibility (that control over expenditures be placed with the taxing authority) there has been a heavy reliance upon conditional central grants, placing responsibility for shaping expenditures funded by transfers in the hands of Congress as the taxing authority. The result has, of course, been a considerable diminution of state autonomy and a constraining of the benefits of decentralized own-source revenues. The other three countries following this general approach have achieved a better balance of autonomy and constituent unit financial responsibility. They have done this by combining an allocation of substantial own-source revenues to the constituent units with some tax harmonization arrangements and significant elements of intergovernmental cooperation and collaboration in their financial arrangements. In addition in these three cases horizontal imbalances in revenue capacity have been moderated by a system of equalization grants, usually unconditional in nature, in order to reduce disparities in the own-source revenues of the constituent units.

Finally, it emerges clearly from this comparative analysis that intergovernmental financial relations are not determined simply by economic analysis and technical adjustments alone, but are at their essence the product of

political compromises.⁶⁰ Thus understanding of the intergovernmental financial relations in any country requires an understanding of the political context which shapes them.

⁶⁰ R. L. Watts, "Introduction: Comparative Research and Fiscal Federalism", *Regional and Federal Studies*, Special Issue: Money matters: Territorial Finance in Decentralized States, vol 13 (4), Winter 2003, pp. 1-6.

TABLE 1: CENTRAL GOVERNMENT SHARES OF TOTAL (ALL GOVERNMENTS) REVENUE AND EXPENDITURES¹

Country	Percent of Total all Governments Revenue	Percent of Total all Governments Expenditure
<i>Mature Federations:</i>		
Australia	69	54
United States	67	54
Germany	65	37
Canada	44	37
Switzerland	40	32
<i>Transitional Federations:</i>		
Spain	83	51
South Africa	95	50
Brazil	69	64
India	66	45
<i>Mature Unitary Systems:</i>		
Japan	58	38
Sweden	57	54
<i>Russia:</i>	91	46

1. Revenue shares are before transfers of shares of central taxes and grants to state and local governments. Expenditure shares are after transfers of shares of central taxes and grants to state and local governments. Figures are rounded to the nearest percent. Countries in each category are listed broadly in descending order of centralization. Depending on source figures are for 2000 or 2001.

Sources: *Government Finances Statistics Yearbook* (various years); R.L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (1999), pp. 52-3; S. Yilmaz and Bindebir, *Intergovernmental Transfers: Concepts and Policy Issues* (World Bank Institute, 2003); Japan, Ministry of Finance "Understanding the Japanese Budget" 2003; Mochida and Lotz, "Fiscal Federalism in Practice, the Nordic

Countries and Japan,” *The Journal of Economics*, 64(4) 1999; Sweden, Ministry of Finance, *Budget Bill* (2003); South Africa, Financial and Fiscal Commission, “Towards a Review of the Intergovernmental Fiscal Relations System” (2003); B. Dafflon and S. Perritez, “Federal-Cantonal Equalization in Switzerland: An Overview of the Present System and Reform in Progress” (BENIFRI, Fribourg, 2003); *Supplement to 2002 Government Finances Statistics Book* (IMF); A. Castells, “The Role of Intergovernmental Finance in Achieving Diversity and Cohesion: The Case of Spain” in R. Bird and T. Stauffer, eds., *Intergovernmental Fiscal Relations in Fragmented Societies* (Fribourg). Russian figures are derived from R.L. Watts, *Russian Fiscal Federalism in Comparative Perspective* (Kingston: Institute of Intergovernmental Relations, Queen’s University, 2005), Tables 1 and 2.

TABLE 2: STATE AND LOCAL GOVERNMENT SHARES OF TOTAL (ALL GOVERNMENTS) REVENUE AND EXPENDITURES¹

Country	Percent of Total all Governments Revenue	Percent of Total all Governments Expenditure	Vertical Imbalance
<i>Mature Federations:</i>			
Australia	31	46	15
United States	33	46	13
Germany	35	63	27
Canada	56	63	07
Switzerland	60	68	08
<i>Transitional Federations:</i>			
Spain	17	49	32
South Africa	05	50	45
Brazil	31	36	05
India	34	55	21
<i>Mature Unitary Systems:</i>			
Japan	42	62	20
Sweden	43	46	03
<i>Russia:</i>	9	54	45

2. Revenue shares are before transfers of shares of central taxes and grants to state and local governments. Expenditure shares are after transfers of shares of central taxes and grants to state and local governments. Figures are rounded to the nearest percent. Countries in each category are listed broadly in ascending order of decentralization. Depending on source figures are for 2000 or 2001.
3. Vertical imbalances are identified by difference between total state and local expenditures and total state and local own source revenues (before transfers of shares of central taxes and grants).

