

# **FISCAL FEDERALISM IN CANADA, THE USA, AND GERMANY<sup>1</sup>**

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## **ABSTRACT**

The intergovernmental financial arrangements in three federations – Canada, the United States and Germany – are compared. Among the aspects compared are the constitutional and political context, the allocation and the scope of federal, state and local revenues and expenditures, the nature and scope of intergovernmental transfers, equalization arrangements and systems of tax harmonization and collection. The three systems are assessed in terms of a variety of economic and political criteria.

## **INTRODUCTION**

This study draws upon earlier individual studies of fiscal federalism in Canada (R. Boadway and R.L. Watts, July, 2000), the United States of America (R.L. Watts and Marianne Vigneault, November 2000), and Germany (R.L. Watts and Paul Hobson, December, 2000), which are available on request from the Institute of Intergovernmental Relations at Queen's University. Each of those previous studies examined and analyzed the evolution of the fiscal

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arrangements in the individual federation over time. This study now pulls together those three, making comparisons among the three federations, and identifying the lessons that may be drawn from them.

All three federations incorporate the major constitutional features of a federation. There are, however, significant differences in the constitutional and political context within which fiscal federalism operates within each of the three federations. Consequently there are variations in the allocation and scope of federal, state and local revenues and expenditures, in the nature and scope of the systems of intergovernmental financial transfers attempting to correct vertical (federal-state), and horizontal (inter-state) imbalances of revenues and expenditures, and in the systems of tax harmonization and collection. Not only are there differences in these respects among the federations, but also within each of them over time.

In considering the lessons that may be learned from the experience of these three federations, attention will be given particularly to the criteria of efficiency, equity, autonomy, transparency, accountability and political stability. Also considered will be the degree of coordination between governments within each federation and the degree to which this has involved federal government influence upon state and local governments. Finally, reference will be made to the significance of political culture in shaping the arrangements of fiscal federalism.

## **FISCAL FEDERALISM IN THE THREE FEDERATIONS COMPARED**

### **The Constitutional and Political Context Compared**

#### *Common constitutional and political features*

All three federations incorporate the major characteristics of a federation: the establishment of two or more orders of government acting directly, rather than through another level of government, on the citizens; a formal constitutional distribution of areas of exclusive and shared (concurrent) legislative and executive authority ensuring at least some areas of genuine 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 a federal second legislative chamber designed specifically for this purpose; a supreme written constitution not unilaterally amendable by either order of government but requiring the consent of the federal legislature and of a significant proportion of the constituent units through their legislatures or representatives of their governments; an umpire in the ultimate 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 those areas where governmental responsibilities are shared or inevitably overlap. Among the common constitutional and political features of three federations which have an impact on fiscal arrangements are the following:

(1) Constitutional distribution of expenditure and revenue responsibilities. Within this common pattern of federal constitutional and political features, in each of the federations there is a constitutionally defined distribution of expenditure responsibilities and revenue sources. The distribution of legislative and executive authority defined in the constitution establishes the scope of expenditure responsibilities that each government in response to political circumstances may undertake. At the same time the constitutional definition of legislative and executive powers has in all three federations defined for each order of government their financial resources from taxation, borrowing or commercial activities. In all three federations, implicit in the United States and Canadian constitutions and explicit in the German constitution, is the provision of a “federal spending power” (with certain limitations in the German case) enabling the federal government to spend its money on areas of responsibility that normally fall within state/provincial jurisdiction.

(2) Intergovernmental interdependence and institutions. Although the degree of intergovernmental interdependence varies in the three federations, common to all three is the inevitable existence of some degree of interdependence related to areas of shared

jurisdiction or overlaps in jurisdiction. This interdependence has had financial implications. For instance issues of the tax harmonization and collection have been important.

Furthermore, in all three federations attention has had to be directed to vertical (federal – state – local) and horizontal (state -- state) imbalances where the expenditure responsibilities of each government and its constitutionally allocated revenue resources are not in balance. These arise because in all three federation the major taxing fields have been assigned to the federal governments because these taxes are important instruments for affecting and regulating the economy and for performing a redistributive role, while more substantial expenditure responsibilities have been assigned to the governments of the states or provinces in the interests of effective decentralization or to meet political pressures from the constituent units for maintaining their distinctiveness. Consequently, in all three federations provision has been made, either constitutionally (as in Germany) or by governmental action in the United States and Canada, for financial transfers from the federal government to the state or provincial governments to correct the vertical and horizontal imbalances. The scope and form of these transfers has varied and will be analysed later in this report.

(3) Regional inputs to federal decisions. In all three federations there have been political pressures for regional 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, over time the significance of different taxes has changed and the costs of expenditures have varied in unforeseen ways. Consequently, all three federations have found the need to make adjustments from time to time. This has raised the issue of the appropriate processes and institutions for making these adjustments and the concerns of state and provincial governments that the decisions should not be taken simply unilaterally by the federal government but should involve the participation of the state and

provincial governments. The actual form and scope of the participation in decisions about such adjustments has varied considerably, however, as noted below.

(4) Supreme constitution, courts and rule of law. Common to all three federations has been the supremacy of the constitution and the role of the courts and the rule of law as the context within which the federal fiscal arrangements have operated. This does not mean that all the fiscal arrangements have been spelled out in detail in the constitutions. Indeed in the United States and Canadian constitutions only the major allocation of expenditure and revenue responsibilities is set out and much of the arrangements for intergovernmental financial transfers has been left to governmental practice and political processes. The German constitution does go into considerably more detail about the arrangements for shared tax proceeds and for transfers between governments. But in all three federations it is the constitution that provides the ultimate framework within which the 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 establishing trust between governments within the federation.

#### *Significant differences in the Constitutional and Political Context*

While, as noted above, there have been broad similarities in the federal context and in the issues of federal finance that they have faced, there have at the same time been significant differences among the three federations in their constitutional and political contexts.

The three federations vary in terms of longevity: the United States operates under a constitution that is still basically that adopted in 1789 (with only some 26 amendments since then), the current Canadian constitution was adopted in 1867 (with some significant amendments in 1982), and the German constitution came into effect 1949 (the major developments since being membership in the European Union and German reunification). The social composition and the character of the diversity with each federation vary considerably and this has produced distinct political cultures.

Of the three, Germany possesses the most homogeneous population and this has produced a relatively integrated political culture that emphasizes the goal of uniform standards within the federation. The United States displays a greater pluralism and is marked by an emphasis upon state and local autonomy. Of the three, Canada stands out by contrast with its sharply bilingual and multicultural provincial diversity which has shaped its emphasis upon provincial autonomy within a decentralized federation and hence its fiscal arrangements. There are variations too in the number of constituent units: 50 in the United States, 16 in Germany since reunification, and 10 provinces and 3 territories in Canada. This is a factor that has affected the relative influence of state or provincial governments in their intergovernmental relations.

(1) Differences in allocation of revenue and expenditure responsibilities. There is considerable difference among the three federations in the constitutional distribution of functions and jurisdiction. In the United States and Canada (with the exception of criminal law in the latter) legislative and executive jurisdiction for each specific area of jurisdiction is constitutionally assigned to the same government. By contrast, in Germany the distribution of responsibilities is largely functional in the sense that most of the legislative functions are assigned to the federal government and most of the administration of federal laws is assigned to the Länder (states). Thus, in the German system where much of federal law is administered by another level of government, much closer intergovernmental collaboration has been required. Apart from differences in the form of the distribution of powers, there is considerable variation among the three federations in the scope of responsibilities constitutionally assigned to each order of government and hence in the relative degree of decentralization and non-centralization. As a result, the United States is legislatively more non-centralized than Germany, but Germany administratively is more decentralized than the United States. Canada in practice is clearly more decentralized legislatively and administratively than both. These differences have provided significantly different constitutional and political

contexts for expenditure and revenue requirements, the fiscal transfer arrangements, and intergovernmental relations in these three federations. The impact of these differences is outlined in the section on Allocation of Federal State, and Local Expenditures below.

(2) Differences in provisions relating to the federal spending power. While the power of the federal government to spend its own-source revenues in areas where the states or provinces have been assigned constitutional jurisdiction is recognized in all three federations the basis and scope of this power varies in them. In the United States and Canada, although the scope of the federal spending power is not explicitly articulated in the constitutions, the courts have supported a broad interpretation of the federal government's revenue – raising and expenditure powers and consequently have upheld the federal government's right to spend its own – source revenues in areas of both concurrent and exclusive state or provincial jurisdiction. As a result its use by the federal government to intrude upon areas of exclusive provincial jurisdiction has been particularly contentious in Canada, and this was a factor in the recent intergovernmental political agreement, *The Social Union Framework Agreement* of 1999, in which nine of the ten provinces recognized the legitimacy of the federal spending power in areas of exclusive provincial jurisdiction in return for the federal government accepting some modest restrictions upon the use of that power.

