

eJournal of Tax Research

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Special Edition: State Funding Reform in the Australian Federation

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Editorial

Fiscal Federalism under Review (at *Speed*)

Neil Warren¹

Australian fiscal federalism is under challenge. At no time in the recent past has there been such a broad based and concerted questioning of fiscal federalism arrangements. When the Commonwealth announced a change in the taxation of mining rents in May 2010², discontent in the mining States (of Western Australia and Queensland) over what they saw as Commonwealth encroachment on State tax bases worsened already simmering resentment about how general grants were distributed amongst States.

With mining royalties being able to be offset against the liability for the new tax on mining rents, the mining States responded by announcing increases in their mining royalties, a position which saw the Commonwealth threaten to cut general grants to States based on their increased royalties revenue. At the same time there was growing concern about the growth in specific purpose grants, in particular proposals by the Commonwealth to assume the role of majority funder of health.

Not only were these developments of interest to States, but given the fact that many of these changes were being undertaken outside Commonwealth Parliamentary review through the Council of Australian Government (COAG)³, the Commonwealth Parliament also became more concerned. In response, in June 2010 a *Senate Select Committee on the Reform of the Australian Federation* was announced which, amongst other issues, sought to review financial relations between federal, state and local governments.

The Commonwealth Treasury(2010) also expressed concern about State reaction to Commonwealth policies and in a briefing note to the incoming Commonwealth government in August 2010, stated that ‘The fiscal equalisation process does not promote reform’ (p21). This outcome was especially evident throughout the second half of 2010 when the mining States joined with mining companies to publicly oppose the Commonwealth mining tax reforms while also arguing that there should be limits on how mining revenue is redistributed away from these States through general grants⁴.

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² See various press releases at
<<http://www.futuretax.gov.au/content/Content.aspx?doc=mediacentre.htm>>

³ See various contributions in Kildea, Lynch and Williams (2012)

⁴ The most vocal critic was Western Australia which argued that there should be limits on the redistribution of their mining revenue to other States and Territories. See for example the discussion in <<http://www.mediastatements.wa.gov.au/Pages/Results.aspx?ItemID=136383>> .

In early 2011, the Victorian Government (2011) also contributed to the chorus of concern with how general grants distribution arrangements are an inhibitor to the timely introduction of agreed State tax reforms because they are based on ‘what is’ current State taxation, not ‘what ought to be’ arising from any intergovernmental agreement (Warren 2010).

The Commonwealth responded to all these criticisms on 30 March 2011 by announcing that there would be a *Review of GST Distribution*. As Prime Minister Julia Gillard stated at the time, ‘Instead of States facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide States with certainty’.⁵

With this renewed attention on fiscal federalism, the challenge was to ensure any debate on the issues was informed. However, the fiscal federalism debate in Australia is associated with a dearth of independent research; a situation which is in marked contrast to most other federations where funding sub-national governments is an issue actively researched. In an effort to stimulate and inform the Australian debate, it was concluded that the Australian discussion would greatly benefit from being exposed to the international debate on these issues.

To facilitate such a discussion, a *State Funding Forum* was organised in Canberra on 12–13 September 2011 involving some 5 international presenters and 5 Australian discussants. Reflections on the Australian experience were provided by 6 Australian presenters and the *Forum* concluded with a plenary session where the international presenters provided their ‘*speed*’ strategies for addressing those issues which will accompany any push to reform intergovernmental fiscal arrangements in the Australian federation.

This special edition of the *eJournal of Tax Research* includes papers delivered at this *State Funding Forum* by both the international and Australian presenters. Below, we provide an overview of the papers presented and ‘*speed*’ strategies recommended in the plenary session.

Professor Alan Fenna from The John Curtin Institute of Public Policy at Curtin University in Western Australia presented the opening paper at the *Forum*, speaking on ‘The Character of Australian Federalism’ including its constitution, politics and society since federation. He argued that the current issues of taxing powers, revenue distribution, policy jurisdiction and intergovernmental relations in today’s federation must be seen in the context of the ‘character’ of Australia’s federal system. That character is created by the interaction between constitutional design, judicial interpretation, economic and social change, and political processes over the 110 years of institutional evolution since Federation.

Designed for an earlier epoch, Australian federalism has undergone substantial adaptation to meet the needs of modern social and economic conditions, he said. As has been widely recognised, that adaptation has been profoundly centralising in its effect. He stressed that while Australia is not alone in this respect — indeed, such tendencies have been endemic in the established federations — this syndrome is particularly evident in the Australian case. Aspects of this particular character raise

⁵ See comments in

<<http://www.treasurer.gov.au/wmsDisplayDocs.aspx?doc=pressreleases/2011/028.htm&pageID=003&min=wms&Year=2011&DocType=0>>

continuing issues for resolution as well as impose severe constraints on what solutions might realistically be considered, he stated, all issues intended for consideration at the *Forum*.

Professor Robin Boadway, Department of Economics, Queen's University, Kingston, Ontario, Canada, began the presentation by international speakers with an overview of the 'International lessons in Fiscal Federalism Design'. His presentation reviewed and evaluated alternative ways of designing federal-state fiscal relations with a view to achieving accountability, efficiency and fairness in the financing and delivery of public programs to citizens of different states. The practices in other federations were drawn upon to illustrate the issues, highlighting in particular the case of Canada. Alan Henderson AM, Chairperson of the Commonwealth Grants Commission (CGC) was the discussant on Professor Boadway's paper.

Dr Hansjörg Blöchliger from the Economics Department in the O.E.C.D., Paris presented a paper which he and his colleague Camila Vammalle prepared on 'Going beyond a zero-sum game: Reforming fiscal relations'. Their paper identifies the political and economic factors that influence the design, adoption and implementation of changes to intergovernmental fiscal relations, based on reform episodes in ten OECD countries. While they said that some factors that determine the success of reforms are outside the scope of policy makers (such as basic constitutional provisions or economic and fiscal conditions), there are many which policy makers have scope to influence and help a reform succeed. Professor Richard Eccleston from the University of Tasmania was the discussant on this paper.

Professor François Vaillancourt, Dept Economics, University of Montreal, Montreal QC, Canada spoke on 'Own revenues in federations: tax powers, tax bases, tax rates and collection arrangements in five federal countries'. His presentation began with an examination of what tax bases best belong to various levels of government. Attention was then given to how to share tax bases when they have more than one owner: joint uncoordinated access, joint coordinated access, interaction between tax bases, while also making a distinction between taxation and using a tax base as a source of formula driven transfers. The use of tax bases in the federations in Canada and the USA were then examined along with the accompanying tax base and rate setting powers, concluding with a discussion of tax collection arrangements in various federations. Don Parker from the Victorian Department of Treasury and Finance was the discussant on this paper.

Professor Violeta Ruiz Almendral, Profesora Titular De Derecho Financiero y Tributario, Universidad Carlos III de Madrid Spain and Letrada (Advocate) Spanish Constitutional Court, presented on 'Sharing Taxes and Sharing the Deficit in Spanish Fiscal Federalism'. She indicated that since 1997, Spanish regions have been able to share the personal income tax equally with the centre, as well as establish tax rates and tax credits in their own region. In her presentation, she reflected on Spain's 14 years of experience with this arrangement, providing an assessment of its results from different perspectives. In particular, how has it impacted vertical fiscal imbalance, whether Communities have become more fiscally responsible and whether the Communities personal income tax share can grow. Rob Heferen from the Commonwealth Treasury was the discussant on this paper.

Professor Greg Smith, Adjunct Professor at the Australian Catholic University, a Senior Fellow of the Melbourne University Law School, and a director of the Centre for Policy Development, spoke on the 'The Way Forward on State Tax Reform: An

AFTSR Perspective'. This presentation reviews recommendations in the 2009 Report to the Treasurer on Australia's Future Tax System relating to the future of state taxes in Australia. The Report proposes greater centralisation of tax collection, abolition of many state taxes, and reforms to others including land, resource and road-related taxes. Professor Smith outlined these proposals and their implications for federalism in Australia.

Bernard Dafflon, Professor of Public Finance, Department of Political Economy, University of Fribourg in Switzerland, addressed the critical question of 'Solidarity and the design of equalization: Setting out the issues. Professor Dafflon began by stressing that inter-jurisdictional differences originate from choices or from situation disparities and that equalization only refers to the latter. He indicated that how these disparities are responded to has moved recently to the adoption of separate disparate measures of revenue potential and expenditure needs through various formula-based vertical or/and horizontal financial transfers (whereas Australia uses a single combined measure). For revenue equalization a representative tax system (RTS) is commonly used but expenditure equalization has seen different concepts (such as needs or costs disparities) adopted to express disabilities associated with decentralized public expenditures and the need for equalization. The presentation explored these issues; questioned the possible criteria for these two aspects of equalization and produced guidelines for policy implementation. Professor Ross Williams, University of Melbourne was the discussant on this presentation.

Three presentations were subsequently given designed to provide reflections on fiscal federalism in Australia. Professor Ross Williams, University of Melbourne provided a brief historical overview of federal-state fiscal relations and the role and influence of the Commonwealth Grants Commission. He noted that attention has been given over time to the changing application of partial versus full horizontal fiscal equalisation, to the interaction between vertical and horizontal transfers, to timing issues and to the impact of grant design on efficiency.

Professor Jonathan Pincus, University of Adelaide, provided some reflections on fiscal equalisation in Australia. This presentation focused on equity and efficiency arguments used in the past to support the case for fiscal equalisation—including those relating to settlement patterns, to fiscal externalities and to risk sharing—and found them weak in contemporary Australia, with its low inter-jurisdictional variance of incomes and fiscal capacities, and low costs of interstate migration and trade.

Professor Neil Warren of the University of New South Wales presented a paper on 'Fiscal equalisation and State incentive for policy reform', arguing that how Commonwealth grants are distributed limits the scope for States to innovate and to risk-take, individually and collectively. He also explored the options available to change equalisation arrangements in a way which would enable States to be rewarded for efficiency improving policy reforms such as reforming inefficient State taxes.

In a world of blogs and Twitter, we are increasingly looking for 'cut through' strategies which quickly give us the essence of the argument. In the final session of the *State Funding Forum*, the international presenters were asked to offer their 'speed' strategies on bringing about change in the complex and difficult area of fiscal federalism in the Australian federation.

On the question of *speed* federalism design, Professor Violeta Ruiz Almendral proposed that the first imperative is to define authority in a clear, simple but flexible way – one that allows authority to evolve. Crucial too is making sure citizens know

who does what and who pays (and sharing taxes such as the personal income tax has the advantage of making that visible). Also, it is important to ensure that there is an institutional infrastructure to solve issues and foster cooperation (for example: an intergovernmental commission to address falling standards in Education). Critical to enduring success will be transparency and three key words are: explain, publish and tell argued Professor Ruiz Almendral.

Professor François Vaillancourt then turned his attention to *speed* tax design for a federation with a focus on tax powers, tax bases, and tax rates. A strong federation requires its subnational governments (SNG) to have access to a reasonable level of own revenues to ensure accountability to their SNGs and to get away from the 'I spend their money for your benefits' approach encountered for example in Scotland, said Professor Vaillancourt. He also stressed that the tax should be selected taking into account both the type of responsibilities of SNGs, the mobility of tax bases and administrative and compliance issues. Hence road type taxes are relevant if SNGs provide road services. In advanced federations, SNGs typically spend a large share of their budget on people oriented services (education, health, social services) and thus the personal income tax is a natural fit.

The tax base used should therefore be set at the national level, argued Professor Vaillancourt, to minimize administrative and compliance issues and to facilitate the attraction of foreign capital. SNGs are given a share of the tax base to tax, not as a transfer. A reasonable share ranges between 20 to 50%. In the case of tax collection, these he said should be carried out by a single agency (eg in Canada except Québec, and Spain), preferably managed jointly by both levels of government but reporting to one level (as this will usually work well) and with each Government paying the cost of collecting their taxes.

SNGs only get access to these tax revenues by explicitly setting a tax rate; the national tax rate does not apply by default (Spain before 2011). If the personal income tax is used, they can either set the rate as a surcharge on the central tax burden, thus adhering to national tax brackets and rates and thus progressivity (Canada before 2000), or set their own brackets and rates giving them a choice in terms of progressivity (Canada since 2000). They can grant personal tax credits but no exemptions or deductions since a common base is used, said Professor Vaillancourt.

On the issue of *speed* equalisation Professor Bernard Dafflon said that since equalization is about solidarity, which is foremost a political issue, a reform of the equalization system must clearly and explicitly distinguish between decisions and choices that are in the competence of politicians, and the political economy of equalization which is in the competence of economic experts. Here, economic experts must contribute to the coherence of the political choices, but they do not assume the responsibility for those choices. Also important is that the origins of the fiscal disabilities to be equalized needs to be duly established and informed, but SNGs' own choice must not be equalized.

Revenue equalization must be founded on RTS he said. Central and state governments must make a common decision on which taxes to consider, for how many years and with which weight. Since RTS is based on the relative position of SNGs, a common decision is also required on the amount of equalization and its vertical and/or horizontal funding.

Expenditure cost equalization should not be considered owing to the paramount difficulties in measuring effective costs disabilities (versus choices and X-

inefficiencies). Professor Dafflon proposed that expenditure-needs equalization is possible under the following sequence: select the functions to be equalized, effective expenditures must not serve as benchmark if they are already modified through equalizing payments (return to the causality criteria); there must be a plausible relation between the explicative variables and the disabilities; if a synthetic index of expenditure needs is estimated, the weight given to each variable must correspond to the proportion of functional expenditures taken into consideration.

On the all-important issue of the reform process, Dr Hansjörg Blöchliger proposed five points which he said were key to a successful reform strategy. These were to firstly clearly name the problem (which equals a common understanding that the status quo is untenable); secondly to agree on a common proposal to amend the problem (such as less horizontal fiscal equalisation or more tax autonomy); thirdly, find allies, incorporate their demands, in order to find a majority (bundling) and agree on transitional compensation mechanisms. Fourth was to wait for a good moment (depending on the reform, either a growth period or a crisis) and finally and most importantly, ‘communicate, communicate, communicate’ he said.

The *State Funding Forum* was an important, timely and well attended event, involving Treasury officials from all States and Territories and from the Commonwealth. Also in attendance were representatives of the Commonwealth Grants Commission, industry and professional organisations and from a number of community organisations and other government agencies. The *Forum* was universally acknowledged as doing much to expose the key participants in the Australian debate to those issues which have been the focus of the international debate and enlightening them on how Australia might be able to benefit from lessons learnt in other federations when reforming their intergovernmental fiscal arrangements.

It was also considered that the proceedings would do much to ensure the deliberations of the *Review of GST Distribution* would be informed by international precedent and that the debate on these issues at the 4-5 October 2011 Commonwealth *National Tax Forum* in Canberra, would likewise be informed. Most importantly, by publishing the proceedings of the *State Funding Forum* in this volume of the *eJournal of Tax Research*, the broader community will now have ongoing access to an important resource which will enable them to better understand fiscal federalism issues in Australia and the available reform options given international precedent.