Sources: As for Table 1.

**TABLE 3: CONDITIONAL GRANTS AS PERCENTAGE OF
TOTAL CENTRAL TRANSFERS**
(Total Transfers = shares of central taxes plus unconditional grants plus conditional grants)

Country	Year	Percentage
<i>Mature Federations:</i>		
Australia	2000	47.1
United States	1996	100.0
Germany	1996	64.5
Canada	1996	43.6*
Switzerland	1997	73.1
<i>Transitional Federations:</i>		
Spain	1998	66.1
South Africa	2001/02	11.5
Brazil	2000	25.0
India	2001	40.7
<i>Mature Unitary Systems:</i>		
Japan	2003	43.5
Sweden	2003	15.7

Note: Figures are mostly for 2000 and 2001 except for those for Canada, United States and Germany which are for 1995 or 1996 (derived from previous studies for this project).

* If CHST transfers are considered as unconditional, the percentage for Canada would be 4.3%.

Sources: *Government Finances Statistics Yearbook* various years; R.L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (1999), p.56; see also sources for Table 1.

TABLE 4: CENTRAL TRANSFERS AS PERCENT OF TOTAL CONSTITUENT UNIT (States and Local) REVENUES

Country	Total Transfers	Conditional Transfers
<i>Mature Federations:</i>		
Australia	45.3	21.3
United States	29.6	29.6
Germany	43.8	9.8
Canada	19.8	15.8*
Switzerland	24.8	17
<i>Transitional Federations:</i>		
Spain	72.8	41.9
South Africa	96.1	11.0
Brazil	30.0	7.5
India	46.0	18.7
<i>Mature Unitary Systems:</i>		
Japan	37.2	16.2
Sweden	15.8	4.4

Note: Figures are mostly for 2000 and 2001 except for those for Canada, United States and Germany which are for 1995 or 1996 (derived from previous studies for this project).

* If CHST transfers are considered as unconditional, the percentage for Canada would be 0.9%.

Sources: *Government Finances Statistics Yearbook*; R.L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (1999), pp.53, 57; see also sources for Table 1.

TABLE 5: EQUALIZATION ARRANGEMENTS

United States	No generalized equalization scheme: some equalization occurs from cumulative effect of provisions in specific federal grant-in-aid schemes as approved by Congress.
Switzerland	Federal transfers based on formulae involving a range of criteria ranking cantons by financial capacity as the basis for tax-sharing and conditional grants, but the equalizing transfer system is smaller than in Germany, Canada and Australia.
Canada	Federal transfers: stand-alone equalization scheme based on formula (adjusted from time to time) assessing provincial revenue capacity in terms of 33 provincial tax and non-tax revenue sources against a middle range five-province standard and providing unconditional grants representing 42% of all transfers.
Australia	Federal transfers: based between 1933 and 1981-82 on recommendations derived from determination of needs of claimant states by a standing independent Commonwealth Grants Commission; after 1981-82 took the form of adjustments to the general Adjustment Grant transfers based on calculation of relativities of expenditure needs among states; since 2000 based on application of relativities to distribution of central GST tax. Allocation by CGC based on calculation of revenue capacity and expenditure needs from comparisons of 18 revenue categories and 41 expenditure categories.
Germany	Primarily inter-state transfers (62%): equalization through an inter-state revenue pool to which rich Länder pay and from which poor Länder draw according to a formula; plus federal transfers (38%): Federal Supplementary Payments of 1.5% of value-added tax (VAT). The primary per capita distribution of the shares of the Länder of a portion of the VAT also has an equalizing effect.
India	Federal transfers from a pool of all union taxes supplemented by unconditional grants, based on the recommendations of quinquennial Finance Commissions recommending both the share to be allocated to the states as a group, and the allocation among states taking account of population, per capita income, area, economic and rural infrastructure needs, and tax effort.
Spain	Federal transfers: since 1987 criteria including population, size, personal income, fiscal effort, number of internal provinces within Autonomous Community, and distance to state capital; applied by federal government to shares of federal tax revenue transferred to Autonomous Communities.
Brazil	Distribution of state participation fund (state share of three main federal taxes) with participation coefficient for each state based mainly on redistributive criteria (85 percent of fund goes to poorer regions in the North, Northeast, and West-West). A similar fund for municipalities is less redistributive and more population based.
South Africa	General national revenue-sharing transfer, with National Government distribution of “equitable shares” among provinces following recommendations of Financial and Fiscal Commission based on demographic profiles of provinces comprising an education share, a health share, a social security share, and population, backlog, economic activity and institutional components.
Sweden	Cost equalization transfers based on 15 indices: municipalities and country councils whose per capita income is below national average receive a grant and those above pay a fee (i.e. scheme is self-balancing), plus a supplementary block grant from the central government containing a population-related and age-related portion. Implemented by an Equalization Commission.
Japan	Local Allocation Tax (the main central government unconditional revenue-sharing transfer) is distributed to local governments on a uniform formula based on basic financial need and basic financial capacity.