In Germany, the constitution itself explicitly permits the federal government to spend in certain areas of Länder jurisdiction, but also explicitly sets limits to that power. Such spending must be defined in detail in federal laws and such legislation must gain a majority of votes in the Bundesrat, the federal second legislative chamber, which is composed of instructed delegates of the Land governments.

(3) Provisions relating to intergovernmental transfers. While extensive intergovernmental financial transfers are found in all three federations, the constitutional basis for these transfers varies significantly. In the United States there are no constitutional provisions prescribing intergovernmental transfers nor any

constitutionally specified portions of federal taxes dedicated to be transferred to state governments. Transfers of federal tax proceeds to states or of conditional or unconditional grants have simply been designated by federal laws made under the broad federal spending power. In practice these grants have been used by Congress to encourage states to pursue nationally defined policies, to support the modernization of state administrative systems, and to assist states with redistributive policies. Most transfers have taken the form of conditional transfers. Because of the broad discretionary revenue – raising and spending power of the federal government, an extensive uncoordinated ad hoc system of intergovernmental transfers has developed with a large proportion of federal grants being passed on from state to local governments.

In Canada the constitutional basis for intergovernmental transfers is broadly similar, except that section 36 (2) of The Constitution Act, 1982, sets out in principle, but not in detail, the requirement of federal equalization payments to ensure that provincial governments have sufficient revenues to provide public services at reasonably comparable levels of taxation. Thus, unlike the uncoordinated variety of transfers in the United States, a systematic system of unconditional equalization transfers has been developed in Canada. In addition, under the political pressure exerted by the provinces concerned about their autonomy, the major proportion of federal transfers directed at correcting vertical imbalances, ie. in support of health, post – secondary education, and social welfare, have been converted from conditional transfers with matching requirements to broadly unconditional, or at best semi – conditional transfers. This contrasts sharply with the pattern of predominantly conditional transfers in the United States.

The German federation provides yet another pattern of intergovernmental transfers. The German constitution sets out in much more detail the provisions relating to revenues and expenditures. This includes the specifying of constitutionally mandated sharing with the Länder of revenues from federal taxes. Virtually all of the major federal tax revenue sources are shared in this way. These thus constitute

extensive non – discretionary unconditional transfers to the Länder. In addition, there are substantial intergovernmental transfers both from the federal government to the Länder, and among the Länder. These transfers fall into two broad categories. First, there are the specific grants, largely conditional, to the Länder for projects in the ‘joint tasks category’, for reimbursement of federally mandated expenditures, and for specific projects related to the creation of uniformity of living conditions. The second are the unconditional equalization transfers consisting of two elements: one, an interstate revenue pool into which rich Länder pay and from which poorer Länder draw according to specified criteria and a formula, and second federal supplementary payments based on a fixed percentage of the VAT.

(4) Differences in political dynamics. The three federations are also marked by significantly different federal institutions affecting policy – making at the federal level. The U.S. Presidential – Congressional institutions with the separation of federal executive and legislative powers and the checks and balances between them, contrast sharply with the Canadian fusion of executive and legislative powers in the parliamentary institutions, and these differences have produced contrasting processes for federal decision – making, consensus generation within the federation and intergovernmental relations. While Germany also has parliamentary institutions, the unique institution of the Bundesrat has provided the Länder a major voice in federal decision – making and produced a distinctive interlocked character to intergovernmental relations affecting the character of federal fiscal arrangements.

(5) Differences in degrees of interdependence and coordination. As result of the differences in the constitutional and political context in the three federations, fiscal federalism in each of them as had a distinctive character. In the United States the large number of states and the separation of powers within both levels of government has led to a diffused, complex and relatively uncoordinated set of financial transfers and intergovernmental relationships. At the same time in the application of the variety of ad hoc financial arrangements, the federal

government has relied extensively on conditional grants to state and local governments, and this has given relations between governments in the United States a highly complex interdependent character. In Germany, on the other hand, the interdependence is more systematic. The closely interlocked legislative and administrative responsibilities of the two orders of government and the unique way in which the Länder have participated in federal decision–making through their representation in the Bundesrat has made that body a key institution in determining the shared revenues, expenditure responsibilities, transfer arrangements and financial interdependence of the two orders of government. Canada, while finding it desirable to develop in earlier periods a cohesive transportation network, and more recently in its history a system of federation – wide social programs and a systematic program of equalization transfers, has in accommodating the internal diversity of its population become one of the most decentralized federations in the world in terms of revenues, expenditures and reliance primarily upon unconditional rather than conditional financial transfers to the provinces.

(6) Differences in constitutional status of local government. The status of local government as a third order of government, distinct from the federal and state/provincial orders varies in the three federations and this has had an impact upon the financial arrangements affecting local governments. In German the self-governing status of local governments is constitutionally guaranteed (Art. 28(2)), and the financial provisions in the federal constitution (Part X, arts. 104a-115) include specific arrangements relating to municipalities. In the two other federations, local governments are not formally recognized in the constitutions as a separate order of government. Indeed in Canada, the only reference to local governments is that they come under the exclusive jurisdiction of the provinces (section 92 (8)). Thus, their organization and financing is totally at the discretion of the provincial governments in what is in effect a unitary devolution within each province. Consequently federal transfers to local governments are unusual. The United States constitution does not specifically refer to local

governments. Thus they come under the residual jurisdiction constitutionally assigned to the states. However, unlike Canada, there is a considerably greater conventional recognition of their importance as a third tier within the federal system, and Congress has approved numerous transfers from the federal government direct to local governments or to state governments to be passed on to the local governments.

### **Allocation and Scope of Federal, State and Local Revenues and Expenditures**

All three federations decentralize fiscal responsibilities to sub-national levels of government, but the manner in which they do so varies considerably. Indeed, the comparison is instructive as an illustration that there are no ironclad rules that should determine either the degree or nature of decentralization that should exist in a well-functioning federation. At the same time, the extent and nature of the decentralization has implications for the features of the fiscal relations between levels of government. We consider in turn the assignment of expenditure and revenue-raising responsibilities, and then the imbalances, both horizontal and vertical, to which these give rise.

#### *Expenditures*

As is the case in virtually all federations, state and local levels of government in Canada, the US and Germany deliver various important public goods and services. These include public goods of a local or regional nature, such as local transportation and infrastructure, sanitation and water, sewage and garbage, libraries, parks and recreation facilities, and so on. Being of a local nature, these tend to be rather uncontroversial except to the extent that their provision is used to attract economic activity to the state or locality. Perhaps more important from a national point of view is the fact that major public services in the areas of education, health and social services are delivered at the state level. The provision of these public services is decentralized in order to exploit the efficiencies associated with local administration, but at the same time they serve important national objectives. These include redistributive equity, equality of opportunity and social insurance. Given the national nature of these objectives, it is not surprising that the

federal government has some interest in seeing that comparable standards of provision are maintained across states. As we stress throughout this study and will return to below, the manner in which the federal government attempts to ensure that national standards are achieved varies considerably across the three countries.

The consequence of this decentralization of service provision is that the expenditures of the state and local levels of government taken together are comparable in magnitude to that of the federal government. In fact, they have grown over the post-war period as health, education and social service spending has become relatively more important. Thus, on the surface all three federations are relatively decentralized on the expenditure side of the budget.

However, a raw comparison of expenditures can be misleading since it does not capture the differing extents of discretion the state governments actually enjoy in the three federations. In fact, characterizing that discretion is complicated because of the very different institutions of government in the three federations. As we have discussed above, provinces in the Canadian federation enjoy exclusive legislative responsibility in areas of purely provincial and local interest as well as in the important public service areas of health, education and welfare, which might also be of national interest. The federal interest in the way these services are delivered follows first and foremost from their importance as instruments of national equity and of efficiency in the internal economic union. As well, Section 36(1) of the Constitution Act recognizes the joint federal and provincial responsibility for providing such public services at adequate levels nationwide and specifically for achieving equality of opportunity. The manner in which the federal government has pursued this interest has been through the spending power — the use of grants both to enable the provinces to provide comparable levels of public services as well as to influence the manner in which they provide them. It is noteworthy that as the provinces have become less reliant on federal funding, the unilateral federal use of the spending power has become less acceptable politically. The recently negotiated Social Union Framework Agreement

was an attempt to subject the use of the spending power to federal-provincial consensus. It remains to be seen how successful such a cooperative approach will be.

At the other extreme, the expenditures of the German Länder reflect only their administrative responsibility for delivering programs initiated by federal legislation. Thus, the discretion of the Länder is seemingly considerably less than that of the provinces, although this is at least partly compensated for by the fact that the Länder have some direct input into federal law making through their representation in the Bundesrat. This absence of discretion is compounded by the powerful principle of the uniformity of living conditions that informs the federal interest in the fiscal activities of the Länder.