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The Character of Australian Federalism

Alan Fenna¹

Abstract

Current issues of taxing power, revenue distribution, policy jurisdiction and intergovernmental relations in Australia today must be seen in the context of the ‘character’ of Australia’s federal system. That character is given by the interaction between constitutional design, judicial interpretation, economic and social change, and political processes over the past century. Designed for an earlier epoch, Australian federalism has undergone substantial adaptation to meet the needs of modern social and economic conditions. As has been widely recognised, that adaptation has been highly centralising in its effect. While Australia is not alone in this respect — indeed, such tendencies have been endemic in the established federations — the syndrome is particularly evident in the Australian case. Aspects of this particular character raise continuing issues for resolution as well as imposing severe constraints on what solutions might realistically be considered.

1. INTRODUCTION

Australia is a notably centralised federation where the Commonwealth exploits a position of fiscal dominance to intervene extensively in areas of State jurisdiction. The consequence of this is not only to reduce the policy autonomy of the States but also to foster a complex overlap and entanglement of the two levels of government sometimes called ‘cooperative’ or ‘administrative’ federalism. Australia is also a highly-egalitarian federation that implements a comprehensive degree of horizontal fiscal equalisation (HFE) to ensure that the States and Territories are able to offer public services of the same standard regardless of their particular circumstances. These vertical and horizontal realities may, in their effect, be good, bad or indifferent — and there are certainly arguments in all three regards. The question here is how these realities are to be explained and how amenable they might be to alteration. The answer is that they are embedded in the design and history of Australian federalism and in the underlying realities of Australian society and are reinforced by external and global forces.²

2. CONSTITUTIONAL DESIGN

The constitutional framework is far from everything one needs to know to understand a particular federation, but it is, as K.C. Wheare (1963: 20) put it, a ‘convenient’ way to begin — and indeed perhaps the most logical place to begin. Australian federalism takes its character from a combination of its constitutional framework and the way it has diverged from that framework.

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² This paper draws on arguments I have made in more detail elsewhere, chiefly in Hueglin and Fenna 2006; Fenna 2007a, 2007b, 2008.

2.1 Original intentions

At the very first meeting the colonial delegates held to discuss the possibility of union, the Federation Conference of 1890 in Melbourne, Alfred Deakin declared that ‘the model of the United States, preserving state rights with the most jealous caution, is that most likely to commend itself to the people of these colonies’.³ When delegates met in Sydney the following year to get down to brass tacks, the very first of only four governing propositions launching those deliberations was:

That the powers and privileges and territorial rights of the several existing colonies shall remain intact, except in such surrenders as may be agreed upon as necessary and incidental to the power and authority of the National Federal Government.⁴

From these declarations flowed two key features of the Commonwealth Constitution: the States were to retain primacy in almost all matters of domestic affairs not fundamentally concerning the integrity of the union; and, the way to ensure this was to follow the drafting example provided by the US Constitution.

2.2 The single list approach

Following that American example, the Commonwealth was assigned a specific set of enumerated powers — the 39 headings of section 51. A small number of these were made exclusive and the rest were to be held concurrently with the States. Most importantly, this was, first of all, a *limited* list. Section 51 comprised, on the whole, two broad matters: those powers necessary to provide a common market and those concerning the country’s external relations and borders. Secondly, it was a *limiting* list: the purpose of listing the areas in which the Commonwealth Parliament was entitled to legislate was simultaneously to empower *and to constrain* the new government. The Commonwealth was intended to be a government of certain specified powers and no more.

The States, meanwhile, were assigned not a single specified power. Instead they were assigned, under s.107, an infinite range of powers, excepting only those explicitly denied them. Thus, the vast majority of domestic responsibilities were to stay the exclusive responsibility of the States. These powers were anything and everything not mentioned in s.51 — such as: infrastructure; resources; the environment; education; health; policing; criminal and civil law.

2.3 Taking full responsibility

Powers were divided by assigning discrete policy domains wholesale to one level of government or the other. Each level would have full responsibility for policy making, implementation and administration for a set range of policy fields; each would be accountable to its own citizens for those domains. Similarly, each would have responsibility for raising revenue from whatever tax bases it had authority to exploit. This was by contrast with the approach that had taken shape in 19th century Germany and prevails in the German system today, which was to assign complementary functional roles rather than specific policy domains. The central government was

³ *Debates and Proceedings of the Australasian Federation Conference*, Melbourne, 13 February 1890.

⁴ *Debates of the National Australasian Convention*, Sydney, 2 March – 9 April, 1891.

given extensive responsibility for general policy frameworks but the States were left with responsibility for implementation and administration. A correlate of that approach has been constitutionally-defined revenue sharing of the main tax bases.

2.4 Tending to their own affairs

An implication of being assigned distinct policy domains was that the Commonwealth and the States would operate autonomously in their respective spheres. The reservoir of exclusive State powers was large and thus the expectation was that the States could carry on governing their populations without let or hindrance from the Commonwealth and the federation could function with a minimal degree of intergovernmental coordination being required. This, again, contrasts with the German approach, which required a more integrated approach, the main conduit for which was a truly federal upper house in the national parliament — the *Bundesrat*, made up of emissaries from the constituent units (*Länder*). Collectively, the *Länder* governments have a say in the design of any federal law that affects them and a veto over the passage of any such laws.

2.5. The safeguards of federalism

Federal constitutions are meant to be self-enforcing in some way. That is to say, they characteristically build ‘safeguards’ into the system of government they are establishing that are expected to preserve the agreed-upon balance between larger and smaller States and between the States and the central government. Four main safeguards were built into the Australian Constitution to protect against serious encroachment by the Commonwealth on the powers of the States. First, the formal division of powers prescribed for the Commonwealth a defined sphere of action. Secondly, a bicameral legislature with equal State representation in the Senate was to provide an internal check on any untoward actions by the Commonwealth. Thirdly, an independent supreme court, the High Court of Australia, with power of judicial review, would provide an external check on Commonwealth expansionism. Fourthly, an amending procedure that requires the approval of a majority of voters in a majority of States before any alteration can be made would prevent unilateral changes to the rules. As it turned out, only the fourth of those, the double majority amendment procedure, lived up to expectations — and even it fell well short of being an adequate safeguard.

2.6 The financial gap

There was one small matter the founders were unable to resolve: the money problem. With federation, the States would, almost unavoidably, lose the authority to levy and collect customs tariffs — the single most important source of government revenue in that period. Since federation was driven in no small part by the desire to eliminate barriers between the colonies, it is not surprising that the Constitution lays down in sections 90 and 92, strict prohibitions on such devices. At the same time as they were losing much of their revenue capacity, the States were losing almost none of their service delivery responsibilities. Australian federalism thus came into this world with a pronounced case of ‘vertical fiscal imbalance’ (VFI) or ‘vertical fiscal gap’ as Boadway (2007) prefers to call it. The founders assumed that subsequent generations would somehow find mechanisms through which the Commonwealth’s ‘surplus’ revenue would be transferred directly back to the States.

To compound matters, the founders made four decisions that stacked the deck against the States. They allocated the Commonwealth a plenary power to tax even though it had very limited spending needs. They included, as per the US Constitution, a supremacy clause stipulating that in cases of conflict Commonwealth laws prevail over State laws (s.109). They prohibited the States not just from imposing customs tariffs, but also from imposing ‘excise’ duties — however those might be defined (s.90). And they gave the Commonwealth authority to ‘grant financial assistance to any State on such terms and conditions as the parliament thinks fit’ (s.96) — a clause without parallel in comparable federations.

3. HOW HAS THIS WORKED IN PRACTICE?

Constitutions may be virtually immutable — and, indeed, governments have enjoyed astonishingly little success in changing Australia’s Constitution — but the systems over which those constitutions preside have proven anything but (Fenna 2012). Australia is no exception in this regard. While on paper we have almost exactly the same federal system as the framers bequeathed us 110 years ago, in practice we have something very different. As is well known, Australian voters have been asked to approve 44 different amendments to the Constitution but have rejected all except eight. Of those eight, only three concerned the federal system and of those three, the one major change was the social services amendment of 1946. Australians have pretty consistently rejected proposals to centralise power.

A Constitution has its primary effect on the evolution of a federal system through application to concrete disputes — and application of a Constitution unavoidably and by definition means *interpretation*. The key to Australia’s federal Constitution was not whether it would be amended, but what meaning it would be interpreted as having in those concrete situations.

3.1. Best laid plans...

Initially things looked quite good for the States: the early High Court was determined to protect the federal character of the Constitution and the States developed new and promising revenue sources. Most important of the latter was the income tax, a new source that might genuinely compensate for the customs revenues they had lost.

Not all went well, though: Commonwealth governments quickly figured out that they didn’t really have surplus revenues, they only had revenues that were surplus to currently existing requirements. And the High Court began its long process of turning s.90 into a prohibition against State sales taxes. Then, in relatively rapid succession, three developments altered the situation fundamentally:

1. In 1920 the High Court decided that the Constitution should be read just like any statute and did not need to be given any special respect as a document of federal union when it came to interpreting and applying specific clauses.⁵ The effect of this was to undermine the single list approach to dividing powers between the Commonwealth and the States, with s.51 becoming much less of a limiting list and more of an empowering one.

⁵ *The Amalgamated Society of Engineers v Adelaide Steamship Co Ltd.* (1920) 28 CLR 129.

2. In 1926 the High Court agreed that s.96 meant exactly what it said and the Commonwealth could use its spending power to extend its control into areas of State jurisdiction howsoever it wished.⁶ This authorised both the *directive* and the *prohibitive* use of ‘tied grants’.
3. In 1942 the High Court agreed that Parliament’s right to set terms and conditions extended as far as being able to force the States to abandon their most important revenue source, the personal and corporate income tax altogether.⁷ This gave the Commonwealth a monopoly over the country’s two most important tax bases.

4. NO ACCIDENT

Possibly the transformation of Australian federalism has been the result of design errors. The American single-list approach, though logical, was clearly ill-conceived; s.96 was a uniquely Australian innovation that could only be described, from a federalist point of view, as perverse; the drafting of s.90 was likewise culpable; being popularly elected, the Senate was never going to act as a States’ house; the amending procedure, while it protected the States, inexplicably sidelined them when it came to suggesting changes (as did the High Court appointment procedure); and the Constitution laid down no meta-rules protecting its federal character.

But there is much more to it than that. The enormous changes that have occurred in Australian federalism, changes that have in many ways reversed the intended relationship between the Commonwealth and the States, reflect two particular realities to do with the underlying society on which the system was to operate.

4.1. Old ideas, new realities

First of all, the American model on which Australian federalism was based presupposed several essential facts that were soon rendered anachronistic by the great economic and social changes of the 20th century. It presupposed that tasks could be neatly allocated to one level or the other. It presupposed that the vast bulk of domestic governance responsibilities were local in their nature and had little or no spillover effects beyond State borders. It presupposed that social and cultural norms were in the first instance a matter for local communities, not the national community, to decide. It presupposed a world where business firms rarely spanned jurisdictions and trade and intercourse between the States was modest. And it presupposed a world without the redistributive welfare state or macroeconomic management.

In all these respects, the basis on which the American model was established was turned on its head by the rapid shift to modern industrial society. Those changes entailed a general migration of tasks from the subnational to the national level.

4.2. Federal systems and federal societies

This explains a powerful tendency common to federal systems, but it does not explain variations between them. The particular design choices made by the framers of the Australian Constitution may go some way to explaining that variation, but there is yet more to the story. The fact is that federal systems cannot help but be fundamentally

⁶ *The State of Victoria and Others v The Commonwealth* (1926) 38 CLR 399.

⁷ *The State of South Australia v The Commonwealth* (1942) 65 CLR 373.

shaped by the kind of society over which they preside and Australian society lacks any of the powerful regional differences that provide such an effective countervailing force to those centralising pressures in Switzerland or Canada. Western Australia may have its own sense of regional difference and grievance, but it does not have any of the kind of identity characteristics — language, religion, ethnicity — that would make it a distinct society within the Commonwealth.

It is also not surprising that the two most regionally homogeneous federations, Germany and Australia, are the two where horizontal fiscal equalisation is the most comprehensive. An absence of significant regional difference means that the logic of a single citizenship prevails. This does not mean that equalisation will be uncontested, but it does help explain why equalisation is implemented to the degree that it is. Equalisation presents real dilemmas for federal systems since it is simultaneously inherent and alien to federalism: inherent because federalism is about providing for collective security and welfare and a common destiny, alien because federalism is about respecting regional diversity and maintaining regional autonomy (Fenna 2011).

5. HOW DO THINGS LOOK TODAY?

The result of the way the Constitution was drafted, the profound changes that have occurred in economy and society, and the disconnect between a federal Constitution and an effectively unitary society is a high degree of centralisation and extensive practical overlap and entanglement of the two levels of government in Australia that is widely criticised (e.g., Warren 2006).

5.1 State revenue

Centralisation is evident in, and facilitated by, vertical fiscal imbalance. As early as 1942, Australian federalism had reached a high degree of fiscal centralisation. Despite the Constitution allocating a shared or concurrent jurisdiction over all tax bases except ‘duties of customs and of excise’, the Commonwealth had come to monopolise the most important ones. The *coup de grâce* was finally delivered in 1997, when the High Court ruled that various efforts by the States to levy some sort of sales taxes, in the form of franchise fees on tobacco and other substances, violated s.90’s prohibition on excise duties.⁸ Canada and the United States, the two federations most similar to Australia, also went through a process of centralisation in the 20th century, but these developments made Australia stand out as the only one of the three where the national government had achieved exclusive control over *either* the general sales tax *or* the personal and corporate income tax, let alone *both*. Under the Fraser government, the States were invited to re-enter the income tax field, but the Commonwealth made no move to create tax room and the offer was an empty one (Saunders and Wiltshire 1980: 358). Being so thoroughly excluded from the main tax bases has left the States scrounging for ‘own source’ revenue in a variety of places where they are regularly accused of imposing economically ‘inefficient’ taxes or encouraging socially harmful activities such as gambling.

Of course, scrounge as they might, the States simply do not have access to sufficient own-source revenue to cover more than a certain part of the substantial service

⁸ *Ha and anor v State of New South Wales & ors; Walter Hammond & Associates v State of New South Wales & ors* (1997) 189 CLR 465.

delivery expenditures. The States must rely on transfers from the Commonwealth for close to half of their funding needs. Being so dependent on the Commonwealth has carried two disabilities: whether the quantum will be sufficient and what the terms and conditions will be. Since the explosion in conditional grants under the Whitlam government, 1972–75, transfers have been split roughly equally between general and specific purpose (i.e., ‘tied’ or conditional).

The heavy reliance of the States on general purpose transfers has given the Commonwealth the opportunity to ‘down shift’ deficit-cutting policies. Fiscal virtue at the national level can be bought at the expense of fiscal pain at the State level. The derisive remark — attributed to Paul Keating — about not wanting to get caught between a State premier and a bucket of money, added insult to that injury. In this regard, the position of the States has improved significantly in recent times. The 1997 High Court decision invalidating franchise fees dovetailed nicely with the Howard government’s desire to replace the old Wholesale Sales Tax with the Goods and Services Tax (GST), a comprehensive value-added tax applied to most goods and services. Support from the States lowered the political risk of this controversial – and in the past fatal – initiative. For that support, the States were endowed with the new tax’s net revenue as a replacement for the general purpose Financial Assistance Grants.