TABLE 6: ARENAS FOR RESOLVING ISSUES OF INTERGOVERNMENTAL FINANCE

United States	Congress: negotiations among representatives of different states within Congress over allocation of grant-in-aid programs: representatives of state administrations act as lobbyists.
Switzerland	Federal Parliament: negotiations within Federal Council (i.e. federal executive) and Parliament (containing cantonal representatives), but with extensive consultation of the Conference of Cantonal Governments, and assisted from time to time by commissions.
Canada	Processes of executive federalism predominate. Ultimate decision lies with federal government and federal legislation, but in practice for each five year period renewal is preceded by extensive federal-provincial negotiations through officials and federal and provincial finance ministers to arrive at an agreed program.
Australia	Processes of executive federalism predominate. Ultimate decision lies with federal government and federal legislation, but equalization transfers from GST pool are based on recommendations of an independent expert Commonwealth Grants Commission (CGC), whose recommendations are usually implemented, the recommendations being made within a context established by an intergovernmental Ministerial Council.
Germany	Executive federalism: ultimately fiscal arrangements require endorsement of the Bundesrat composed of representatives of the executives of the Länder.
India	Ultimate decision lies with Union government, but constitutionally mandated independent Finance Commissions make recommendations for total state share of shared central taxes and for unconditional grants to states, and for distribution of both among states. Recommendations have in practice usually been implemented. These transfers are supplemented by substantial conditional grants allocated on the recommendation of the Planning Commission.
Spain	Executive federalism: regional financial arrangements are negotiated every five years in the Fiscal and Financial Policy Council, an intergovernmental ministerial body with the decisions made by a qualified majority vote in which the vote of the two central government ministers is equal to that of all the regional councillors. Legally an advisory body but in practice decisive.
Brazil	General lack of institutional structures for financial arrangements expect for National Council for Fiscal Policy (CONFAZ) for coordinating the fiscal and tax policies of the states, but in practice this performs purely formal functions.
South Africa	Ultimate decisions lie with the national government, but an independent Financial and Fiscal Commission (FFC) of 22 members, of whom 9 are appointed by provinces and two by local governments, is mandated by the constitution to make recommendations on the "equitable shares" for state and for local governments and on the formula for distribution. These are reviewed by the Budget Council and the Budget Forum (both intergovernment councils). In practice, the FFC has been treated by the Finance Ministry of the national government largely as an advisory body.
Sweden	Decisions relating to transfers lie with national government, with implementation of equalization arrangements being carried out by an independent Equalization Commission. The Swedish Association of Local Authorities and Swedish Association of Country Councils handle the contacts and annual negotiations between the local and central governments.
Japan	Decisions lie with the central government but prefectural governors and administrators spend a great deal of time lobbying the central government and Diet members.