The United States is between these two extreme in the amount of discretion available to the state governments and their localities. While the states assume comparable expenditure responsibilities to the provinces and the Länder, important public services have been partly financed by conditional grants of the federal government that specify program design features with which state spending must abide. In some cases, state spending has been subject to federal mandates, without associated funding. Moreover, the federal government in the US has not been reluctant to use the Trade and Commerce Clause of the Constitution to strike down state legislation that is alleged to interfere with interstate trade. The combination of these federal policy instruments — conditional grants, mandate and disallowance — have resulted in a situation where the states have considerably less discretion over their own expenditures than their Canadian counterparts, though presumably more than German Länder. As a broad generalization, the result is that the level of uniformity in the design of major public services is probably highest in Germany and lowest in Canada. At the same time, the amount of policy innovation and accountability has the opposite ranking.

Federal governments in all three countries assume responsibility for public expenditures of a national nature. These include national defense, foreign affairs and treaties, control of the currency, various elements of the justice

system, international trade, competition policy and national environmental policy, to give some examples. At the same time, their powers to regulate markets differ considerably, and this can affect the ability of the national government to achieve national efficiency and equity objectives. In Canada, unlike in the other federations, significant regulatory policies reside at the provincial level, including much labour market regulation and the regulation of capital markets other than the banking sector. This contributes further to the fact that the Canadian federation is economically more decentralized than either the United States or Germany.

### *Revenues*

Differences among the various levels of government in revenue-raising are even more pronounced than in the case of expenditures. The Canadian case is again instructive for the extent of decentralization. The Canadian provinces have access to virtually all tax bases, including some not available to the federal government. Moreover, they are responsible for financing a higher proportion of their own expenditures than is the case in either Germany or the United States. The Canadian provinces all levy personal and corporate income taxes, payroll taxes and specific excise taxes on items like alcohol, tobacco and petroleum products. All but one levies a general sales tax. They all levy taxes on resources revenues or profits generated within their jurisdictions, and property taxes are used to finance much of local government expenditures. The federal government levies many of the same taxes, with the major exceptions of resource and property taxes. Payroll taxes are earmarked for the financing of specific social programs. In the Canadian system, the provinces have full discretion over the choice of their tax systems, although as discussed in a later section they are able to participate freely in federal-provincial income tax and sales tax harmonization arrangements. The result is a reasonably harmonized income tax system, but otherwise a set of provincial tax regimes that differ substantially. Over the post-war period, revenue-raising has become gradually more decentralized. Now the provinces and their municipalities raise more revenue than does the federal government,

and finance a substantial proportion of their own revenues. At the same time, the capacity to raise revenues varies considerably over provinces, a phenomenon that gives rise to the case for equalizing transfers discussed below. Of course, the further decentralization proceeds, the greater the need for equalization and at the same time the more difficult it is to sustain by political consensus.

The American system of revenue raising shares with the Canadian one the range of discretion that the states have over their own taxes. Most states levy their own corporate and personal income taxes as well as their own retail sales taxes. Their municipalities use property taxes extensively as well as taxes on natural resources. The federal government shares many of the same tax bases, with the notable exception of the sales tax. It also uses the payroll tax for financing a specific program, the Social Security system. There are, however, some major differences. For one thing, the revenue system is much less decentralized than in Canada: the states finance considerably less of their own expenditures. For another, there is no formal mechanism for tax harmonization with the result that the tax system varies considerably from state to state. Finally, while as in Canada state own-revenue raising ability gives rise to fiscal disparities among states, in the US there is no equalization system devoted to correcting for those disparities. The result is likely a state and local tax system that induces much more inefficiency in the internal common market and inequity across states.

The German system is much more homogeneous. The major tax bases — personal and corporate income and value-added — are all federal taxes. The Länder share in the revenues raised, but have no discretion over either the tax base or the rate with their jurisdictions. The result is a system that contributes to efficiency within the federation and implements common standards of equity in all Länder, but which at the same time detracts from accountability by giving virtually no discretion to individual Länder in their revenue raising. (The Länder can influence federal tax policies through the Bundesrat, but they cannot do so individually: their tax systems must all conform.) The extent

of revenue sharing means that the revenues accruing to the Länder are comparable to those accruing to the federal government, and to that extent the system is quite decentralized from a financial point of view. As well, since the shared revenues obtained from income taxes are returned to the Länder of origin, different Länder will have different capacities to obtain revenues. As we have seen and shall discuss again below, these differences are addressed by a system of equalizing transfers. Shared VAT revenues do not give rise to tax capacity differences since they are allotted to the Länder in equal per capita amounts.

#### *Vertical and Horizontal Fiscal Imbalances*

Virtually any decentralization of fiscal responsibilities will give rise to horizontal imbalances. Moreover, since in most federations, expenditures are decentralized more than revenues, there will be vertical fiscal imbalances as well. These three federations are no exception, although the extent of the imbalances varies considerably in the three federations. In the German case, such imbalances have been traditionally minimal, although they increased at least temporarily when unification with the eastern Länder was affected. A high proportion of expenditure needs are offset by revenue sharing of income and sales taxes, and in any case adjustments in the latter account for changes over time in financing requirements. Horizontal imbalances that would otherwise arise from the differences in income levels across the Länder are also mitigated by the revenue-sharing system. Most of the shared VAT revenues are returned in equal per capita amounts to the Länder. This leaves as the main sources of imbalance differences in per capita income tax bases as well as differences in expenditure need, which are most pronounced with respect to the city states and the Länder in the former east Germany.

At the other extreme, differences in tax capacity among Canadian provinces are pronounced. This is a consequence not only of the high degree of decentralization of revenue raising in the Canada federation, but also because of the economic disparities that exist among Canadian provinces, especially between manufacturing-intensive Ontario and resource-



rich Alberta and the rest of the provinces. In addition, different provinces may well have different expenditure needs per capita, but these have not been systematically estimated and are not easy to estimate. At the same time, the problem of vertical fiscal imbalance is no longer a serious one. The provinces have gradually occupied more and more tax room relative to the federal government, and now finance a substantial proportion of their own expenditures. Thus, in Canada, the main problem is one of horizontal imbalance.

The United States shares with Canada the propensity to generate fiscal disparities because of the way in which the states have access to the major tax bases. However, there are major differences. Unlike the Canadian case, vertical fiscal imbalances are quite large: the states rely on federal transfers for a significant proportion of their financing. At the same time, there are significant horizontal imbalances, though on a smaller scale than in Canada since the states raise less revenue. As in the Canadian case, there are presumably also horizontal imbalances arising from differences in expenditure need across states, but such differences have not been accurately measured.

Vertical imbalances have the capacity to correct themselves as long as the sub-national governments have adequate revenue-raising discretion. That is, if states or provinces have inadequate revenues to meet their expenditure requirements, they can always adjust their own taxes. In both the Canadian and American cases, where vertical imbalances do exist, the provinces or states do in fact have considerable discretion to raise their own revenues. Of course, this ability may well differ among provinces or states. The implication is that vertical imbalances may not be as much of a problem as horizontal ones, as noted above.

In contrast, horizontal imbalances are not self-correcting. 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 will be either a violation of horizontal equity — otherwise identical citizens in different states will be treated differently by the government sector —

or an inefficient allocation of resources across states — businesses and individuals will have a purely fiscal incentive to locate in states with higher fiscal capacities. This provides one motivation for federal intervention through grants, to which we turn next.

### **Nature and Scope of Intergovernmental Transfers**

Like most other federations, Germany, the United States and Canada are characterized by vertical fiscal imbalance. This in itself implies that there must be federal-state transfers. Such transfers also serve other purposes in a federation, including especially the offsetting of horizontal fiscal imbalances that arise naturally with decentralization, and the influencing of state expenditure programs to take account of national objectives. The three federations again differ considerably in the way in which they address these objectives of closing the vertical fiscal gap, equalizing fiscal capacity differences, and influencing state behaviour.

#### *Importance of Transfers*

Both the relative size and the structure of transfers differ considerably across the three federations. As we have mentioned, the average size of transfers in Germany are small since a high proportion of Länder expenditures are covered by revenue sharing. In that sense, transfers are less important than in the other two federations. However, this masks the fact that there is a substantial equalization system that is to a large extent self-financing and that comprises an important component of transfers.

In the case of the United States, transfers are more important than in Germany in the sense that they are proportionately larger, so make up a larger proportion of state expenditures. They are also important in another sense. They are an important vehicle for the federal government to use to achieve its national equity and efficiency objectives. A substantial proportion of federal transfers in the US consists of conditional grants, and these have as one of their objectives the influencing of state expenditure priorities and programs. At the same time, transfers in the US are not systematically equalizing, although individual transfers do have components that

implicitly equalize differences in state fiscal capacities.