This was a win for the States and removed one major source of fiscal vulnerability. However, it was not without its limitations and compromises. One of those is that although the deal is enshrined in legislation, any Commonwealth government with sufficient support in the Senate can readily alter it — as both the Howard government’s Treasurer, Peter Costello, and Labor Prime Minister Kevin Rudd, threatened to do at different times. Rudd, in particular, announced that he would withdraw a third of the GST revenues to finance his health and hospital program (Fenna and Anderson 2012). The other is that while the GST is indeed a ‘growth tax’, generally increasing with economic activity, it could not help but perform poorly by comparison with the Commonwealth’s surge in income tax revenues from the mining boom that took off only a few years later. It also gave the States no control individually, and very limited influence collectively, over the rate and nature of the tax. Ideally for the States, perhaps, they would be in a position to raise the GST rate with the Commonwealth being obliged to compensate by a proportionate decrease in the personal income tax; but that is not within their power.

5.2. Commonwealth grants

More significantly, perhaps, the GST superseded the general purpose payments previously received by the States and did nothing to curtail the Commonwealth’s use of tied grants. There are two federations today, Australia and the United States, where extensive use is made of conditional grants to circumvent the constitutional division of powers. As some of the foregoing suggests, this has been one of the main ways a pre-industrial constitution has adapted to modern conditions. At the same time, though, it has created a number of pathologies: decreasing efficiency, accountability and legitimate local autonomy while allowing opportunistic intervention to flourish. The Howard government’s Mersey hospital rescue during the 2007 federal election was the most flagrant example of such opportunistic intervention, but by no means the only example.

Enthusiasm for the Rudd reforms of 2008–09 reflected widespread desire to address that problem and some of the pathologies of Australian federalism more broadly (Fenna and Anderson 2012). Conversion of a large number of individual Specific Purpose Payments (SPP) into a handful of omnibus block grants provided sought after relief from a number of intrusive Commonwealth requirements. However, this came at a cost for the States in the form of new outcomes assessment carried out by the COAG Reform Council. While the Council of Australian Governments (COAG) has functioned as the peak forum for intergovernmental relations in Australia since the early 1990s, this represented a significant increase in COAG's monitoring and coordinating function (Anderson 2008). Even then, the SPP reform did not close the door on the individual tied grants. They have been rebadged as National Partnership Payments, of which there have already been at least sixty to date. Some of those are truly trivial, others seriously substantial; many apply the kind of intrusive conditionality that was so deplored in the old-fashioned SPPs.

6. CONCLUSION

Australian federalism has undergone extensive change to adapt what was fundamentally a pre-industrial Constitution to modern conditions. Many functions whose boundaries were then unambiguously local have assumed a much larger footprint or an entirely national dimension; increasing economic integration is driving a push for a single market as distinct from merely a common market; the national economy requires a degree of 'management' unknown at Federation; greater integration and mobility continually weaken local taxing power; the national community is far less tolerant of diversity in policy and practices across the country than citizens might have been a century ago; and there is little by way of countervailing pressures from distinct subnational communities.

Responding to these radically changed realities, national governments have exploited loopholes in the Constitution to create national policies where once Australians relied on their State governments. The Commonwealth now plays an extensive role in areas of State jurisdiction. The primary mechanism for this has been conditional grants, a mechanism built on the vastly superior financial resources the Commonwealth has been able to consolidate for itself and facilitated by the explicit grant of a directive spending power. In doing so it is responding both to citizen expectations and to the various pressures for national action coming from the international economy and the international community. Though not designed as one, Australia has become much more of an 'integrated' federation, where the central government plays an overarching policy-making role in many areas and the States wrestle with their service delivery responsibilities.

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International Lessons in Fiscal Federalism Design

Robin Boadway¹

Abstract

We review and evaluate alternative ways of designing federal-state fiscal relations with a view to achieving accountability, efficiency and fairness in the financing and delivery of public programs to citizens of different states. We draw on practices in other federations, particularly in decentralized ones such as Canada.

1. FEDERAL-STATE FISCAL ARRANGEMENTS: THEIR FORM AND PURPOSE

Federal-state fiscal arrangements can include a variety of elements. The *system of transfers* from the federal to state governments is an important one, and can consist of general unconditional transfers, bloc conditional transfers and specific-purpose transfers. The transfers can be unilaterally determined by the federal government or subject to federal-state agreement. They can be formula-based or can include discretionary elements. They can be enacted for a fixed term or can be indefinite. Two key features of federal-state grants that influence their role in achieving policy objectives are the extent to which they are equalizing among states and the extent to which conditions are imposed that are intended to influence state behaviour.

Related to federal-state transfers are *revenue-sharing arrangements*. In their simplest form, these specify what proportion of revenues collected by specified taxes are allocated to the states, and according to what formula. The absence of state discretion over tax rates on shared bases implies that shared revenues are essentially like unconditional transfers, albeit according to a particular allocation formula. Shared tax revenues may be regarded as own-source revenues and equalized to the extent that the equalization system includes revenue capacity as a determinant of transfers.

There might also be *bilateral agreements* between the federal government and individual states or groups of states that involve transfers of funds to achieve some agreed objective. For example, in Canada, bilateral agreements exist between the federal government and one or more provinces to fund provincial immigration activities and worker training programs.

Another important class of fiscal arrangements includes *harmonization agreements* negotiated between the federal and state governments. These can be tax harmonization agreements, when both levels use the same tax source and agree to use a common base and possibly a unified tax collection administration. They can also include the

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harmonization of spending programs or regulations, such as social insurance programs, environmental regulations or the regulation of product or labour markets.

The fiscal arrangements can also include *broad agreements* setting out principles that govern or constrain government policies. There might be an agreement to abide by internal economic union or common market behaviour to preclude policies that distort product and factor flows across state borders (e.g., the Agreement on Internal Trade in Canada), unless such behaviour is already restricted by constitutional provisions, as in the USA. A similar agreement might establish common principles for social policies (e.g., Social Union Framework Agreement in Canada). In principle, there could be agreements on the limits to deficit financing and debts accumulated, analogous to the Growth and Stability Pact in the European Union. For whatever reason, such agreements have typically not been used in federations. The tendency has been to rely on the cruder tool of balanced-budget legislation or constitutional provisions instead. Finally, institutions might exist that serve an advisory function on federal-state fiscal relations, such as the Commonwealth Grants Commission in Australia or comparable bodies elsewhere.

Federal-state fiscal arrangements serve various objectives. In the broadest sense, their purpose is to facilitate the decentralization of fiscal responsibilities to the states so as to take advantage of the benefits of decentralization, while at the same time ensuring that national objectives are satisfied. These national objectives, in addition to the standard provision of public goods and services at the federal level, include such far-reaching goals as the efficiency of the economic union, the appropriate extent of equity in the social union, and goals of social citizenship and national solidarity that reflect the national consensus. While these broader objectives may not be stated explicitly in the constitution, nonetheless, they are presumed in most nations to be the responsibility of the national government.

More specifically, the federal-state fiscal arrangements can be designed to allow the states as much freedom as possible to pursue their legitimate legislative objectives on behalf of their citizens in an accountable and responsible manner, while at the same time encouraging them to abide by shared national objectives. The key point is that some of the most significant programs that the states are called on to deliver — because they can do so most efficiently — are programs that necessarily have national equity and/or efficiency dimensions. These include important social programs like education, health, welfare transfers and social services. They also include state regulatory programs in areas like labour markets, capital markets, environment and communications. The federal government has a legitimate interest in the outcome of these programs to the extent that they affect national efficiency or national equity, insofar as they reflect the national consensus. While the states may have primary legislative authority in these areas, the federal government may be able to influence the design and delivery of them through the use of conditional transfers or negotiations. The key features are that the interests must be seen to be national by the citizenry, and the manner in which the federal government influences state decisions and priorities must be only as intrusive as necessary for the purpose. Therein lies one of the major challenges faced by federations.

One of the ways that national efficiency, equity and social citizenship objectives can be achieved with minimal disruption to state responsibilities is through policy harmonization. Federal-state tax systems can be harmonized while allowing varying

degrees of state discretion over rates and rate structures. This can best be achieved when states and the federal government both have access to the tax base in question, since then the federal government can coordinate harmonization among the states. The harmonization of transfers, including refundable tax credits, can also be achieved by federal-state agreement.

In practice, federal-state tax and transfer harmonization is implemented by a series of individual state-federal agreements (e.g., Canada and the USA). Harmonization of social policies is more difficult to the extent that states have legislative supremacy over social policy programs. Harmonization may be achieved by the federal government attaching broad conditions to the transfers it makes to the states in support of social programs. Indeed, encouraging states to abide by national standards in the design of their social programs is one of the main purposes of such transfers.

Another critical role of the federal-state transfer system is to equalize differences in fiscal capacity across states that arise from decentralization of revenue and expenditure responsibilities. The more decentralization there is, the greater the disparities there will be. There are two main dimensions to that. One arises from the fact that different states will inevitably have different ongoing fiscal capacities. In this case, the federal government can make equalization transfers so that all states are able to provide comparable levels of public services using comparable tax rates should they so choose. In the absence of equalization, fiscal inefficiency can arise as households and business have an incentive to locate in regions of greater fiscal capacity simply to take advantage of lower tax rates and/or higher public service levels. As well, fiscal inequity applies in the sense that otherwise comparable persons residing in different states are treated differently by their state governments. Note the critical point that equalizing for such inequities involves accepting the idea that citizens are entitled to roughly comparable fiscal treatment — subject to inevitable differences in the mix of public services and taxes that states choose given their fiscal capacities — regardless of their state of residence. This can be viewed as a dimension of social citizenship or solidarity for which varying degrees of consensus might exist. In some federations, the requirement that states have the ability to provide comparable levels of public services to their citizens is actually written into the national constitution (e.g., Canada, Germany, South Africa).

The second reason for equalization transfers is to provide a form of insurance to states when they are subject to temporary idiosyncratic shocks. The presumption is that the federal government is better able to provide such insurance than states themselves, given its superior ability to pool risks and its better access to capital markets. This stabilizing property of equalization is an important macroeconomic feature of federations that is missing in economic unions without a strong central government. In the latter cases, responses to shocks require more costly forms of adjustment, such as changes in wage rates or unemployment.

The need for transfers to address problems of differing fiscal capacities and idiosyncratic shocks, as well as to enable the federal government to have some influence over nationally important state policy decisions, entails that there should be a vertical fiscal gap: the federal government should raise more revenue than it need for its own spending programs so that it can make equalizing and conditional transfers to the states. In a well-functioning federation, the use of these transfers by the federal government will respect the legitimate responsibilities of the states. As well, it will

foster transparency and accountability at both levels of government. It will also forestall one level of government exploiting the other, especially by avoiding incentives that lead to either soft budget constraints exploitable by the states or situations in which the federal government can pass its fiscal problems on to the states in the event of a fiscal shock.²

There is no magic prescription for guaranteeing a well-functioning federation in which each level of government assumes the responsibility for pursuing its own responsibilities without impinging on the responsibilities of the other. A federation with a weak central government will be a federation in which national efficiency and equity are not achieved. If the federal government is too overpowering, it may seek to exercise too much influence over the states in ways that detract from responsible and accountable decision-making by the latter, and in the end foster dependency and state inefficiency. Striking the right compromise between decentralization and federal influence is the main challenge posed for federal-state fiscal arrangements.

2. WHY NOT SELF-SUFFICIENCY OF ALL LEVELS OF GOVERNMENT?

In principle, states could be made responsible for raising sufficient own-source revenues to cover all their needs without recourse to federal transfers. This would disentangle government budgets and promote accountability. This is virtually never done in federations. At the risk of some repetition, it is useful to pause to ask why this is the case. It will help to inform subsequent discussion of the design of federal-state fiscal arrangements.

There are a number of reasons why full self-sufficiency would be deleterious for achieving the objectives of a federation. First, self-sufficient states would have both different abilities to raise revenues and different needs for public services. Better-off states would have larger tax bases per capita and could raise greater revenues at comparable tax rates, or comparable revenues at more favourable tax rates, than less well-off states. States whose populations contain a higher proportion of groups that are heavier users of public services would need to raise greater revenue per capita to provide levels of services comparable to other states. In the absence of perfect mobility of persons, those residing in states with higher fiscal capacities and lower needs would benefit from better public services at lower tax prices. This would be a violation of fiscal equity or social citizenship whereby persons through their state governments could expect reasonably comparable fiscal treatment wherever they reside. It would also give an incentive for migration to higher-income regions to obtain the benefits of better fiscal treatment. Equalizing the capacity of different states to provide public services can be achieved without compromising the ability of states to choose their own mix of services and taxes to satisfy the local political consensus, but such a state of affairs requires equalizing fiscal transfers.

² Both of these have happened in the Canadian case. In the early 1990s, the federal government addressed its unsustainable debt and deficit crisis by fiscal austerity measures that disproportionately involved reduced transfers to the provinces. A vigorous debate ensued about vertical imbalance that has soured relations since. Conversely, the federal government struck bilateral deals with Newfoundland and Nova Scotia to allow them to receive revenues from offshore petroleum production without suffering equalization consequences. The rationale given was the high debt level of these provinces, inviting reference to soft budget constraints.

Second, fully decentralized state decision-making inevitably results in inefficiencies or distortions in the federal economy, even if the distortions are not intentional. State taxes on mobile factors of production cause them to be allocated inefficiently across states; beggar-thy-neighbour subsidies to attract investment play one state off against others; residence restrictions on the use of public services discourage mobility; state regulations distort the location decisions of firms; state procurement policies favour in-state over out-of-state firms; capital market regulations restrict the free flow of capital across the federation; and so on. The harmonization of fiscal and regulatory policies can in principle be achieved by agreement among states, and an internal free trade and investment agreement could avoid beggar-thy-neighbour policies. However, such agreements are difficult to consummate in the absence of a federal government that represents the nation as a whole.

Similar problems compromise redistributive objectives. Self-sufficient states would raise comparable levels of revenue as the federal government, and revenue sources would include those that are used for redistributive purposes. But, fiscal competition among states would encourage a race to the bottom in redistribution policies. The federal government could, in principle, compensate by making their tax-transfer systems sufficiently progressive. However, this would be difficult if their share of the tax room is highly constrained.³ More importantly, state public services are important components in the redistribution arsenal. To the extent that the national consensus calls for common levels of social protection in the programs the states deliver, the federal government has an interest in influencing state policies to meet minimum national standards. In the absence of federal-state transfers, a key policy instrument is not available for the federal government to meet this objective. Of course, this depends on there being a consensus for a high enough degree of social solidarity or social citizenship, and this can differ significantly across federations. Nonetheless, citizens in a federation are national citizens, and one presumes that actual citizenship brings with it some expectation of social citizenship at the national level.