The Canadian case differs from both the US and German cases. In Canada, transfers fall somewhere between the US and Germany in terms of their size. Though the Canadian fiscal system is decentralized, the provinces still rely on the federal government for a significant proportion of their expenditure financing, though less than in the US. And like Germany, there is a substantial program of fiscal equalization in place, which is perhaps the most important feature of the Canadian system.

#### *Transfers to Correct Vertical Fiscal Imbalances*

It is somewhat artificial to distinguish those transfers that correct vertical fiscal imbalances and those that correct horizontal ones: almost all transfers do both to some degree. Nonetheless, most transfers are predominantly for one purpose rather than the other. In the German system, this is not really an issue since vertical balance is virtually achieved by the revenue sharing system. Indeed, some would regard revenue sharing as a form of transfer from the federal government to the Länder. Under that interpretation, which is certainly legitimate, revenue sharing would be the instrument for closing the vertical fiscal gap (although it also serves to address horizontal imbalance issues at the same time).

In the United States, as we have mentioned, the vertical fiscal gap is closed by a wide array of conditional transfers, both block and specific. This widespread use of conditional transfers is a relatively unique feature of the US federal system. It arises at least partly as a device to inducing accountability in state executive branches that, unlike in parliamentary systems, are not accountable to state legislatures. In federations where the division of powers is not as pronounced, the case for conditional transfers might not be as strong. Conditional transfers not only serve to facilitate accountability, they are also important instruments by which the federal government can encourage state governments to design their public service provision programs in such a way as to be compatible with national objectives. It is worth stressing that although such conditionality is a common feature of most

federations, its role in the US is much more widespread than in most federations

As usual, the Canadian case differs from both of the other federations. The vertical fiscal imbalance is covered by the two major transfers systems that remain in existence, the block transfer used to support provincial social program expenditures (the Canadian Health and Social Transfer or CHST) and the equalization system. The latter is not primarily intended as an instrument for vertical imbalance, but because the system is a gross one (unlike the German self-financing net system), it does transfer funds from the federal government to the equalization receiving provinces. The CHST on the other hand serves largely to close the vertical fiscal gap. It is an equal per capita transfer to all provinces. It does have some conditions attached, but they are relatively general, unlike in the case of US conditional grants.

As mentioned, the effectiveness of transfers to correct for vertical fiscal imbalances is not in question. Vertical fiscal imbalances are simply defined as being the excess of provincial expenditure over own-source revenues. Perhaps more important is the extent to which these transfers serve subsidiary purposes. They can be partially equalizing, as is the case when they are allocated in equal per capita terms or on the basis of expenditure needs (the latter being common in many federations, such as Australia and South Africa). More importantly they can be the vehicles for exercising a federal influence on state expenditures. For this purpose, their size is important. If federal transfers comprise too small a part of state or provincial expenditures, it is not clear that the federal government has the political or moral authority to use them as a device for affecting state program design. Indeed, this is the real issue with respect to the vertical fiscal imbalance in the Canadian case. There is a real question as to whether the size of the CHST is sufficient for the federal government to exercise effective influence over how the provinces design their health care systems.

### *Transfers to Correct Horizontal Fiscal Imbalances*

Horizontal fiscal imbalances refer to differences in the capacity of state governments to provide 'reasonably comparable levels of public services at reasonably comparable levels of taxation', as the matter is put in Section 36(2) of the Canadian constitution. The source of such differences can be unequal tax capacities, or it can be differences in the need for spending on public services because of, say, different demographic make-ups across states. There is a consensus among economists that horizontal imbalances can result in both inefficiency and inequity in the federation. In virtually all federations, and more generally in countries with multiple levels of government, some explicit system of equalizing transfers exists whose purpose is to achieve some degree of horizontal balance. In many cases, the principle of equalization is 'constitutionalized', including in Canada and Germany.

A notable exception to this pattern is the United States, where no formal equalization system currently exists, and none is contemplated in the constitution. Nonetheless, the structure of conditional grants does incorporate a considerable implicit equalization component. The fact that some significant grants are matching, or are related to state expenditure needs, implies that the fiscal system is to some extent equalizing with respect to needs. On the other hand, states with greater revenue-raising potential are better able to take advantage of these grants. Moreover, some grants have elements of state per capita income in them or even equal per capita components that contribute to the equalization goal. However, unlike in most federations, the extent of equalization is not based on a formula that properly relates transfers to either revenue capacity or to expenditure need. Although data are not available for verifying the exact extent of horizontal imbalances after transfers are taken into account, it is unlikely that in the absence of a systematic attempt to address the issue, horizontal fiscal balance will be achieved.

Both Canada and Germany have highly developed equalization systems. In the case of

Canada, the formal equalization system is designed to compensate provinces whose tax capacities are below some minimum national standard. The system is not perfect since, for example, it effectively excludes most of the unequally distributed oil and gas revenues and is a gross rather than a net scheme. Nonetheless, it is quite successful at ensuring that provinces have reasonably similar revenue-raising capacities. The system does not include a component reflecting the relative needs of different provinces. However, there is some implicit need-based equalization in the equal per capita CHST program, and there was even more so in the shared-cost programs that it replaced. As in the United States, various other components of federal spending (some would argue, too many) have equalizing features to them, such as the regionally differentiated unemployment insurance program, various regional development programs, and the relatively small conditional grants that remain.

Germany has an even more complete system of equalization. It is achieved by three main ways. First, three-quarters of the VAT share of the Länder are distributed on an equal per capita basis, which is an effective form of equalization on the basis of need (expenditure needs being highly influenced by the population being served). Second, there is an explicit equalization program applying to shared income and local taxation. Unlike in the Canadian case, the German equalization system operates on a net basis — payments to receiving Länder and financed by contributions from the better off Länder. The amount of equalization is based in the first instance of the revenue capacity of the Länder, but this is adjusted to take account of some elements of need. In particular population density is used as a scaling factor, with various density steps being involved. This is a relatively crude form of needs equalization, especially compared with explicit needs-based systems used in countries like Australia, South Africa, Japan, and the Scandinavian countries. These systems attempt to estimate the cost per demographic group of providing a standard level of important public services. The third component of German equalization is the so-called German Unity Fund, which is essentially a

program directed at raising the fiscal capacity of the eastern Länder to levels comparable with the west. This program is obviously unique to the German situation, and is intended to be an interim measure only. As in the Canadian case, the German system of equalization is reasonably successful at ensuring that all Länder have the financial means to provide reasonably comparable public services to their residents.

#### *Degree of Conditionality of Transfers*

The issue of conditionality is a key one in all federations. Many of the important public services whose provision is decentralized to the state level are also those that are very important from a national point of view. Conditionality is one means by which the federal government can induce the states to design their programs in a way that contributes to national equity and efficiency objectives. But conditionality is a two-edged sword because it implies that the federal government is influencing purely state priorities in areas of state expenditure responsibility. There is also a balance to be drawn between the legitimate aim of the federal government to achieve its national objectives, and the possibility that such conditionality will be too intrusive on state policies and detract from accountability to the needs and desires of citizens of particular states or provinces. Moreover, there will also be a choice between federal influence being affected by the spending power as opposed to by perhaps even more intrusive means, such as mandates or the disallowance of state legislation.

The three federations studied here vary considerably in the way they have approached the use of conditional grants as a means of achieving federal objectives. In a sense, German transfers are the most 'conditional' since they are intended to finance expenditures that the Länder incur in administering federally legislated programs. Such conditionality is obviously absolute in the sense that all Länder are required to administer uniform national public service programs in their own jurisdictions. On the other hand, the power of the federal government in legislating such programs is not absolute because the Bundesrat with its representatives drawn from the Länder must approve such legislation.

In the United States, conditionality of federal-state transfers is the norm, but the states retain the right to legislate their own programs. The degree of conditionality can vary considerably from being based on specific program design to bloc grants with only general conditions. The extensive use of conditionality (as well as the more limited use of mandates) implies that the federal government does have considerable power to impose national standards on the design of state programs. This can enable it to ensure that, where relevant, state programs contribute to national goals of equity, equal opportunity and efficiency in the economic union. As mentioned, it also embeds a form of accountability on state executive branches that would otherwise be absent with unconditional transfers, given the division of powers. But at the same time, such a heavy use of conditionality can detract from a key advantage of the federal system, which is to allow state governments to have the discretion to design their programs in a way that are most suitable to the need and references of their constituents.

In contrast with Germany and the United States, conditionality of transfers has been strongly resisted in Canada in recent years, especially as the provinces have become more self-sufficient in financing their own expenditures. The federal government shares with the provinces a constitutional commitment in principle to ensure that major equity and equality of opportunity goals are addressed by the provision of public services. There are also widely held economic arguments for the federal government having an interest in fostering the efficiency of the internal economic union. At the same time, the constitutional legitimacy of the use of the spending power as a way of encouraging the provinces to design their public expenditure programs to abide by national norms has been confirmed. However, the federal government has retreated from the unilateral use of the spending power as it has reduced the size of its transfers to the provinces. Recent developments have focused on ways of making any future use of the spending power less intrusive and more based on cooperative agreement between the federal government and the provinces. As we have mentioned, this is

reflected in the *Social Union Framework Agreement* of 1999, which while accepting the spending power as a proper policy instrument for achieving national objectives (at least by all provinces except Québec), emphasizes that future spending power initiatives should be based more on consultation and less on unilateralism than in the past. It remains to be seen to what extent cooperative agreement can be made the basis of the use of the spending power. There has been relatively little success in the use of federal-provincial agreements in the past as vehicles for achieving equity and efficiency in the national economy. A major agreement on reducing internal barriers to trade (the *Agreement on Internal Trade*) has been criticized for being toothless. On the other hand, federal-provincial cooperation on a national child tax credit has been more promising.

### **Systems of Tax Harmonization and Collection**

The extent of tax harmonization provides an interesting contrast among the three countries. All have very different forms and degrees of tax harmonization, and this is only partly related to the extent of decentralization or revenue-raising responsibilities.

The German case is the easiest to deal with. All major broad-based taxes comprising about three-quarters of tax revenues raised are fully harmonized and subject to a single federal tax law. The bases and rate structures of personal income, corporation income and sales (VAT) taxes are identical nation-wide, and there is no scope for the Länder to choose their own levels of rates. The only significant taxes over which the Länder and the local governments do have discretion are the property tax, the motor vehicle tax, the inheritance tax, taxes on beer and gambling and local business taxes, which are assigned exclusively to these lower-level governments. These account for a relatively small proportion of tax revenues and are not of crucial importance from the point of view of harmonization.

In Canada, the major broad-based taxes are co-occupied by both the federal and provincial levels of government. There are varying degrees of harmonization of these taxes. In the case of the 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. Until recently, these agreements have required the provinces to abide by the federal tax base and rate structure in return for which the federal government collects the tax on behalf of the provinces. Each province is allowed to select a provincial rate to apply to federal tax liabilities, and is allowed to choose a set of non-discriminatory tax credits. This has led to a highly harmonized income tax system, though one that also allows for provincial discretion in setting their own rate levels. (The non-participating province, Québec, has a tax base that does not deviate too much from that of the other provinces, and also abides by the same allocation rule in the case of out-of-province income earnings). The system has come under increasing pressure from the provinces. As they have occupied more and more of the income tax room, they have petitioned for more discretion in setting tax policy. This has culminated in a federal-provincial agreement that allows provinces the flexibility to choose their own rate structures and their own set of credits, with some restrictions. The base would remain fully harmonized, and single tax collection would continue to apply. A number of provinces have indicated that they will take up this option, and in some cases plan to make the provincial rate flatter than the federal one. There is also a corporate income tax collection agreement system of a similar sort. The federal government collects taxes on behalf of participating provinces, in return for which the provinces can apply their own tax rates to the federal base as well as a number of tax credits. The three largest provinces have chosen not to participate, but their bases do not deviate much from the federal one, and they use the same rules for allocating income to provincial jurisdictions.

While income taxes are reasonably harmonized in Canada, other major taxes are not. Four provinces harmonize their sales taxes with the federal GST (the name for the VAT). Three of the four are fully harmonized and are unable to select their own provincial rates. For them, the system is basically a revenue-sharing one. The fourth province, Québec, operates its own

provincial VAT along side the federal one, and acts as tax collection agency for the latter. Five of the remaining provinces have separate single-stage retail sales tax systems with different rate structures and exemptions. One has no system at all. The result is a patchwork of sales taxes across the federation with the inefficiencies that entails. By the same token, provincial resource taxes, which are a major source of revenue for some, are completely unharmonized. Many provinces also have their own variants of a payroll tax, though in this case the scope for differentiation is relatively limited.

In the United States, there is no formal system of tax harmonization. The major taxes co-occupied by the federal and state governments are personal and corporate income taxes. In both cases, states have their own independent systems. Some states choose to piggyback on the federal system by basing state tax liabilities on the federal tax base, and sometimes also the federal rate structure. However, other states define their taxes independently. In the case of the corporate tax, there is the additional problem that different states apply different conventions for allocating to themselves taxable income earned by firms that operate in more than one state. This gives rise not only to inefficiencies but also to instances of double taxation or of non-taxation of some portion of incomes. Sales taxes are used only at the state level, and here too there is no harmonization. State sales taxes are single-staged retail taxes (for those that use this tax source), where bases and rate structures can vary considerably across states. Thus the tax system in the United States is highly differentiated across states, though the significance of this is somewhat diminished by the fact that states collect a relatively smaller proportion of total tax revenue than in Canada.

## **LESSONS LEARNED**

### **Criteria to be taken into account**

In assessing fiscal federalism in Canada, the United States and Germany and the lessons to be learned from their experience a number of criteria need to be taken into account: economic efficiency, equity, autonomy, transparency of decision-making, democratic accountability, and

political stability. The emphasis upon each of these criteria and the balance struck among them has varied in the three federations.

*Economic efficiency* relates to the extent to which the specific decentralized fiscal arrangements in a federation contribute to the improvement of economic efficiency or compromise the efficiency of the federal economy as a whole.

*Equity* in a federal setting relates to the achievement of the equity objectives of equality of opportunity and 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.

*Autonomy* relates to the degree of freedom from external control by other government experienced by a government within the federation. This is important because an authentic federal system involves a combination of shared rule for certain specified purposes through a common government and of self-rule for certain specified purposes by the governments of the constituent units. In such a context the extent of genuine autonomy of the governments of the constituent units in their areas of constitutional responsibility gives an indication of the degree to which the political system is genuinely federal.

*Transparency* 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.

*Accountability* is a closely related requirement for effective democratic processes. The 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 within a federation should involve processes by which those making these decisions are publicly and legally accountable.

*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 federation. A closely related consideration is the ability of the fiscal arrangements to assist the federation to adapt over time to changing circumstances without destabilizing the federation.

### **Lessons in relation to these criteria**

In this section we examine the lessons to be learned from the effects and incentives of different arrangements in the three federations regarding (a) tax and expenditure assignment, harmonization and collection, and (b) the scope and form of transfers and different approaches to equalization in terms of the criteria listed above.

#### *Economic Efficiency*

Efficiency is a very broad concept with many dimensions. It encompasses efficiency in the allocation of resources in the private sector, which is inevitably affected by government policies, as well as efficiency in the provision of government services. Moreover, the multi-tiered nature of a government decision-making in a federation lends itself to conflicting effects on efficiency. On the one hand, the case for decentralization itself is largely based on efficiency arguments. Decentralization is said to contribute to the provision of the mix of public services best suited to the needs of state and local constituents and to induce cost-effective and innovative delivery. At the same time, the interdependence among state economies implies that policies in one jurisdiction will have spillover effects on other jurisdictions. And, perhaps most important, fiscal decentralization inevitably leads to differences in the fiscal capacity of the states, which provides an incentive for individuals and firms to locate inefficiently in fiscally advantaged states. These conflicting effects of decentralization on efficiency mean that the overall effect of a federation's fiscal arrangements is difficult to assess. The best we can do is to highlight the sorts of effects that various features of the federation have on efficiency, and where it might be possible to achieve efficiency improvements. Even that will not be conclusive because the sorts of measures that might improve efficiency might also exacerbate some of the other criteria

discussed in this section. We proceed on a country-by-country consideration of efficiency.

The German case is an interesting one to start with because in it uniformity is the norm. The Länder are obliged to provide a common set of important public services as legislated by the federal government. As well, most of the financing of these public services comes from a common national tax system. And, the funding arrangements ensure that all Länder are able to provide comparable levels of public services at comparable tax rates to their citizens. Such a high degree of uniformity has two main efficiency advantages. First, efficiency in the internal common market is virtually guaranteed because economic activity faces common government policies no matter where they locate, and the possibility of individual Länder to use the fiscal system to attract businesses from their neighbours is minimal. Second, the high degree of equalization eliminates the possibility of fiscally induced migration since all Länder provide a uniform set of public services at basically the same tax rates (that is, so-called net fiscal benefits are largely eliminated).