Finally, self-sufficient states are less able to cope from a macroeconomic perspective than if their self-sufficiency were suitably restricted by a strong federal government. The latter can, through its transfers, provide implicit insurance to states against shocks. Federal-state transfers provide important shock absorbers to help states adjust when participation in a common national currency means they do not have access to macroeconomic policies like monetary and exchange rate policy. Moreover, national stabilization policy is more powerful than it would be in a fully decentralized federation, especially when state fiscal behaviour might be pro-cyclical.

3. WHY NOT A HIGHLY CENTRALIZED FEDERATION?

By the same token, the opposite extreme of a highly financially centralized federation, where states rely on federal transfers for the bulk of the revenues they need to finance their public spending, has serious disadvantages. With limited discretion over own revenue-raising, states are unable to control the size of their fiscal programs, thereby

³ The term *tax room* is commonly used to refer to the division of tax revenues from given tax bases between the federal government and the states when both have access to the base. This division is endogenous and depends jointly on the tax rates chosen by the two levels of government. Nonetheless, the higher the tax rates applied by one level of government, the more difficult it is for the other level to increase its rates. In some instances, the federal government can transfer tax room to the states by reducing its tax rate and inviting the states to increase theirs in response.

sacrificing one of the presumed aims of federalism. They are allegedly less accountable if they rely on funds from elsewhere to finance their spending: they are certainly not accountable to the federal taxpayers or the federal legislatures who provide the funds. If state revenue-raising power is very limited, they have limited accountability for even marginal spending decisions where arguably there is the possibility for determining the size of their budget. To the extent that they try to exercise discretion over marginal fiscal choices, they may over-rely on narrow sources of revenue thereby increasing the inefficiency of the tax system.

Highly financially dependent states are also more prone to soft budget constraint problems, especially if they have unexpected needs for spending. More generally, they are less able to self-insure against fiscal shocks that they inevitably face given the cyclical nature of some major state spending programs. This is exacerbated by the fact that borrowing is less effective if they must rely on future transfers to finance the loans.

Finally, excessive reliance on federal transfers predictably leads to excessive federal control over state spending priorities and programs. Federal legislators naturally seek to have some measure of accountability over the funds they disburse to the states, and this may take the form of intrusive interference with state choices. This defeats one of the main purposes of federalism, which is to allow state governments the discretion to provide the types and levels of public services most suited to their unique circumstances, albeit while abiding by national standards of efficiency and equity.

There are thus disadvantages both to federations that are too financially decentralized and to those that are too centralized. Some decentralization is beneficial for fostering accountability and for giving the states the discretion to match their fiscal structures to local needs and priorities. At the same time, too much decentralization compromises the efficiency and equity of the economic union. The key design question facing the fiscal arrangements in federations is how to achieve the correct balance. Indeed, as we have mentioned, one can view a role of federal-state fiscal arrangements as being to facilitate decentralized decision-making by the states, with all the advantages that brings, while at the same time enabling the federal government to counter the adverse effects of decentralization, which arise both from the fact that decentralization leads to horizontal fiscal capacity imbalances and to possible compromises of the rights and expectations of social protection that all citizens might anticipate wherever they reside. The role of the federal government is key in this regard, especially its judicious use of federal-state transfers, and the moral authority it has to broker pan-federation arrangements that harmonize state policies while leaving them with discretion to pursue legitimate state objectives.

The appropriate balance will be unique to each federation, since it depends on such things as the extent of heterogeneity of the population, the degree of consensus and social cohesion in the country as influenced by its history, and political institutions. Nonetheless, there are certain broad design features of fiscal relations that are shared among federations. The following section summarizes some of these.

4. A STYLIZED SUMMARY OF ACTUAL PRACTICES

There are some stylized features of federations that will inform our discussion. A key one is that state expenditure responsibilities share some common features. In addition

to being responsible for state and local public goods, states typically also provide important public services of a social nature, such as education, social services and health care. They may also be responsible for targeted transfers, such as welfare and disability payments. These social programs make up the bulk of state program spending, and constitute a main component of redistributive program spending in the federation. How state social programs are designed and delivered is of relevance to the nation as a whole to the extent that national norms of redistribution, social insurance and equality of opportunity apply.

State responsibility for public services of a social nature follows from basic subsidiarity arguments for decentralization: states can more efficiently deliver services to persons, can do so in more cost-effective ways, can better target to those in need, and can better innovate. Moreover, they are subject to the discipline of fiscal and yardstick competition from neighbouring states, which discourages waste. The federal contribution to redistribution through expenditures tends to focus on the transfer system, including transfers delivered through the income tax system, transfers that are relatively easy to administer on a large scale, like public pensions, and transfer programs for which risk-pooling is important, like unemployment insurance. Of course, not all federations have identical expenditure assignments. Some federations centralize welfare payments, while some decentralize unemployment insurance. Sometimes unemployment insurance and welfare are delivered as part of the same program, so federal provision applies. Nonetheless, in most federations, states have significant responsibility for social programs, while the federal government delivers transfers whose eligibility is not heavily reliant on individualized targeting. An important influence on federal-state fiscal arrangements is the coordination of redistributive programs delivered by the states and the federal government.

The share of expenditure responsibilities borne by the states tends to be relatively similar across federations (Watts 2008). Overall, state spending tends to be of comparable magnitude to that of the federal government. Where federations differ is in the extent to which states finance their spending through own revenues, and the breadth of tax sources to which they have access. In federations where states have significant revenue-raising authority, the states have access to broad-based taxes, such as income, sales or payroll taxes, typically sharing these tax bases with the federal government. Tax sources that are sometimes assigned more or less exclusively to the states include taxes on property and property transactions (property taxes, natural resource levies, stamp duties and land transfer taxes) and some excise taxes. Where broad-based taxes are jointly used by the federal government and the states, they may be harmonized and administered by a single national revenue agency.

Even those federations with the most decentralized revenue responsibilities maintain a sizeable vertical fiscal gap: the federal government raises more revenues than it requires for its own program spending, and transfers the excess to the states. In one sense, this vertical fiscal gap exists simply because the arguments for decentralizing expenditures are more compelling than for decentralizing revenue-raising responsibilities. Large-ticket items like social programs are state responsibilities because they can be more effectively delivered by the states. But, excessive decentralization of revenue-raising leads to inter-state distortions, administratively complex collection and compliance, and compromised equity outcomes.

Rather than being a residual between expenditure and taxation decisions, a vertical fiscal gap may be desirable in its own right, and its size may be a consequence of the explicit choice of federal-state transfers. These transfers serve three main purposes. The traditional role is as a device to encourage states to spend on programs that have spillover benefits to residents of other states, though this is a minor role in practice.

A second role is to equalize the fiscal capacities of states that have different abilities to raise revenues and different expenditure needs. This role becomes more pressing, and at the same time more difficult to fulfill, the more decentralized is the federation. In principle, equalization could be done at no cost to the federal government by financing the transfers to low-capacity states by taxes on high-capacity ones. However, such 'net equalization schemes' are rare since it is constitutionally difficult for the federal government to tax a state. Thus, equalization is typically financed by federal general revenues. It may provide funding only to those states that are below average fiscal capacities, as in the Canadian case, or it may achieve full equalization by providing funding to all states commensurate with their fiscal capacities, thereby replicating a net scheme, as in Australia. The latter is much more expensive to the federal government than the former, and therefore entails a larger vertical fiscal gap.

The third role of federal transfers is as a vehicle for the federal government to influence state program spending to encourage them to design their social programs to conform to minimum national standards and to harmonize them sufficiently so that persons who move between states continue to have access to such programs. Bloc grants with broad conditions attached can be used for this purpose. There may be instances where the federal government wants to encourage the states to institute some new social programs, as was the case in Canada when provinces were being induced into legislating public health insurance programs. In that case, the conditions need to be more explicit and the incentives in the financing stronger until the transformation is complete and the programs are established. Most federations have mixes of specific conditional grants, equalization transfers and conditional bloc grants in various combinations. A major exception is the USA, where equalization is absent.

State governments are also usually given significant discretion in macro-management of their budgets. The ability of states to borrow at their own discretion is common, although there may be self-imposed restrictions, such as balanced-budget legislation or constitutional provisions, as in the USA. There is no analogue of the Growth and Stability Pact of the European Union to constrain states from accumulating debt. It may seem odd that states have full discretion over fiscal policy, despite being part of a common currency arrangement and having no influence over monetary policy. The existence of a sizeable federal government that implicitly redistributes among states both through its tax-transfer policies and federal-state transfers implies that states are not left entirely to their own devices in responding to shocks. Nonetheless, the decentralized nature of federations means that countercyclical fiscal policy, to the extent that it is thought of as a policy option, is more difficult to implement.

Suppose we take as given the assignment of expenditure responsibilities of the federal and state levels of government. Their exact details will vary from federation to federation in ways that are relatively inconsequential for our purposes.⁴ We simply

⁴ For example, in addition to the specific types of expenditure programs that each level alone can enact, some expenditure categories might be permissible for both levels of government, in which case one

assume that aggregate state expenditure responsibilities are of the same order of magnitude as federal ones. Our concern is then with how to finance those expenditure responsibilities. There are two options, and the next two sections consider them in detail. The first is for the states to raise their own revenues, and the other is to rely on federal transfers. The next two sections focus on some of the details of these two methods, both of which will be used in varying degrees in practice. We later discuss the appropriate mix of own finance and transfers.

5. STATE REVENUE-RAISING

If the states are expected to self-finance a reasonable proportion of their spending, which is the norm in most federations, they need access to at least some broad-based tax revenues, such as those from income, payroll or sales taxation. We can distinguish three alternative ways for states to obtain significant levels of own revenues: revenue-sharing, decentralized access to one or more broad tax bases, and harmonized access. Consider each in turn.

5.1 Revenue-Sharing

Revenue-sharing involves states being assigned a share of revenues raised by the federal government from some source. It involves both an overall share of tax base revenues being assigned to the states, and an allocation of the revenues among states. The latter may be according to the principle of derivation, or the revenues can be allocated according to equalization principles. To the extent that an equalization system exists alongside revenue-sharing, it matters little whether the revenues are equalized before being turned over to the states or subject to equalization afterwards. In principle, any tax base can be used, and the system is administratively easy to implement. Revenue-sharing maintains a fully harmonized tax system, and avoids fiscal externalities between state and federal governments. As well, it provides a relatively certain flow of funds to states.

However, revenue-sharing has serious drawbacks. It affords no discretion to states to choose their own tax rates and tax mixes. It makes the states dependent on the federal government for much of their funding, and may induce the federal government to exert leverage, implicit or explicit, on state program spending. It may also lead to adverse incentives by the federal government in administering the shared tax to the extent that the revenue share of the states is high relative to the federal government. As such, revenue-sharing is perhaps better thought of as an alternative to discretionary transfers rather than as a means of revenue assignment. Countries that rely on revenue-sharing typically have relatively highly centralized revenue systems (Australia, Germany). A form of revenue-sharing has been used in Canada to share VAT revenues with certain provinces as discussed below, although in recent years participating provinces have been allowed some discretion in setting their own VAT tax rates. The discretion is limited, though, and the system is more like access to a harmonized tax base considered below.

level might be paramount. One level may be able to delegate some expenditure functions to the other. Some expenditure categories may not be explicitly assigned, in which case the level of government with the residual power assumes responsibility. The federal government may have the power to disallow state legislation, for example, if it is deemed to violate the free movement of products and factors across state boundaries. The federal government may also be able to mandate some state expenditure programs.

Revenue-sharing can be particularly constraining if shared revenues make up a substantial portion of state revenues. The states must then typically rely excessively on narrow forms of tax to vary their desired revenues, and this can lead to distorting taxation.

5.2 State Access to Decentralized Taxes

States are typically allowed discretionary access to certain tax bases, either exclusively or in co-occupation with the federal government. They may choose to harmonize their taxes among themselves or with the federal government, the consequences of which we discuss in the next subsection. Taxes assigned to the states vary across federations. They include both broad taxes capable of generating substantial revenues and taxes on narrow transactions. They may also include taxes that fulfill a redistribution role, as well as taxes on relatively immobile tax bases.

The fiscal federalism literature provides some guidance on the ideals of tax assignment, though there is far from consensus about the optimal assignment in practice. Roughly speaking, taxes regarded as most suited for states include those on immobile bases, those that are primarily revenue-raisers rather than instruments for redistribution, and those that more closely reflect benefit taxation. Indeed, an influential line of argument, inspired by the classic Tiebout model⁵ is that benefit taxation is the ideal benchmark for state taxation.⁶ However, given the amount of own revenues that states must raise in many federations, the need is for broad-based revenue sources that almost certainly have redistributive consequences. Moreover, given that a high proportion of state spending is on public services of a redistributive nature, implementing benefit taxation financing would be counterproductive.

There are a large number of potential tax bases states could deploy. A brief summary of them follows.

Property Tax

States and their municipalities are typically assigned responsibility for property taxes. This has often evolved from systems where municipalities are fully responsible, to harmonized systems where common bases are applied within states (e.g., market value assessment in Canada), and property evaluation and collection are done by a provincial agency, while municipalities are allowed to choose their own rates. Given the immobility of real property and the tendency to view property taxes at least partly as benefit taxes, this is reasonable. Local governments typically rely on a mix of own property tax revenues, user fees and transfers from state governments. Over-reliance on property taxes, which may be a result of states restricting local transfers as a way of addressing their own fiscal problems, can lead to inefficiencies, especially where they include business properties (as in Canada).

Payroll Tax

⁵ Tiebout (1956) developed a model in which local communities competed for mobile individuals by offering different mixes of local public goods and personal taxation. Individuals chose their community of residence based on their most preferred tax-spending mix. Tiebout argued that in equilibrium, taxes would reflect benefits, and individuals would allocate efficiently among communities.

⁶ McLure (2001) has argued forcefully for state benefit taxation.

States also often have access to payroll taxes, typically earmarked for social insurance programs. In fact, payroll taxes satisfy many of the ideal properties of decentralized taxes. They are relatively immune to tax competition, are easy to administer, and have some potential for progressivity, especially when combined with refundable tax credits. From a fiscal federalism perspective, payroll or even progressive earnings taxes seem to be an ideal state revenue source, especially if they are harmonized. For whatever reason, non-earmarked payroll taxes have not been as prominent as state revenue sources as might be desired. This may be due to the largely erroneous presumption that payroll taxes are taxes on jobs, a presumption that might be perpetuated by the fact that they are often levied on employers as well as employees. An earnings tax imposed as a direct tax on individuals might dispel that notion.