While these are significant advantages of the fiscally centralized German system, they have disadvantages as well. Because the Länder act as administrators of major spending programs that are legislated federally, they have relatively little discretion to choose programs to suit their own needs. By the same token, given that they rely heavily on revenues raised nationally and distributed through revenue sharing, they do not have strong incentives for providing public services in the least cost way, for searching for better methods of delivery, or for enhancing the quality of services. Nor is inter-Länder competition available to provide a spur to efficiency. In other words, many of the efficiency advantages of decentralization are forgone by the uniformity of fiscal policies across Länder.

The Canadian case achieves a number of the efficiency advantages of the German one while avoiding the major disadvantages, so receives relatively high marks on efficiency. The system of Equalization ensures that provinces have roughly comparable revenue-raising capacities.

Provided needs are not too different across provinces, this ensures that provinces can provide comparable levels of public services at comparable tax rates, thus reducing the possibilities for fiscally induced relocation. The decentralization of expenditure responsibilities is accompanied by real discretion for the provinces to tailor their programs to suit the needs and preferences of their constituents. As well, the many supposed efficiency advantages of decentralization can be achieved since provinces have wide discretion to design their own programs in the important areas of health, education and welfare. The decentralization of revenue-raising responsibility also contributes to accountability and thereby to efficiency. The federal government, through its limited use of the spending power, as well as whatever powers of moral suasion its fiscal power has over the provinces, is able to induce the provinces to design major social programs in a way that does not discriminate against non-residents or unduly distort internal trade.

The main issue in the Canadian case is whether there is too much decentralization from the point of view of efficiency. The provinces do have considerable discretion to engage in strategic or beggar-thy-neighbour policies with respect to each other, and there are plenty instances of this having occurred. While in some areas of provincial spending, programs are reasonably harmonized, in an area like education, which is arguably the most important one for efficiency purposes, there is virtually no harmonization. The federal government retains the ability to use its spending power to intervene, but the political arguments against this are strong, and the extent of fiscal decentralization militates against the use of the spending power. The provinces have important regulatory policies in areas that are of importance for the internal economic union (especially labour and capital markets). More generally, there is no effective means of fostering efficiency in the internal economic union, despite a federal-provincial agreement on the matter. Finally, the extensive and growing decentralization of revenue raising to the provinces makes the goal of tax harmonization increasingly elusive. The provinces can now use their corporate tax

policies to attract business activity to their jurisdictions. Sales tax systems vary across provinces and can impose significant distortions on transactions within and across borders.

The United States federal system, like the Canadian one, has considerable decentralization of expenditure responsibilities to the states. However, some of the advantages of this are undermined by the fact that a substantial proportion of grants are conditional or are used to support mandated state expenditure programs. Although, as mentioned, this introduces some accountability to state executive branches that would otherwise not exist if the grants were unconditional, it also detracts from the discretion of the states over their own expenditures. This can have adverse consequences for efficiency. A further unique feature of the US federation is the absence of an equalization system. Although some equalization undoubtedly takes place through the design of specific transfers, it is likely that differences in fiscal capacity remain across states with the result that incentives for an inefficient allocation of resources across the federation exist.

As well, although the tax system is not as decentralized as it is in Canada, there is no explicit system of tax harmonization. The implication is that the state tax systems are likely to distort the allocation of resources within the internal economic union. At the same time, the potential for explicit beggar-thy-neighbour policies is mitigated by the apparent ability and willingness of the federal government to disallow state legislation that interferes with interstate commerce. In fact, the mere willingness to use the power of disallowance may serve as a means of detaching states from engaging in discriminatory policies.

### *Equity*

The pursuit of equity is a pervasive objective of government. A high proportion of program expenditures, including some of the more important ones delivered by lower-level governments, are devoted to that pursuit. Equity is a multi-faceted notion. It includes three broad objectives that are addressed by social programs— equality of opportunity, social insurance and equality of outcomes — as well as



non-economic objectives such as non-discrimination and employment equity. Judging the contribution of government institutions and programs to equity is a difficult task. The extent to which equity should be pursued is a matter of value judgment on which reasonable persons can disagree. As well, the ability of governments to address equity issues is disputable, given the difficulty in knowing either the importance of the equity-efficiency trade-offs involved or the appropriate design of policy to meet given objectives.

In a federal setting, these problems are even more profound. As mentioned, important social programs that deliver equity are often decentralized to the state level of government. The extent to which (and the manner in which) the federal government ought to influence the states in the design of these programs is an issue. While decentralization is intended to improve the efficiency of program delivery, there is also the possibility that the existence of inter-state competition will diminish the redistributive content of social programs. There might also be serious disagreement about the role of national versus state-level equity objectives in guiding policy. To what extent should state-level preferences for redistribution influence policy rather than federal preferences, both expressed through political consensus? Thus, one must be cautious about drawing conclusions about the success or otherwise of achieving equity objectives in different federal systems.

One perspective that can be taken is to abstract from the major value judgment about the optimal degree of redistributive equity, and ask how well a given federal system is able to deliver whatever consensus level might be agreed on politically. In fact, this is the perspective taken in much of the fiscal federalism literature, and many of the normative judgments about the achievement of equity in a federal system are not dependent on the degree of redistribution. Instead, the emphasis is on horizontal equity issues, that is, the extent to which common levels of equity are achieved across the federation. Even this only partially resolves the problem, for it begs the question as to whether common levels of equity ought to be achieved across the nation. Should otherwise identical households residing

in various states, provinces or Länder be treated comparably by the public sector? Should common levels of vertical equity, of equality of opportunity, of social insurance, prevail? These must remain open questions.

The social policies of the three federations achieve quite different degrees of redistributive equity. The progressivity of their tax-transfer systems differ; the extent of coverage under social insurance programs like unemployment insurance, health insurance and disability insurance differ; the extent of equality of opportunity achieved by their education systems differ. We can take these differences as given, yet ask to what extent the federal systems facilitate the achievement of the respective equity goals. Once again, the three federations differ considerably in their approach to equity.

In the case of Germany, common standards of equity apply across the federation. Social programs are highly uniform because of the fact that they are nationally legislated. Similarly, a common national system of income and sales taxation means that the extent of vertical redistribution is the same in all jurisdictions. Finally, the system of equalization roughly ensures that full horizontal equity applies nationwide. Indeed, it is a constitutional principle that that should be the case. On the other hand, this high degree of uniformity implies that there is little scope for individual Länder to affect their own equity objectives, should those differ from the national consensus. The most that they can do is to influence national standards through their representation in the Bundesrat.

In Canada, the tension between federal and provincial prescriptions for equity is palpable. The equalization system goes considerable way to ensure that the goal of horizontal equity applies, at least in potential terms. That is, the system ensures that the have-not provinces have comparable revenue-raising capabilities such that they could, if they so choose, provide a reasonable national standard level of public services. However, the decentralization of major social programs and the relative absence of federal oversight through conditionality or other means imply that in practice different standards

of equity can apply in different provinces. So, for example, different provinces have very different levels of support for the poor, very different education systems, and even somewhat different coverage under their health care systems. The discretion available over the design of social programs, which is justified on the basis of other criteria, leaves itself open to the potential problem of provinces competing down redistributive equity. In addition, the increasing degree of discretion the provinces have over their own tax structures, and the growing importance of provincial taxes relative to federal ones, means that the scope for differentiated progressivity of the tax-transfer system is increasing. Overall, while the federal system in Canada incorporates the potential for horizontal equity, in practice the wide degree of discretion enjoyed by the provinces over the design of their social programs and tax systems leads to a distinct lack of uniformity of equity standards across the nation.

The United States differs from both the Canadian and the German cases. It is generally agreed that the degree of equity pursued in the United States is substantially less than in Canada or in Germany, but this has probably little to do with the federal system. The extent to which common standards of equity are achieved across the federation also differs. On the one hand, the federal system is more centralized than in Canada. The delivery of many important social programs are in the hands of the states, but the federal government is able to enforce some common national principles by its use of conditional grants, and by more forceful means such as mandates or disallowance of state legislation. Thus, relatively common standards of equity can be achieved. At the same time, the absence of an explicit system of equalization transfers implies that horizontal equity is likely violated: states differ in their capacities to provide public services.

#### *Autonomy*

While the constitutional assignment of exclusive legislative and executive authority to the constituent units of government will largely shape the degree to which the constituent units have a measure of autonomous decision-making

authority, the extent to which the constituent units lack their own tax levying powers or are dependent upon transfers from the federation government, and particularly the extent cut to which these transfers are generally conditional in character may seriously modify their degree of political autonomy.

In this respect there is considerable variation among the three federations under consideration. In terms of specific conditional transfers as a percentage of the total revenues of the constituent units of government, these varied in 1996 from 29.6 percent in the United States, to 9.8 percent in Germany and 0.9 percent in Canada.<sup>2</sup> At the same time it is worth noting that unlike the United States where the balance of total state revenues is virtually all from the levy of own source revenues, a considerable proportion of the total revenues of the German Länder are derived, not from own-source taxes, but from shares of federal taxes. These constitute unconditional transfers whose extent is controlled by the Federal Parliament, although the Länder through their voice in the Bundesrat do have significant influence on the size of these. These have represented about 40 percent of the total revenue of the Länder. In the Canadian case, while the proportion of conditional transfers is clearly much less than in the other two federations, it should be noted, as Table B.3 of our Canadian Study indicates, that the addition of substantial unconditional transfers whose size is determined in effect by the federal government means that total transfers as a percentage of total provincial revenues in 1999 were 13.0 percent.

In terms of both reliance upon own-source revenues and of predominance of unconditional transfers, the Canadian system of fiscal federalism leaves the provinces with the highest degree of autonomy among the 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

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<sup>2</sup> Ronald L. Watts, *The Spending Power in Federal Systems: A Comparative Study* (Kingston: Institute of Intergovernmental Relations, Queen's University, 1999), Table 4, p. 57.

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 United States.

#### *Transparency and Accountability*

In regard to transparency and accountability in relation to the arrangements for fiscal federalism, differences in the three federations in their form of executive and legislature relations has had a significant bearing. The oldest of the three federations, the United States is characterized by a Presidential/Congressional form of government with the separation of the executive and legislature and incorporating checks and balances. This has been replicated at the state level in the relationships between the governors and their legislatures. The result has been a diffused system of governmental decision-making and intergovernmental relations. Furthermore, the considerable discretionary power of the federal government in both revenue-raising and expenditure decisions, and the checks and balances between the executive and Congress at the federal level have resulted in an extensive but uncoordinated system of federal expenditures and intergovernmental transfers in many areas of both concurrent and exclusive state jurisdiction. This complexity has resulted in low transparency and public understanding of these arrangements.

A consequence of this has been a high degree of concern in the United States literature on fiscal federalism about the principle of financial responsibility. There it has often been argued that in a separation of powers system where the executive at either level is not directly accountable to its legislature, accountability for funds transferred intergovernmentally is enhanced if the government transferring those funds sets strict conditions for how the state or local governments may expend them. This explains why currently virtually all federal grants to state and local governments in the United States are conditional in form. The trade-off for this form of accountability is, as noted above in the preceding sub-section on autonomy, decreased state autonomy. When the spending priorities established by the federal government

have not coincided with state priorities but states have accepted the federal conditions to access these transfers, state autonomy has been undermined. On the other hand while the complexity of the United States system of intergovernmental fiscal relations weakens transparency, the reliance upon conditional transfers makes it clear to citizens that the responsibility for those decisions lies in the Congress. Furthermore, as compared to the relatively closed system of intergovernmental executive relations in such parliamentary federations as Canada and Germany, the bargaining “free for all” which takes place in the Congress 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 legislatures. A significant result of this has been the predominance in their intergovernmental relations of negotiations between the executives, a process often 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 executives behind closed doors have meant that there is very little transparency for the citizenry concerning intergovernmental fiscal relations. In regards to accountability in these matters, the primary method in both federations for ensuring accountability 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 responsibilities of each government in relation to a particular policy or program.

In Canada, the processes by which “executive federalism” has operated have not been set out in the constitution, but have simply developed over the years. They range from high profile First Ministers’ Meetings and Finance Ministers’ Meeting to numerous meetings at the bureaucratic level between public servants in the various departments of the federal and provincial

governments in closed meetings which receive little, if any public attention. The lack of any formal constitutional status for “executive federalism” has raised concerns about the accountability for decisions by governments participating in this process. The fact that representatives of the executives of the federal and provincial governments behind closed doors negotiate among themselves intergovernmental agreements that have wide-ranging implications for Canada’s major social and economic policies has created the impression of a lack of transparency and democratic accountability in these processes.

A further problem in Canada with the lack of a formal constitutional basis for the processes of “executive federalism” is that despite extensive negotiations, the ultimate power to institute, change, or reduce transfers remains with the federal government acting unilaterally in the exercise of its spending power. It was concern about this that led to the effort of the provinces in negotiating the recent Social Union Framework Agreement to exact some federal government commitment to consultation before changes in the financing of such programs.

While Germany also has parliamentary institutions, its form of “executive federalism” is more highly developed and unlike Canada grounded in its constitution. The Länder-controlled Bundesrat plays a key role in ensuring their constitutionally required involvement in federal decisions relating to the financial arrangements and transfers. One result of this arrangement built on to a system where the constitution also requires that much federal law be administered by Länder is the highly interlocked nature of Federal-Land relationships in decision-making within the German federation. These complex interrelationships intended to improve intergovernmental coordination have tended, however, to weaken transparency and accountability. The interdependent network of shared taxes, equalization transfers, expenditure responsibilities and even decision-making institutions has rendered it practically impossible for voters to identify which government is taxing or spending for particular purposes. As noted in our report on Germany, the objectives of

economic efficiency, revenue equalization, solidarity and coordination have largely trumped autonomy, transparency and accountability. Thus, where it might be said of Canada that fiscal intergovernmental relations have been marked by inadequate coordination, the arrangements in Germany have given rise to calls for some loosening of these interlocking arrangements in order to introduce larger elements of autonomy and intergovernmental competitiveness and clearer transparency and accountability.

#### *Political stability and adaptability*

An important consideration in assessing intergovernmental fiscal relations is the extent to which intergovernmental conflict is minimized and provides a stabilizing influence upon the operation and development of the federation. Closely related to and contributing to political stability is whether the fiscal arrangements assist the federation to adapt to changing circumstances over time.

An obvious measure of the political stability of the United States as a federation has been its continued existence under the same constitutional structure over the past 135 years since the conclusion of the Civil War of the 1860s. This reflects a general consensus in support of the principles of non-centralized and diffused governmental processes which is reflected in the financial arrangements by such features as the emphasis upon differentiated state policies and the lack of a generalized equalization program. That is not to say that there have not been areas of dispute, particularly about what has been described in recent years as the “coercive” impact of Congressional mandates upon the states. These are exemplified by the heavy reliance on program-specific conditional transfers, the use of “crossover sanctions” to link compliance with conditions of particular programs to compliance with conditions of other programs, the imposition of “cross-cutting requirements” making funding in a program dependent upon requirements of other policies (such as accessibility to the disabled), and most resented by the states and local governments, “unfunded mandates” which involve federal directions for policies to be carried out by state

or local governments. Thus, despite the repeated rhetoric of noncentralization, the impact of fiscal arrangements in the United States has over time contributed to a progressive and cumulative centralization and dominance of the federal government within the United States federation over two centuries. More recently, despite repeatedly stated objectives of decentralization, there has been a relative stability since 1960 in the share of total public spending attributable to the federal government (Table B1 of our report on the United States).

On the whole, the United States fiscal transfers system has shown a remarkable ability to adapt to changing circumstances over its two centuries. The matrix of interconnections among legislators, administrators and executives in all three levels of government has produced an uncoordinated but flexible system able to incorporate the variety of regional views in its decision-making processes.

Canada, by contrast with the United States has over its 134 years of existence evolved from a relatively centralized to a more decentralized federal system, and a key element in that trend has been the evolution of its fiscal arrangements. Indeed, as Table B2 in our report on Canada indicates, the federal share of total public spending has declined sharply from 1961 to 1999. Nevertheless, 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."

There have, of course, been areas of contention. Most important has been Quebec's ongoing insistence upon its financial autonomy as its highest priority. This has focused especially on criticisms of the federal government's use of its spending power to finance programs in areas of exclusive provincial jurisdiction. Quebec has always sought greater fiscal and policy autonomy from Ottawa than have the other provinces. The result has been the development of an asymmetry between Quebec

and the other provinces as a result of exercising Quebec opting out of certain programs, exercising its constitutional rights in relation to income taxation and its own pension plan, and its decision not to participate in the Social Union Framework Agreement, 1999. Other provincial governments too have resented cases of the unilateral exercise by the federal government of its spending power in their areas of exclusive jurisdiction, but they did sign the Social Union Framework Agreement in 1999 under which the federal and provincial governments (except Quebec) reached an agreement on how new or additional federal-provincial programs might be implemented when the federal government uses its spending power in areas of exclusive provincial jurisdiction.

Given the difficulties and rigidities of the processes for constitutional amendment in Canada, the adjustments in federal-provincial financial arrangements have been a major factor enabling the federation to adapt to changing circumstances. The processes of "executive federalism" and the federal-provincial financial arrangements have been flexible enough to accommodate Quebec's pressure for greater fiscal and political autonomy while at the same time allowing the federal government to use its spending power to assist provinces and to achieve federation wide policy objectives in areas of provincial constitutional responsibility.