Excise Taxes

States typically can deploy narrow taxes of various types, often along with the federal government. These can include taxes on alcohol and tobacco products (sin taxes), taxes on petroleum products, and taxes on property transactions (stamp duties). They can also include licences for motor vehicles and driving permits. While these are suitable taxes for states, they are not large revenue-raisers so are inadequate as sources of own revenues to finance the large spending programs of states. They are not satisfactory to meet objectives of fiscal responsibility and accountability. To the extent that states are forced to over-rely on them for revenue-raising, their use leads to excessive excise tax rates and inefficient tax systems. In fact, from a public economics perspective, differential tax rates on particular goods and services are mainly advocated as devices for correcting market failures or serving as pseudo-benefit prices rather than as revenue-raisers. For revenue-raising purposes, the consensus is that a broad-based sales tax with minimal exemptions is preferable both from the point of administrative simplicity and optimal taxation.⁷

Income Tax

In some federations, states have relatively unfettered access to personal and corporate income taxes alongside the federal government (Canada, USA). If such taxes are not harmonized, they give rise to differences in tax bases and rate structures across states, as well as compliance costs since taxpayers must deal with more than one tax authority. This is especially a problem for business income taxes, given the potential for tax competition and beggar-thy-neighbour state policies. In the case of personal income taxes, state rate structures tend to be less progressive than federal rate structures, judging by the experience in Canada and the USA. When both state and federal governments occupy the income tax, the division of tax room and therefore the vertical fiscal gap are important. The more tax room the federal government occupies, the more able it is to pursue its redistributive objectives. As well, the less states rely on own tax revenues, the lower is the demand on the equalization system, and the more likely it is that the federal government can facilitate tax harmonization, which is a bottom-up process, discussed further below. Modern tax reform initiatives, such as the schedular or dual tax system, lend themselves to federations. The earnings part of the tax can be co-occupied, while the capital income part as well as the corporate tax

⁷ The recent Mirrlees Review in the UK (Mirrlees et al 2011) argues forcefully for a fully uniform sales tax system alongside a progressive income tax system as the fairest and most efficient tax system.

could remain centralized. Integration is less important, so the ability to divide the taxes between the federal and state levels is easier.

Sales Tax

Sales taxation might be thought to be potentially ideal for the states, given the immobility of the base (except for cross-border shopping), the potential for relatively large sums of revenue, and the fact that sales taxation is not relied on for redistribution. However, administration problems are legion in the absence of harmonization. The sales tax of choice is the VAT, since it avoids taxing business inputs and treats local and non-local firms on a par. But, there are particular problems with administering decentralized state VATs when there are no border controls. Collection and compliance are costly both for firms and for revenue authorities, especially when there are different state tax rates and exempted or zero-rated products. Not only must firms deal with separate tax authorities and keep track of taxes and credits applying with each, but the absence of border controls opens up opportunities for fraudulent behaviour that can undermine the integrity of the tax. Fortunately, as discussed below, these problems can be largely mitigated by a system of VAT harmonization between the federal government and states with a single tax-collecting agency that has full access to taxpayer information as necessary, even if states adopt different VAT rates and exemption. Otherwise, decentralized access to the VAT is not a practical option in the absence of harmonization.⁸

Wealth and Wealth Transfer Taxes

States may also levy wealth taxes on firms in their jurisdictions. As the Canadian experience indicates, this is tempting since previously accumulated wealth is like a fixed tax base that should not respond to being taxed punitively (the so-called hold-up problem). However, from a longer-run perspective, taxes on wealth discourage capital formation. Similarly, wealth transfer taxes, including inheritance or bequest taxes, could be used by the states. However, given that their role is redistributive and that wealthy persons are relatively mobile among states, it is not a suitable tax for state use. We mention it mainly to highlight the experience in Canada with decentralizing the inheritance tax from the federal government to the provinces in the 1970s. The almost immediate consequence was that the provinces all abolished inheritance taxation, a telling testimony to the power of tax competition when the tax base is mobile.

Natural Resource Taxation

A final significant problem concerns natural resource revenues. In some federations, states have access to natural resource revenue-raising (Australia, Canada, USA), in some cases exclusively. From a tax assignment perspective, state access to natural resource revenues makes sense because of the immobility of natural resources and so their resistance to tax competition, and the fact that their management and development can best be done locally. At the same time, there are significant problems

⁸ There have been mechanisms suggested for addressing the problems of decentralized VATs in situations where there are no border controls, such as the EU. These are summarized in Crawford, Keen and Smith (2010). However, even these require some central tax authority, and may also require agreement on the allocation of tax revenues among states.

to resource revenue decentralization owing to the fact that natural resources are typically very unequally distributed among states. This gives rise to two serious concerns. First, the horizontal imbalance resulting from the unequal pattern of state resource endowments leads to the potential for fiscal inequity and fiscal inefficiency unless equalization transfers are able to offset it. Undoing the horizontal resource imbalance is costly and strains the viability of the equalization system. It also effectively undoes the property rights of the states over the natural resources in their jurisdictions that lead to the states' right to tax them in the first place. This stress between state ownership of natural resources and the constitutional obligation of the federal government to equalize state fiscal capacities has led to enormous amounts of unresolved tension in the Canadian case. Second, decentralization of natural resource revenues exacerbates the so-called resource curse. State governments seem unable to resist using them for current spending rather than saving them in a resource fund whose capital income is spent, as in the case of Norway. Moreover, the state spending is likely partly devoted to infrastructure spending designed to build state industries, and to attract factors of production from other states. There is no apparent reason why non-resource development should be induced to locate in resource-rich states. These problems can be at least partially avoided if the lion's share of natural resources revenues accrues to the federal government.

5.3 Harmonized Tax Base Sharing

Many of these problems with state taxation can be overcome, while at the same time affording the states considerable revenue-raising discretion, by allowing both states and the federal government to have independent access to a common broad tax base with a single tax administration. There are various ways in which this can be done, varying in the amount of discretion given to the states. A critical condition required for the success of harmonized federal-state tax systems is cooperation between the two levels of government. State and federal participation are voluntary, so the terms of participation must be agreeable to both. In the case of the states, this means that they must be satisfied both with the definition of the tax base and their permissible deviation from it, with the discretion they have to set their own rates, and with the tax room that the federal government makes available to the states so that both sides can enjoy ready access to the common base. Indeed, the creation of tax room for the states by the federal government is often a necessary first step to implementing a harmonized tax system. The possibility of a single tax authority should be attractive to both levels from an administrative simplicity point of view. Even if the federal government bears the collection and compliance costs, it is willing to do that in return for ensuring that an efficient and fair tax system is in place nationwide that still respects state independence.

Harmonized tax systems can be deployed for both direct and indirect taxes, though their characteristics differ. Different considerations arise for personal and corporation income taxes and for general sales taxes. Let us consider them in turn.

Personal Income Tax Harmonization

The personal tax lends itself to various gradations of federal-state harmonization depending on the amount of discretion that it is desirable to give the states, or that they

demand as a price for participation.⁹ The states could, in fact, voluntarily and unilaterally harmonize their income tax bases with that of the federal government simply to economize on administrative costs. This is largely done in the Canadian province of Quebec, where maintaining an independent tax authority is highly valued. However, in the absence of a single tax authority, important collection and compliance benefits are not achieved since taxpayers must report to two separate agencies.

The form of income tax harmonization that leaves least discretion to the states is a state surtax on federal tax liabilities. This is simple to administer by a national tax agency, it assures a common base and also maintains the progressivity of the federal rate structure. The only discretion the states have is over their rate, so limited accountability is achieved. States are vulnerable to changes in their tax revenues when the federal government changes its rates, and to that extent accountability and predictability of tax revenues are compromised. This system was used by nine out of ten Canadian provinces until the early 1990s, and was replaced in response to provincial dissatisfaction with the limited discretion they were afforded.

A less restrictive method is to allow the states to impose a surtax on the federal income tax base. This maintains a fully harmonized base, and avoids the states being vulnerable to federal tax rate changes. However, it leaves the states no discretion over their rate structure, and in fact implies a proportional state tax.¹⁰ The overall progressivity of the income tax can be compromised unless the federal government changes its rate structure.

More state tax policy discretion can be achieved by allowing the states to impose their own rate structure on the federal base. The rate structure can be taken to include not just the defined tax brackets and rates but also the system of tax credits — refundable or otherwise. This allows the states to impose their own preferences for progressivity. The overall level of progressivity nationwide is affected, depending on the shares of tax room occupied by the federal and state governments. This is the system now in effect in Canada. The provinces agree to abide by the federal base, and can choose different rate structures and state-specific values of the credits used by the federal government within limits. In practice, the provinces have chosen less progressive rate structures than the federal government, typically by having fewer tax brackets. One province has even opted for a flat tax. This may not be surprising from a fiscal competition perspective, but it does imply that decentralizing income tax room to the provinces reduces the overall progressivity of the income tax, especially when the tax system as a whole (including the broad-based sales tax) is taken into account.

More generally, the ability to initiate and maintain tax harmonization probably requires that the federal government occupy a significant share of the relevant tax room compared with the states. The Canadian experience indicates that harmonization becomes more fragile the larger the tax room the provinces occupy.

Two other elements of personal income tax harmonization are relevant. One is that both federal and state taxes can be administered by a single tax authority, which

⁹ Similar principles apply to earnings or payroll taxes, so these need not be considered separately.

¹⁰ This is the method recently adopted in the UK to devolve some income tax responsibility to Scotland. It was implemented by the UK government reducing its tax rate to Scottish taxpayers, creating enough room for the Scottish Parliament to choose its own tax rate.

reduces administrative costs for the government and the taxpayers alike. In Canada, there is the quasi-independent institution, the Canada Revenue Agency (CRA), that administers, interprets and enforces the personal income tax for the federal government and all provinces except Quebec. It reports jointly to the federal finance minister as well as to a Board of Management consisting of federal and provincial nominees. The CRA also administers the harmonized corporation income tax and sales tax as well as other federal taxes. Ease of compliance is particularly important in Canada because virtually all citizens file tax returns. This is required for all those liable to pay taxes, but it is also necessary to be eligible for a series of refundable tax credits, which are income-tested.

The second element of any tax harmonization system is an allocation formula. When taxpayers earn income in more than one state, a method must be found for attributing income across states. There is no perfect way of doing that, so typically some arbitrary method is chosen. For example, in Canada, a taxpayer's province of residence is deemed to be where he or she resided on December 31 of the tax year. In addition to being arbitrary, this could invite taxpayer avoidance choices if tax rates across provinces vary significantly. Fortunately, the equalization system (discussed below) ensures that provincial tax rates do not diverge widely, so this has not been perceived as being a problem.

Corporation Income Tax Harmonization

In some federations (e.g., Canada, USA), states have access to corporation as well as personal income taxes. This is perhaps not surprising, given that corporate and personal income taxation are both enacted by an income tax law that defines tax bases the same for all businesses, incorporated or not. On the other hand, given the mobility of capital, the case for state taxation of corporation income is weak on fiscal federalism grounds. Nonetheless, where state corporation taxes exist, similar tax harmonization arrangements can apply as with personal taxation. States can be encouraged to adopt the same tax base as the federal government both to reduce administration costs as well as to avoid distortions in the allocation of business activity across states. State corporate taxes can then be applied to the common base (as in Canada), and they may even be able to apply different tax rates to different types of firms (e.g., small versus large). In the Canadian case, provinces also have the ability to enact province-specific corporate tax credits provided they do not discriminate against firms of other provinces and do not distort the flow of products and factors across provincial borders.

The advantages of a single tax authority apply here as well, especially so since many firms will operate in more than one state. As well, an allocation formula is required to assign corporate taxable income among states. Ideally one wants to design the formula to discourage profit-shifting across borders, such as by concentrating borrowing in high-tax states to take advantage of interest deductibility or by engaging in transfer pricing of intra-firm transactions. In Canada, half of profits are allocated according to the shares of payrolls in each province and the other half by gross revenues. In the USA, some states include a third factor, the state share of capital, though the convention is not uniform across states. Indeed, some states tax firms on the basis of their world profits, a practice that lends itself to double taxation. Allocation is further enhanced if corporate accounting for tax purposes is consolidated rather than being separated by branches of the firm operating in different states.

The exact allocation of profits among states will likely not accurately reflect the source of income. However, this will be of little concern to the states in federations in which corporate income tax is equalized using a representative tax approach. As discussed below, differences in corporate tax base across Canadian provinces are equalized at the national average provincial corporate tax rate, but this only applies for provinces with tax capacities below the average. For them, any shortfalls of allocated corporate income from its true value will be fully equalized unless the province's tax rate differs from the average. This also applies to allocations of the personal tax base, as well as of harmonized sales taxes, to which we now turn.

Sales Tax Harmonization

General sales taxes, like payroll taxes, would seem to be excellent candidates for decentralization to the states. The sales tax base is broad and the only apparent source of fiscal competition is cross-border shopping, which would be a minor concern in large federations. However, there are significant administrative challenges that apply if states adopt VATs for sales taxation. There are strong economic reasons for the VAT as the sales tax of choice, especially their ability to avoid taxing producer inputs, and to treat domestic products on a par with imported products by taxing imports and zero-rating exports. The problem, as discussed above, is that in a federation without state border controls, the taxing of imports and zero-rating of exports gives rise to serious problems in the absence of carefully designed harmonization measures.

Decentralized VATs in situations without border controls have been deployed both in some federations (e.g., Brazil, Canada and India) as well as in economic unions (e.g., European Union, EU). In practice, two main approaches to harmonization have been used, both of which are present in the Canadian case. In one approach — exemplified by Quebec — an attempt is made to mimic a destination-based VAT within a state. Exports from the state are zero-rated, so exporters collect no tax on their sales and receive full credit for taxes paid on their inputs. Imports into the state are treated on a deferred basis: no tax is levied at the border, and a tax is applied when the imported product is first sold domestically. While this delays the collection of VAT for one stage, in most cases this is of little consequence since this is made up when full tax is levied at the next stage. Deferral simplifies compliance and collection since it avoids the need for the state tax authority in the importing state to collect taxes on sales made by non-state firms to those within the state. This is a practical necessity in the absence of border controls since the exporting firm is not under the jurisdiction of the importing state tax authority.

This system has some practical problems as a method of decentralizing VATs, even if all states agree to a common base. Firms operating in more than one state must deal with more than one tax authority and keep track of both tax payments and tax credits accruing to each state in which they operate. This is further complicated if there is a federal VAT alongside those of the states, with a federal tax authority. In the Quebec case, there is a unique bilateral agreement according to which the Quebec tax authority collects not only the Quebec VAT (called the Quebec Sales Tax, QST), but also the federal Goods and Services Tax (GST). Also, the deferral of taxation of imports implies a break in the VAT chain at the border. It is known from EU experience that this opens the possibility of tax fraud. Firms exporting from one state to another obtain a refund of their input taxes and, through unreported transactions, can avoid paying

tax on subsequent sales.¹¹ There is little evidence on the importance of this problem in the Canadian context, but the possibility can be avoided by the next method of harmonization.

The second method of harmonization avoids the break in the VAT chain at state borders and minimizes administrative costs by using a single tax-collecting authority for all state and federal VATs, while sacrificing the true destination approach within the federation. The Canadian Harmonized Sales Tax (HST) illustrates the beneficial properties of this approach as well as its prerequisites. The HST has been adopted by five of the ten provinces. It consists of a federal GST component of 5 percent and a provincial component that varies from 7 to 10 percent. The participating provinces have been allowed to exempt certain necessity products that are not exempt under the GST (e.g., children's clothing and footwear, and diapers), but otherwise the bases are harmonized. The CRA acts as tax agency for the HST as well as for the GST in non-participating provinces. All firms with annual revenues in excess of \$30,000, excluding those operating only in Quebec, must register with the CRA. They collect taxes on their sales anywhere in Canada and pay the relevant rate in the province of sale. They claim an input credit on purchases from other registered firms. Each tax period, they self-report their total tax collections and total input tax credits without attributing either to particular provinces. This is enforced by the quasi-independent CRA, which can perform audits and impose penalties, and which files a report every five years on the operation of the system. The tax revenues collected by the CRA are then allocated to the provinces according to a formula that is meant to reflect spending on taxable consumption in each province and provincial tax rates, and is based on data provided by Statistics Canada.