As in the other two federations, the processes of intergovernmental relations and fiscal arrangements in Germany have had both stabilizing and conflictual elements. The emphasis upon the objective of equivalence of living conditions throughout the federation and upon inter-state equalization transfers was based on a strong consensus contributing to the unity of the federation during its first 40 years. During the past decade, however, the strains arising from the attempt to apply these arrangements to the new added Länder after reunification has become somewhat contentious. This has led to various proposals for territorial reform of Land boundaries in order to reduce disparities among Länder and thus enable them to carry more symmetrical financial responsibilities. To date, efforts to redraw Land boundaries have been rejected, however. The same pressures have also

led to demands from Länder for a reform of the fiscal transfer system including the level of equalization payments and the manner in which joint tasks' are funded.

Despite these areas of contention, the fact remains that the Federal Republic of Germany has proven itself remarkably adaptable over its first fifty years. Adjustments in the federal fiscal balance have been accomplished by partial revisions to the constitution, by intergovernment negotiation and agreement, and by judicial review.

Some critics, such as Fritz Scharpf, have criticized the interlocked intergovernmental decision-making processes for being an impediment to adaptation.<sup>3</sup> In such an institutional culture which puts an emphasis upon consensus, the result may be indefinite postponement of difficult policy choices and hence a tendency to inertia in dealing with problems. While there is some evidence for this, overall the financial arrangements within the German federal system have, nevertheless, proved remarkably flexible to date. Nevertheless, enduring disparities in economic development of Länder since reunification and the consequent need for high levels of transfers are currently straining severely the inter-Länder solidarity on which the system depends.

### **Coordination and the degree of federal government influence upon state and local governments**

It is clear from the review of these three federations that the financial arrangements in each involve a high degree of interdependence between the orders of government within them. This has arisen from two factors. One has been the inevitability within federations of overlaps and interdependence in the exercise by governments of their constitutional powers. This has required the different orders of government to treat each other as partners. The second is that in the realm of fiscal arrangements it has never been possible to match precisely in the constitution the autonomous revenue sources and

expenditure responsibilities of each order of government within a federation. Thus, there has been a continuing need to correct vertical and horizontal imbalances through financial transfers as well as a need to harmonize the levying and collection of taxes as far as practicable within each federation. This has required extensive consultation, cooperation and coordination between governments in all three of the federations. Thus, how the processes and institutions for intergovernmental collaboration have contributed to intergovernmental collaboration has been a major factor affecting the effectiveness of fiscal federalism in each federation.

While the requirement of intergovernmental collaboration regarding fiscal matters has been common to all three federations, the form and extent of this collaboration has varied considerably. In the United States no formal intergovernmental institutions for coordination financial relations have been established, and consequently Congress itself has come to play the key role. States, localities and various interest groups have pressed their cases as lobbyists before members of Congress, but ultimately it has been Congress, itself a loose composite of state, local and other interests, that has determined the appropriate transfers to the states and local governments and the conditions to be attached to these transfers. In the United States these transfers have been directed not only to the states but to the local governments. The nature of Congress with its weak party discipline and representation of various interests has resulted in a vast array of uncoordinated transfer programs each with their own conditions. On the other hand Congress's insistence upon virtually all transfers to the states and local governments incorporating strict specific conditions or even directions has led to the perception of these as 'coercive' in imposing the priorities of Congress over those of the states and local governments.

In Canada, the constitution has not established any formal institutions for coordination between federal and provincial governments in fiscal matters, but during the latter half of the twentieth century there developed an elaborate system of federal-provincial consultations and meetings between

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<sup>3</sup> Fritz W. Scharpf, "The Joint Decision-Trap: Lessons from German Federalism and European Integration," *Public Administration* 66 (1988), 246.

their executive branches relating especially to financial relations. These processes have come to be known by the label 'executive federalism'. In Canada, unlike the United States, these direct intergovernmental relations have been confined to the federal and provincial governments, with all the financial transfers to local governments coming under the sole control of the provincial governments.

The main areas in which the involvement of the federal government in Canada has focused in intergovernmental financial relations has been the use of its spending power in support of provincial programs in health, post-secondary education and social welfare, a formal program of equalization payments to assist the poorer provinces, and the collection on their behalf of provincially levied income taxes in order to facilitate tax harmonization. The conversion of the transfers for shared cost programs into predominantly unconditional transfers and the unconditional nature of the equalization transfers has limited the degree of federal control over provincial programs, however. Nevertheless, the fact that the size and purposes of these unconditional transfers has ultimately been determined unilaterally by the federal government exercising its spending power (although often but not always after considerable federal-provincial consultation and negotiation) has provided a not unimportant and contentious measure of federal control.

In Germany, by contrast to the other two federations, the constitution itself has shaped the processes and institutions governing intergovernmental financial relations. The extensive formal institutions for intergovernmental consultation, cooperation and coordination articulating its distinctive 'executive federalism' have derived from the key role of the Bundesrat, representing the Länder, whose consent (by a majority vote) is required on virtually all matters concerning intergovernmental financial relations. From this has derived an extensive network of intergovernmental committees and councils. Furthermore, unlike Canada, the federal constitution does also include some provisions directly relating to the financing of the municipalities.

The major portion of the discretionary federal transfers to the Länder have been conditional, thereby enabling the federal government to exert considerable influence by what Germans have come to call the federal 'golden lead' in its financing of 'joint tasks' and delegated administration. On the other hand, the additional substantial transfers to the Länder is in the form of constitutionally mandated unconditional shares of federal taxes have provided a measure of financial autonomy for the Länder. Given the requirement of Bundesrat consent for changes to financial arrangements and indeed for all legislation affecting the Länder (in practice about 60 percent of all federal legislation), intergovernmental relations in Germany have been characterized by mutual interdependence rather than by federal control.

The most significant feature in Germany is the degree of coordination of intergovernmental financial relations. Indeed, these can be characterized as establishing a virtually interlocked character to German federalism. While as noted above, some critics have suggested that this has resulted in a tendency to inertia, nevertheless, the degree of coordination and flexibility in Germany has been distinctive among federations.

### **The significance of political culture**

It is clear from our reports on fiscal federalism in the Canada, the United States and Germany that although as federations they have faced similar issues, there has been considerable variation in the ways in which they have dealt with these. The essential lesson here is that there is no single ideal theoretical model of federation or of fiscal federalism that is universally applicable everywhere. Ultimately federalism requires a pragmatic approach and represents a dynamic political technique for accommodating the circumstances and needs of the particular society in question. Thus, while we can learn from the varied experience of federations such as Canada, the United States and Germany, the most important lesson to be drawn is the need to adapt the federal financial arrangements to the particular situation.

Here a major factor is differences in political culture. While the values of federalism – the

combination of shared rule through a common government and of genuine self-rule of the constituent units, the overriding rule of constitutional law, respect and tolerance for territorial minorities, and the need for compromise to achieve democratic consensus – are common to the political cultures of all three federations, there are also significant differences in their political cultures and these have shaped the character of their intergovernmental financial relations.

Germany, for instance, of the three federations has in relative terms the most homogeneous society and this has been both reflected in and reformed by its intergovernmental fiscal arrangements. Examples are the emphasis upon equivalence of living conditions, upon an 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 is reflected in the relative dominance of the federal government and the reliance upon conditional intergovernmental transfers. However, compared to Germany the emphasis in the U.S. political culture upon governments as representing a variety of groups and interests and upon the diffusion of power among multiple decision-making centres has meant that, unlike Germany, there is no coordinated overarching system of equalization or of intergovernmental financial transfers. There is instead a vast array of uncoordinated intergovernmental transfer programs, each attempting to respond to particular specific needs and interests.

The Canadian political culture has been characterized by linguistic and regional cleavages and the processes of intergovernmental relations and fiscal arrangements have both reflected and reinforced these characteristics. The linguistic and regional differences and the inadequate representation of the provinces within the Canadian Senate have resulted in the provincial premiers becoming the primary advocates of provincial and regional interests on the federal scene. This explains why intergovernmental meetings and the processes of

‘executive federalism’ have in practice come to dominate intergovernmental fiscal relations in Canada. The intensity of the linguistic and regional cleavages also explains the insistence of the provincial governments, and particularly Quebec, on ensuring their autonomy and hence the trend over time to reliance upon broadly unconditional transfers in the system of intergovernmental financial relations. 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. The largely unconditional or only semi-conditional character of these transfers has at the same time allowed considerable discretion in how the provinces deliver these programs. The intergovernmental financial arrangements have thus reflected the diverse regional and linguistic political culture of Canada while permitting the federal government to develop broad Canada-wide social programs and policies.

These examples indicate that each of the three federations has developed its particular form of fiscal federalism reflecting the distinctive character of its society and political culture.