The HST system shows that it is possible to implement a VAT in a multi-jurisdiction setting in a way that is administratively efficient. States are able to choose their own tax rates with discretion, and to have state-specific refundable tax credits and exemptions. As long as there is a single tax agency, the VAT can be applied seamlessly on cross-border transactions. One seemingly unattractive feature of the HST is that taxes are not applied strictly on a destination basis by province. Instead, total tax collections must be allocated among provinces according to estimates that may be inaccurate. However, as long as state sales tax revenues are equalized — as they are in the Canadian case — this is a relatively benign problem. Any shortfalls of revenues allocated to a province will be roughly compensated through equalization provided the province is equalization-receiving and has a provincial VAT rate that is not too different from the national average provincial tax rate.

In summary, significant tax revenues can be made available to the states in ways that give them some discretion in tax policy while at the same time maintaining an efficient and equitable harmonized system. The introduction and sustainability of such a system is very much facilitated by a federal presence in the relevant tax base. In fact, the most likely way of introducing such a system is from an initial situation in which the federal government is the main occupant of a tax. The states can be encouraged to participate in a harmonized system by the federal government turning over of tax points the states by unilaterally reducing its tax rate and inviting the states to increase

¹¹ See Crawford, Keen and Smith (2010) for a discussion of such fraud, referred to as missing-trader schemes.

theirs. In return, the states would be asked to agree to abide by a single tax authority and the federal tax base.

6. FEDERAL-STATE TRANSFERS

Federal-state transfers are a feature of all federations, and their design is intimately related to the extent of decentralization of revenue-raising. The greater the share of tax room occupied by the states, the greater will be interstate fiscal disparities and the exposure of state to fiscal shocks. The need for equalizing transfers will be greater, but the federal government will be harder pressed to finance such transfers. As well, greater state revenue-raising autonomy will make it more difficult for the federal government to induce tax harmonization among states and provide incentives for state fiscal programs to respect national objectives. In light of this, some amount of vertical fiscal gap is desirable, although it would be folly to attempt to specify exactly what that amount should be. The federal government is instrumental in determining the extent of the fiscal gap, or equivalently the extent of decentralization, since it takes the initiative in deciding how much tax room to occupy and what level of transfers to make to the states.

There is an important relationship between federal-state sharing of tax room and the level of fiscal transfers. Given the notional division of expenditure requirements between the two levels of government, each level will require a given level of finance: the states from own revenues and transfers, and the federal government from own revenues less transfers to the states. If the federal government occupies too much of the overall tax room relative to its own needs and the amounts it transfers to the states, there is said to be a vertical imbalance.¹² This can happen, for example, when the federal government takes unilateral action to deal with a debt problem. The potential for such problems to arise, which can lead to a deterioration of federal-state relations, reflects the interdependency of federal and state fiscal stances and emphasizes the need for cooperative decision-making. This is outside the realm of economic expertise, like much of the fiscal arrangements.

We mentioned earlier the fundamental roles played by federal-state transfers. They equalize persistent differences in fiscal capacity across states. They provide a form of insurance against temporary fiscal shocks, both national and regional. They provide an instrument by which the federal government can induce transformational change in state programs. They can be used to encourage states to maintain some broad national efficiency and equity standards in their major public services. And, they serve to close the fiscal gap. The two main instruments used for these purposes are unconditional and conditional transfers. While, in principle, they could be aggregated into a single mega-transfer designed to serve all purposes, it is useful to discuss the two separately. We follow the Canadian convention whereby unconditional transfers are delivered through the equalization system while conditional transfers consist mainly of bloc transfers. The distinction is somewhat artificial because bloc conditional transfers are implicitly equalizing, but the principles should be transparent.

¹² This situation was alleged by the provinces to be the case in Canada in the wake of federal deficit reduction measures in the mid-1990s. It led to an outcry from the provinces, reflected in two major reports from the Séguin Commission in Quebec (Commission on Fiscal Imbalance 2002) and the Council of the Federation (Advisory Panel on Fiscal Imbalance 2006), and more than a decade of poor relations between the two levels of government. The concept of fiscal imbalance is discussed in Boadway (2005).

6.1 Equalization

Most modern federations (apart from the USA) have explicit equalization systems, whereby transfers to states are related to states' fiscal capacities, and other transfers such as bloc transfers and revenue-sharing are implicitly equalizing. There is a substantial literature on equalization that emphasizes both the social value judgments required to validate equalization and the technical difficulties involved in implementing those judgments.¹³ A stark way to see the difficulties is to imagine as a benchmark the unitary nation. In such a nation, a common tax structure is applied to all citizens, and common public services are provided. Even in such a setting, difficulties arise. It will be more costly to provide public services in some geographical areas, so in practice there is a compromise between equitable provision and costs. Nonetheless, persons living in comparable geographic settings should expect comparable access to public services. On the tax side, local costs of living or amenities may differ by region and these are reflected in wage rates. Ideally, such differences ought to be taken into consideration in the income tax system, but this is difficult to do, so a tax system based on actual wages is the norm.¹⁴ Roughly speaking, comparable citizens are treated comparably by the fiscal system of the unitary nation and in that sense horizontal equity applies.

Once the imaginary unitary nation becomes a federation with independent state legislatures, the unitary norm is violated for our purposes in two main ways. First, different states will choose different tax and expenditure programs. It is a perfectly legitimate consequence of federalism that states exercising their discretion will deviate from unitary nation policies. It should not cause alarm as long as the policies do not unduly violate national efficiency and equity norms. To preclude the latter, policies such as those considered in the next sub-section can be considered.

Second, different states will have different capacities for providing public services at comparable tax rates so could not achieve the unitary nation allocation even if they wanted to. States may differ in their average income levels, in their needs for public services, in the costs of providing them, and in their access to natural resource revenues and other source-based taxes. In these circumstances, there will be incentives for residents to move to states where fiscal capacities are higher, so-called fiscally induced migration. More important, otherwise comparable persons will be treated preferentially in states with higher fiscal capacities: there will be fiscal inequity. The key question is whether and to what extent equalization transfers should be directed at removing such fiscal inequities, so that different states have the potential for providing comparable levels of public services at comparable tax rates whether they choose to or not. The answer to this involves a value judgment: should citizens be entitled to potentially comparable fiscal treatment regardless of their state of residence? An affirmative answer implies a dedication to social citizenship or social solidarity at the national level regardless of the heterogeneity of states. Many federations are prepared to make that judgment, including Australia, Canada and Germany, and this is reflected in their equalization systems, and in the latter two in their constitutions. However, this

¹³ See, for example, Boadway and Shah (2009) for a full discussion on the principles and practice of equalization.

¹⁴ Albouy (2009) analyzes the consequences for the USA of the failure of the income tax system to take account of the fact that regional wage differentials in part reflect local amenities.

requires some national consensus, and this could be strained the more decentralized the federation.

Suppose that we accept this notion of social citizenship and try to design an equalization system that, to borrow the wording from the Canadian constitution, enables all states ‘to provide reasonably comparable levels of public services at reasonably comparable tax rates’. There is no perfect system, but some principles can be outlined. It is useful to distinguish the equalization of revenue capacity from the equalization of expenditure needs and costs. In both cases, a suitable approach for equalizing the capacity to provide comparable public services at comparable tax rates is to define representative fiscal capacities, that is, the ability to provide a standard bundle of public services by applying standard tax rates to standard tax bases. The standards reflect a representation of the public services that a typical state provides using typical tax bases and tax rates.

Revenue Equalization

Canada applies a *representative tax system* (RTS) approach to equalizing revenue capacities of provinces. Tax bases for inclusion in the formula are first defined. Currently there are five (personal income, corporation income, sales, property and natural resources), having recently been reduced from over 30 to simplify the system.¹⁵ For all except natural resources, a standard tax base is defined, and the size of the tax bases in each province estimated.¹⁶ Then, the national average provincial tax rate for each base is calculated by dividing total provincial tax revenues by the sum of provincial tax bases. A province’s per capita equalization entitlement for base j is calculated as $e_j^i = t_j(b_j - b_j^i)$, where t_j is the national average provincial tax rate for this base, b_j is the national average per capita tax base and b_j^i is the per capita tax base in province i . This calculation is done for all tax bases other than natural resources. For the latter, because of the heterogeneity of resource tax bases, equalization is based on actual per capita revenues relative to the national average, and only 50 percent of revenues are included. Total per capita entitlements for a province are then given by $\sum_j e_j^i$, where all five bases are included in the summation.

Finally, for all provinces whose per capita entitlements are positive — the so-called have-not provinces — the federal government makes per capita equalization payments equal to per capita entitlements, while other provinces receive nothing.¹⁷ This effectively brings the tax capacity of the have-not provinces up to the national average.

A number of features of this RTS approach are worth noting. It equalizes only revenue capacity, so effectively assumes that per capita expenditure needs are identical across provinces. It equalizes have-not provinces up, but high-capacity provinces retain

¹⁵ This simplification was recommended by the Expert Panel on Equalization and Territorial Formula Financing (2006), which the federal government had commissioned to rationalize the equalization system.

¹⁶ Actually, for the personal tax, each tax bracket is treated as a separate base since each has different tax rates.

¹⁷ There are some nuances. Equalization entitlements are based on a three-year moving average, and the growth of aggregate equalization is constrained not to exceed annual GNP growth.

higher than average abilities to raise revenues, implying that fiscal equity is not satisfied. In the Canadian case, where horizontal imbalances are marked, this is a significant concern. This concern is exacerbated by the fact that only half of natural resource disparities are equalized. There are three purported reasons for special treatment. One is to respect the provincial ownership of natural resources. A second is affordability. Natural resources are the largest source of provincial disparities, and the federal government has limited access to revenues from natural resources to finance equalization. Their access is limited to income and sales taxes obtained from the resource sector. The third is that, given the extent to which the provinces can influence resource development, full equalization would impose a significant disincentive to such development. In principle, the problem of incentives should affect all equalized tax bases. Since the amount of a province's equalization depends on the size of its tax bases, to the extent that the latter is influenced by provincial fiscal decisions, there would be a disincentive to take measures that increase the tax base, such as reducing tax rates. In practice, this problem is particularly apparent in natural resources, given the direct control that provinces have.¹⁸

The RTS approach is formula-driven, including both the aggregate amount and the division among provinces. Occasionally the government has departed from this principle, either by arbitrarily reducing aggregate equalization payments in times of fiscal constraint, or by offering special discretionary treatment to particular provinces to deal with some contingencies. In either case, the predictability and transparency of the system is compromised, and in the case of special treatment the potential for provinces to exploit the federal government's inability to commit to a formula-based approach introduces the possibility of adverse incentives for provincial behaviour. More generally, governance issues have surfaced from time to time. Equalization is based on federal legislation and is renewed in five-year intervals. Because it involves spending, it is formulated as part of the annual budget process and is therefore subject to budget secrecy. This reduces the predictability and transparency of the program, and from time to time leads to abrupt changes that affect the provinces' finances. Concern has been expressed about this lack of transparency and the short-sightedness of the process, and proposals have been floated for a more open process, such as the establishment of an arms-length advisory body analogous to the Australian Grants Commission. But these have not been acted on, and policy remains firmly within the federal Department of Finance.

As a final comment, the RTS system becomes more complex and requires more administrative judgment the more diverse are state tax systems. It relies on the definition of representative tax bases, and this becomes more and more arbitrary as states choose different tax bases and rate structures. Moreover, when a representative tax base is formulated, its size then has to be estimated for each state. This is made much easier if the states have harmonized their tax bases. Absence of harmonization has been one of the difficulties faced in Canada in equalizing natural resource revenues. In highly decentralized federations, harmonization is more difficult to achieve and at the same time the need for equalization is greater. Alternatives to the RTS approach have been proposed, such as so-called macro-systems under which

¹⁸ In principle, provinces also have an influence on the national average tax rate. This is only a concern where a province has a significant share of particular tax bases. In earlier years, when natural resource equalization was disaggregated by type of resource, this was a problem for selected resources (e.g. potash in Saskatchewan). Concessionary treatment existed to mitigate this problem.

equalization is based on some broad measure of revenue capacity such as per capita gross state product or disposable income.¹⁹ Such approaches represent very imperfect measures of revenue-raising capacity, and they invite thinking about equalization as a means of equalizing disparities in state incomes rather than disparities in the ability to provide public services.

Expenditure Equalization

Expenditure capacities can be equalized along with revenue capacities using a representative expenditures approach, but the procedure is inherently more complicated. For one thing, public services are very heterogeneous in make-up and quality, which complicates the definition of comparable levels of public services. This problem can be mitigated by concentrating on the main state expenditure categories, education, health and welfare, where the bundles of services offered by different states tend to be comparable. Nonetheless, taking account of quality differences is challenging, even relatively quantifiable ones like average classroom sizes and hospital wait times.

For another, the ability to provide comparable levels of public services contains different factors, and aggregating these into a single measure poses difficult problems. We can broadly aggregate the factors into two categories: needs and costs. Since different public services serve different segments of the population, states' needs for public services will differ according to their demographic composition: the young, the elderly, the disabled, the unskilled, etc. These are relatively easy to measure, and provided the cost per unit of public services is similar across states, equalizing for needs should be relatively straightforward. However, costs are likely to differ across states as well, reflecting wage costs, rental costs, population density, geographical terrain, and distance. Taking account of cost differences raises the issue of whether comparable public services ought to be the norm. As we have mentioned, even within states common levels of public services are not provided to all regions: because of cost differences there is an equity-efficiency trade-off. One way to deal with this issue is to equalize the ability to provide comparable levels of public services to comparable regions across states, and rely on how states actually treat different regions for how the equalization system should treat them.

The upshot is that equalizing for differences in expenditure capacity is very difficult, given the heterogeneity of public services provided, the differences in level of service in different regions within states, and the various sources of difference in costs and needs. In addition, one might expect that these factors would be to some extent offsetting. States with more need for public services, which tend to be the more disadvantaged ones, will generally have lower costs because wages and property values will be lower. This would suggest that disparities arising on the expenditure side will not be as great as those on the revenue side.

These factors have persuaded successive Canadian governments and policy prescribers, including the Expert Panel on Equalization (2006), to argue against expenditure equalization and to equalize solely on the basis of revenue capacity differences. Such a system is deemed to be more transparent and more reliable. It

¹⁹ Barro (2002) had proposed such a system. For a critique of the macro approach to equalization, see Boadway (2002).

might be suggested that one could equalize on the basis of those factors of expenditure capacity that are more readily estimated, such as needs or wage costs. The danger of such a selective approach is that the factors left out might work in the opposite direction.

The formal equalization system is not the only source of equalization in the broader sense. If bloc grants exist, they will inevitably be implicitly equalizing. The Canadian case is again instructive. The main bloc grants are those in support of provincial social programs: the Canadian Health Transfer (CHT) in support of provincial health programs and the Canadian Social Transfer (CST) in support of welfare and post-secondary education. Both programs are equal per capita transfers financed by federal general revenues. As such, they are effectively perfect revenue equalizers, mimicking a net equalization system that equalizes all provinces to a common level of revenue-raising ability unlike the existing gross equalization system that only equalizes the have-not provinces up to a national average. These transfers serve more than an equalizing purpose, however, since they also have conditions attached to which we now turn.

6.2 Conditional Transfers

Conditional transfers form one class of instrument that the federal government deploys to encourage states to institute programs or maintain program standards that contribute to national objectives. Transfers can be designed to achieve specific objectives, such as to construct roads or bridges that provide cross-state benefits or to implement sector-specific programs, and can include matching components. Such specific grants are of relatively minor quantitative importance and are non-controversial. Of more importance for us are bloc grants in support of broad policy areas of expenditure, such as social programs that serve broad national objectives. Conditional bloc grants represent the only device that the federal government has to exercise its responsibility for national efficiency and equity in program areas that are state legislative responsibilities.

The particular features of bloc grants will reflect the needs of each federation. However, there are some broad elements of design that can be singled out, and the Canadian experience is again instructive. In Canada, as in many federations, the provinces are responsible for key social programs because they can most effectively be delivered at a sub-national level. There may be an advantage in some social programs abiding by some basic standards of efficiency or equity, such as accessibility to benefits of social programs for persons migrating or simply visiting across provinces, universality of coverage of programs meant to serve all residents, breadth of services offered, availability of public services, professional standards of those delivering the services, and the role of the public versus private sector in delivering and financing the services. Bloc transfers in support of social programs in Canada include broad conditions that provincial programs must satisfy to be eligible for full transfers. The exact manner in which these conditions are applied will vary from program to program, and given that the provinces are assigned responsibility, the conditions should be flexible enough that provinces can design their programs in the most suitable way.

The important thing is that the conditions not be too intrusive since that would detract from provincial program responsibility. The provinces would also object to conditions

that they deem to interfere with their program discretion, especially if the conditions are not widely accepted by the public. There is obvious potential for federal-provincial conflict, given that it is the federal government that determines whether the conditions have been met, and if so, what the penalty should be. In fact, penalties have not often been applied in Canada, and their application has most often been in connection with conditions that might be deemed to be excessive, such as the prohibition of extra-billing by doctors and user fees in provincial health insurance programs, and the requirement that all basic health services be public in nature. More generally, the most effective conditions are those that elicit voluntary compliance by the provinces.

The design of bloc transfers depends on the purpose that they are meant to fulfill. Transformative bloc transfers whose intent is to induce states to institute major programs, such as public health insurance programs or welfare programs, can provide an incentive most effectively by having some matching provision (though not necessarily 50-50). The problem with matching is that it detracts from the equalizing role of bloc transfers: states able to spend more will obtain more transfers. This could be minimized by applying matching to only a proportion of bloc transfers and base the rest on either needs-based criteria or more simply population.

For established programs, bloc transfers serve two purposes. One is to encourage states to design their social programs in a way that respects national efficiency and equity objectives using broad conditions as discussed above. The other is to serve as a main vehicle for closing the vertical fiscal gap. Both objectives can be met by allocating the transfers across states in a manner consistent with equalization principles. In the Canadian case, this means equal per capita allotments, which is how bloc transfers have been allocated.²⁰

Two important questions remain. One is what programs ought to have conditions imposed on them by bloc grants? The candidate programs are the large social programs that are delivered by the states but have obvious implications for national objectives. Health care is a case in point, since the main reason for public intervention in the provision of health care and insurance is to provide social protection or social insurance. If states are left to their own devices, state political and fiscal competition may result in a fragmented system that fails to serve the less healthy and less well-to-do segments of the population. The same could be said for welfare programs and social services. Education might also be a candidate, given its importance in fostering equality-of-opportunity. In Canada, post-secondary education is a provincial responsibility and has been a target of bloc transfers, but significant conditions have never been applied. This is surprising given the mobility of university students and graduates, the extent to which the federal government finances university research and scholarships, the barriers that exist among many provinces with respect to university entrance and fees, and the non-portability of some professional qualifications.

The second is what should determine the aggregate level of bloc transfers, or equivalently the size of the vertical fiscal gap? There is no easy answer to this, since there is no ideal fiscal gap. At the same time, transparency, predictability and good

²⁰ It could be argued that the allocation of funds under Canadian bloc transfers should be used to equalize down the high fiscal-capacity provinces so as to correct a deficiency of the equalization system. There is certainly merit in this argument from an equalization point of view, though it could detract from the value of bloc transfers as devices for encouraging cooperative social program design.

governance would favour determining the level and rate of growth of transfers according to some objective criteria whose interpretation reflects the purpose of the transfers. The absence of an objective criterion in the Canadian case has led to adversarial debates over the size of the transfer, as well as to discretionary changes by the federal government that, for example, have passed on federal deficit problems to the provinces. As well, reductions in the vertical fiscal gap are not easy to reverse. The Australian approach has been to earmark GST revenues for the states. While this leads to certainty, it is not an approach that reflects any underlying principle of the ideal fiscal gap, nor is it one that takes account of changes in the relative growth of state versus federal expenditures. A candidate that to some extent addresses these deficiencies is to base the rate of growth of bloc transfers on the average rate of growth of aggregate state program spending in the target areas. This approach was actually used in Canada in the 1960s and 70s when social transfers were first established, but was abandoned partly because the rate of growth of provincial social programs exposed the federal government to rapidly growing commitments. Of course, under such an approach, the federal-state sharing of tax room would have to adjust as necessary.

6.3 Other Considerations

Some of the goals pursued by federal-state transfers can be pursued by other means. National objectives, such as equality of opportunity or the free flow of products and factors of production across state borders, might be written into the constitution. If so, it would be up to the courts to interpret and enforce them, which might reduce the flexibility of their application and the degree of harmony in the federation. Legal remedies might also take the form of federal disallowance of state programs or federal mandates on state programs as in the USA, which are also fractious. A less contentious approach, but one that is difficult to deploy, is the negotiation of federal-state agreements in important policy areas. In Canada, various examples of this exist. The federal and provincial governments signed an *Agreement on Internal Trade*, which was a wide-reaching document covering interprovincial trade and investment, labour mobility, procurement, consumer regulation, agriculture, communications, and other areas. The premise of the agreement was sound, but the absence of a binding dispute settlement mechanism rendered its application rather toothless. Some provinces have negotiated labour market agreements that have been more effective. The federal government and the provinces also signed a *Social Union Framework Agreement* that set out some principles governing the use of conditional social transfers by the federal government. There have also been various program-specific agreements in areas of joint responsibility, like immigration and training. Broad agreements of these sorts are difficult because they require unanimous approval by all governments. This is difficult to achieve, especially when implicit interprovincial redistribution is a feature.

An important part of the Canadian federal landscape has been the use of asymmetric fiscal arrangements, whereby provinces are able to opt out of federal transfer programs with compensation. These have typically been instituted as a way of accommodating Quebec's unique place within the federation, although in most cases the opportunity to opt out has been offered to all provinces even though others have not taken advantage of it. Some programs, such as tax harmonization, involve voluntary opting in by provinces. Here again, Quebec has most often been the most reluctant to sign on to a federal-led harmonization initiative.

In the end, conditional bloc transfers combined with equalization are the most effective ways for the federal government to fulfill its responsibility for achieving national economic and social objectives given that some of the important programs for that purpose are state responsibilities. These are most effective if they are formula-based, principles-based, transparent, and as non-intrusive as possible on provincial discretionary decision-making. They work best when there is substantial cooperation and agreement among the federal government and the provinces.

7. CONCLUDING REMARKS

As mentioned, the federal-state fiscal arrangements will ideally enable the states to exercise as much discretion as possible in areas of state legislative responsibility in a transparent and accountable way while at the same time ensuring that any adverse effects of state fiscal decisions on national equity and efficiency are mitigated. This is a daunting task given that state expenditure responsibilities in most federations are of the same order of magnitude as that of the federal government. The most challenging aspect of it is to decentralize revenue-raising responsibility to the states while at the same time avoiding the potentially disruptive effects of uncoordinated state tax and transfer decisions.

The Canadian case offers an example of how the benefits of fiscal decentralization can be achieved without sacrificing national standards of efficiency and equity, or social citizenship. The states can be given revenue-raising discretion for their own income taxes and VATs in a harmonized manner, provided the federal government retains enough tax room to provide leadership in establishing and maintaining harmonized tax-transfer systems. Some vertical fiscal gap is necessary to allow the federal government to manage the decentralization. It must be able to mount an effective equalization system to address the fiscal disparities that necessarily accompany decentralization. It must also retain enough transfer capacity to be able to encourage the states to abide by broad national standards of efficiency and equity. The ideal size of vertical fiscal gap is not well-defined. It is clear from the Canadian case that it is feasible to decentralize significant revenue-raising authority to the states without jeopardizing the integrity of the federation.

The Canadian case also illustrates the importance of a cooperative approach to the fiscal arrangements. Cooperation is important for sustaining tax and transfer harmonization, and for the states abiding by the conditions that the federal government imposes on its transfers. It requires that federal actions not be too intrusive and lead to predictable and fair outcomes. Unilateral and unannounced actions lead to distrust and poison the cooperative functioning of the federation. There may well be federal institutions that can contribute to the smooth functioning of the federation, but that goes beyond the competence of an economist.

Each federation will have its particular sources of tension. In the Canadian case, there are a number of these. One is the challenge posed by the highly unequal endowments of natural resources combined with the constitutional rule that these belong to the provinces. Another is the continuing urbanization of the country such that the largest cities are larger than the smallest provinces. Financing the cities is a major challenge, given that they are all creatures of their respective provincial governments. Coming demographic trends will also be difficult to manage. The population is aging, but the aging is disproportionate in the lower-income provinces. Environmental policy will

pose difficult problems, given that both federal and provincial governments will necessarily play a part, and given that polluting industries are concentrated in the resource-rich areas of the country. Managing all these challenges will require maintaining some vertical fiscal gap so that the federal government can play its part in collectively addressing these issues.

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Going beyond a zero-sum game: reforming fiscal relations

Hansjörg Blöchliger and Camila Vammalle¹

1. INTRODUCTION

1.1 How to reform fiscal relations?

One of the salient features of fiscal federalism in OECD countries during the past decade has been a trend toward decentralisation, as policy reforms have increased the power of state and local governments. From 1995 to 2008 the average share of sub-central in general government spending rose from less than 31% to more than 33%, while the share of sub-central in general government tax revenues rose from 16% to 17%. Some countries have embarked on a long-term decentralisation path involving wide-ranging changes to their institutional arrangements (Box 1). However, many attempts to reform fiscal relations have encountered difficulties. Various reforms – including the territorial reorganisation of public service delivery, changes to the sub-central tax structure and the tightening of sub-central fiscal rules – have stalled or been introduced only partially and after several unsuccessful attempts. The technical and political obstacles to wide-ranging reforms of fiscal arrangements are formidable. The question arises as to how they may be overcome and the benefits of decentralised policy making fully realised, especially in a context where sub-central governments will have to share in the efforts of fiscal consolidation.

In an effort to help governments to understand the obstacles to reform and the best ways to overcome them, the OECD Network on Fiscal Relations across Levels of Government put a set of reform episodes under the lens of “political economy of reform”. This concept refers to how political, economic and institutional factors influence the design, adoption and implementation of policy changes, and to how policy design and the reform process are intertwined. Given the idiosyncrasies of fiscal federal institutions, such reforms appear very country-specific, with little scope for cross-country comparison, as exemplified by the wide variation of sub-central tax autonomy across OECD countries (Fig. 1). But within this context of diversity, policy makers face similar challenges and opportunities to make fiscal relations more efficient, more equitable and more stable. They may be able to influence the timing, the scope and the sequencing of the reform process and thereby change the balance between winners and losers or between short- and long-term effects. By adapting the

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design of the reform, they may be able to reduce opposition and to secure a majority in favour of the reform. The study is based on ten episodes of reform in nine OECD countries, which show that despite the wide differences in institutional backgrounds, the challenges are similar. Although the effects of the reforms presented here are not evaluated, most of them tend to make a country's fiscal federalism arrangements more efficient, more equitable or more stable.

Box 1. Why reform fiscal relations?

Fiscal relations reforms in most OECD countries are driven by a multitude of factors, whether structural, macroeconomic or political. Sub-central entities are integrated into interregional and international trade and vulnerable to globalisation pressures, requiring changes to sub-central taxation, more productive public spending and better intergovernmental transfer systems. Responsibilities across government levels are often opaque, raising demands for a more efficient division of tasks between government levels. Technical progress changes the way public services are provided and consumed, calling for the administrative reorganisation of service delivery. Demographic change, spatial mobility and widening interregional disparities – often the consequence of economic agglomeration and the attraction of metropolitan areas – increase pressure to introduce or amend fiscal equalisation systems. Deficit bias and the need for fiscal adjustments call for amended sub-central fiscal rules or other forms of enhanced fiscal co-ordination. In some cases, the need for reform is a consequence of earlier reforms: Spending decentralisation can lead to unfunded mandates, and other revenue-side imbalances can require improvements to sub-central tax systems or intergovernmental grants. Finally, the emergence of political movements such as communitarianism leads to demands for local and regional empowerment.

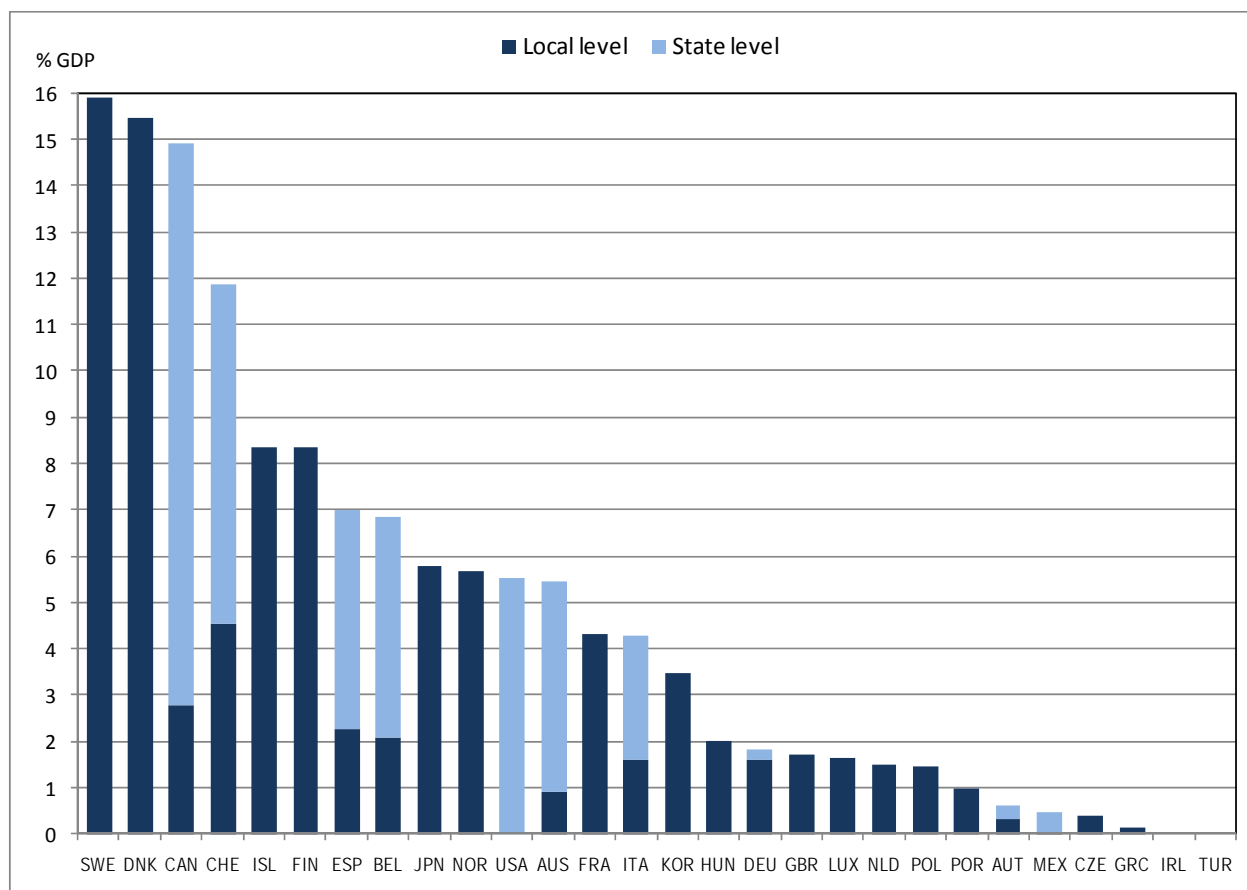
1.2 The stakes in fiscal relations reforms

The problem for policy makers aiming to reform fiscal federalism and local government is that benefits do not accrue to all citizens and jurisdictions alike. While reforms are supposed to benefit the economy and the society as a whole, their costs and benefits are unevenly distributed, and some individuals and groups are bound to be net losers, particularly in the short run. These losers, whose numbers may not be large, often have well-identified stakes and interests, which they tend to defend vigorously. The benefits of reform are often thinly spread over a large and dispersed group of beneficiaries that is often unaware about the potential gains of reform. In addition, the cost of the reform tends to become apparent immediately, while the benefits, whose extent is uncertain, tend to emerge later. The asymmetry between winners and losers in the reform process and uncertainty about the size and distribution of the future benefits may weaken the support for reform. A bias toward the status quo, and resistance to reform, may result, even if potential winners are likely to outweigh the losers in the long run. Only under certain circumstances can uncertainty about the outcome of a reform create a “veil of ignorance”, *i.e.* a situation where stakeholders, unaware of how they will be affected individually, may be ready to agree to social contracts that increase the overall effectiveness of fiscal federalism arrangements.²

² The “veil of ignorance” is a concept originating in political philosophy that explains how productive arrangements and social contracts evolve (Rawls, 2001). The “veil of ignorance” and the “status quo bias” are opposite outcomes of the same underlying fact, namely uncertainty. Somewhat simplified, the

Figure 1. Taxing power of sub-central governments

Taxes for which sub-central governments have the right to set the rates and/or the base, as a percentage of GDP, 2005



SOURCE: OECD Fiscal Decentralisation database

Fiscal federalism and local government reforms can be seen as a blend of structural reforms including tax reforms, and public administration reforms, and they can be analysed using the appropriate political economy framework.³ Fiscal relations reforms have their peculiarities, however:

The main actors and interests in fiscal relations reforms are government levels and individual governments, rather than interest groups outside the public sphere. The fact that governments will be dealing mainly with each other is likely to shape the reform and the reform process.

“veil of ignorance” assumes that overall efficiency gains will help to pass a reform because the average gains are assumed to be positive, while the “status quo bias” assumes that uncertainty about individual outcomes will block the reform because risk aversion puts a negative value on the stakeholders’ expected average outcomes.

³ Political economy of reform issues in selected areas are reviewed in the OECD publication *Making Reform Happen* (OECD, 2010), with contributions, among others, by Price on fiscal consolidation, by Brys on fundamental tax reform and by Charbit and Vammalle on public administration reform. Tompson (2009) scrutinises pension, product and labour market reforms in ten OECD countries.

- The impact of fiscal relations reforms is highly visible, especially in the short run. Governments and administrations are often obliged to quantify short-term effects with great accuracy, leaving both winners and losers with a precise idea of how reforms to the tax system, intergovernmental grants or fiscal rules affect them individually.
- Fiscal federalism reforms tend to be a zero-sum game in the short run, where one government level or group of sub-central governments (SCGs) is going to lose what the other government level or other SCGs will win. As a result, such reforms are plagued by a strong bias towards the status quo. The political discussion revolves around short-term distributional effects, and stakeholders will concentrate their efforts on ending up on the “right” side.

1.3 Methodology

This paper is based on ten country case studies and applies the method of “focused comparison” (Table 1 and Box 2). In order to make reform experiences comparable, case studies follow the same structure and methodological framework. They describe and discuss issues such as reform outcomes, the reform context and the issue history, the actors and interests involved, the reform process, the design of the reform, and finally the adoption and implementation of the reform. The reforms studied were adopted between 2001 and 2009, although some reforms were initiated many years earlier. They include the introduction or amendment of fiscal equalisation programmes; the upgrading of (non-equalising) intergovernmental grant systems, particularly a move from earmarked to non-earmarked grants; the introduction or tightening of sub-central fiscal rules; a sub-central sales tax reform; the territorial restructuring of public service delivery, including the merger of municipalities; enhanced inter-jurisdictional co-operation and the introduction of a new regional layer; and the reorganisation of power and competencies across ministries with respect to fiscal relations. In most cases, a reform covers more than one of the topics mentioned.

While the summary might give a comprehensive picture of the reforms recently on the agenda in member countries, the case studies could be said to suffer from selection bias, in the sense that all reforms under scrutiny were adopted and can hence be considered “successful”. Moreover, all reforms, except for the Canadian equalisation reform, some of whose elements became fiscally untenable after the 2008 crisis, were implemented in a sustained way. Once adopted, the reforms were not reversed or watered down. The ten country case studies do not cover reforms that eventually stalled, and they do not analyse the factors that lie behind aborted reforms, nor do they cover situations where the government considers reforms urgent but has so far made no serious attempts to carry them out. Given this selection bias, it is clear that this study has more to say on the factors that promote comprehensive fiscal federal reforms than on the obstacles that impede them.

Table 1. The ten case studies

Country	Name of the reform, year of adoption
Australia	Intergovernmental Agreement on Federal Financial Relations, 2008
Austria	Reform of the Financial Equalisation Law, 2007
Belgium	Lambermont Agreement on Tax Autonomy and Community Refinancing, 2001
Canada	Equalisation Reform, 2007
Denmark	Local Government Reform, 2007
Finland	Restructuring of Local Government and Services, 2008
Italy	Law 42 on Fiscal Federalism, 2009
Portugal	Local Finance Reform, 2007
Spain	Reform of the Autonomous Community Funding System, 2009
Switzerland	Reform of Fiscal Equalisation and of Responsibility Assignment, 2004

SOURCE: Individual country case studies.

Box 2. The method of "focused comparison"

The method of "focused comparison" basically entails asking the same questions across a substantial number of cases in order to discern similarities among them (Tompson, 2009). Findings generated in this way do not enjoy the level of formal verification that may be achieved via quantitative analyses of very large numbers of cases. However, the method of focused comparison offers significant advantages, chiefly by facilitating a more detailed study of the context-dependent nature of certain relationships among variables. In particular, it permits a greater degree of "process-tracing" – *i.e.* tracing the links between possible causes and observed outcomes in order to assess whether the causal relationships implied by a hypothesis are evident in the sequence of events as they unfold. Because it examines specific cases in depth, rather than simply comparing data across cases, a focused case-study approach is better able to explore the policy process, to take account of institutional and political complexities and to explore more complex causal relationships, such as path dependence or the issues that arise when, for example, a given factor may favour adoption of a reform but hinder its implementation. A case-study approach also permits exploration of variables that can be extremely difficult to quantify or code for inclusion in regression analyses.

2. THE REFORM CONTEXT

This section describes the factors that shaped and influenced the reforms and the reform process but that were largely outside the control of policy makers.

2.1 Favourable economic and fiscal conditions can help reforms succeed

One of the most salient conclusions of the country studies is that a sound economic and fiscal position is strongly linked to the success of a reform. While some reforms were initiated during times of economic slack or driven by the need to consolidate, implementation of literally all reforms took place when central and, to a lesser extent, sub-central public finances were in good shape. Good economic conditions and sound fiscal positions help central governments to “buy” reforms and to grant a reform dividend on the spot. The role of a sound fiscal position is most obvious in equalisation reforms, whose explicit distributional objectives inevitably create short-term winners and losers among SCGs (a zero-sum game). In most reform cases the central government provided additional transfers to the sub-central level so as to make almost every SCG a net reform winner. Even territorial reorganisation and tax reforms, whose distributional impacts are weaker, are often bankrolled with additional resources from the central government. Finally, some reforms were implemented as part of a fiscal stimulus programme, as in the case of Australia. Without considerable financial help from the central government, resistance to reform tends to be much stiffer and failure is more likely.⁴

The recent economic and financial market crisis and its dire fiscal implications are likely to change for some time the economic and fiscal environment for reform. Most of the reforms studied were adopted before central governments had embarked on fiscal consolidation. Few reforms have been adopted during the crisis, although Canada’s sales tax harmonisation, which had been delayed for years, was prompted by the crisis and by the need to help the economy out of recession. Portugal’s local government reform, part of a strategy of fiscal retrenchment, was the only reform studied that was fiscally “neutral”, *i.e.* where the central government did not put additional resources on the table. Weak growth and a lack of financial resources will now limit the prospects for reform and the central government’s role as paymaster. Fiscal positions will shape reform outcomes: while good economic and fiscal conditions appear to favour reforms that increase equalisation and more generous handouts to SCGs, economic and fiscal crises will likely trigger reforms that increase sub-central government efficiency and tighten fiscal discipline. The coming years will show what type of reform can be initiated, adopted and sustained under conditions where central governments can no longer afford to pay.

2.2 Electoral mandates are useful but not crucial for success

Electoral mandates are an important driver in fiscal federalism reforms, although intergovernmental fiscal relations rarely feature as a high priority in election campaigns. Once a new government was elected on a platform that included a fiscal

⁴ Indeed, one of the most robust findings to emerge from econometric work in the field of the political economy of structural reforms is that sound public finances are associated with more comprehensive reforms (Tompson, 2009).

relations reform, it tended to act quickly, as shown by the Australian, Belgian, Danish or Portuguese reforms. Governments without a mandate tend to engage in small and often piecemeal reform attempts. Acting against electoral promises can create strong opposition to a reform by special interest groups and the public at large, even if the reform is financially supported by the central government. Compulsory mandates – *e.g.* the obligation to amend fiscal relations every four years as is the case in Austria – may create a positive climate for reform, but again, the scope and outcome depends on the electoral mandate. The more convincing the mandate, the more comprehensive the result of the reform tended to be. Electoral mandates to increase the efficiency of public services, to reduce fiscal disparities or to increase sub-central fiscal autonomy were stronger than mandates for sub-central fiscal consolidation and tighter sub-central fiscal rules, and the respective reforms also tended to be bolder.

Electoral mandates are not always necessary, however. Fiscal federalism itself is a technical topic that arouses few political emotions, except when voters are strongly attached to “their” jurisdiction or “their” local service. Interest in which government level provides a public service is slight; voters are usually more interested that it be tailored to their needs and delivered at a reasonable cost. In the reform cases under scrutiny, campaigns tended to focus on generic objectives such as “more autonomy”, “better public services” and “fair regional distribution” and less on the intergovernmental mechanisms that were necessary to achieve them. Only with time did governments become aware that fiscal relations played a pivotal role in their endeavour to reform the public sector, public finances or tax systems. Moreover, it was generally expert or administrative groups rather than politicians that drove reform, which kept the discussion at the technical level and below the radar of party politics. Since fiscal relations are rarely viewed through an ideological prism, governments have some scope to negotiate a reform that was not initially on the political agenda.

2.3 Some arrangements provide sub-central governments with considerable leverage

Constitutions and electoral systems may give local and regional governments considerable power to shape the reform or veto undesired outcomes. Very basically, members of a national parliament will represent the interests of their jurisdiction. In several federal countries, reforms have to be approved by two parliamentary chambers, with the second chamber representing the states or regions. In some unitary countries, especially in Scandinavia, municipalities enjoy the right to fiscal and administrative self-governance, putting limits on the central government’s ability to change acquired rights against their will. Certain forms of collaborative federalism and comprehensive consultation across government levels and with other social groups add to the constraints. Also, the distribution of sub-central governments in terms of size or economic wealth across the country has a strong impact on the outcome of reform, often favouring small and/or economically lagging SCGs.⁵ A system of many small electoral districts is likely to favour redistribution and the interests of certain groups over considerations of efficiency.⁶ Finally, SCGs with strong regionalist

⁵ The Canadian equalisation formula, with its strict reliance on tax-raising capacity, strongly favours poorer provinces with a lower cost of living (Albouy, 2010). The Austrian reform of 2007 has reduced the equalisation premium for large urban areas, and the new Swiss equalisation formula does not include such a factor at all.

⁶ See Rodden (2009). This is why constitutional economists have suggested at least partially abandoning electoral districts and running elections at the national level (national election districts). Given that

ambitions and the ability to deliver crucial swing votes can strongly influence reforms of fiscal relations. In sum, an institutional bias toward the status quo can complicate radical overhauls if they do not benefit a large majority of SCGs.

Another complication is the fact that fiscal relations reforms require an administration to reform itself. The public administration at one or more government levels must design and implement measures that may negatively affect part of its own constituency (Charbit and Vammalle, in OECD 2010). While an internal distribution of power between ministries may increase administrative efficiency, it may also create resistance within the administration, particularly when the power to oversee fiscal relations is shifted from the line ministries and concentrated in the hands of the Ministry of Finance. Country cases suggest that ministries such as those for education or health care – often closely linked to their respective constituencies, such as the medical or educational sector – may provide impetus for a reform, but they also often slow down the reform process or tilt it towards their own interests. Certain reforms – *e.g.* the move from earmarked to non-earmarked grants – had an impact on special interests within and outside the administration and met with tacit resistance that could often be only partly overcome. Widening the scope of fiscal federalism reform by an internal market reform (*e.g.* removing trade barriers between SCGs) and incorporating the interests of the business sector, can help overcome this type of status quo bias, but it can also create additional opposition from businesses in protected markets.

2.4 The central government must often mediate between diverging sub-central government interests

Government levels and individual jurisdictions are the main actors and interest groups in fiscal federalism reforms. Summing up the country cases studies, the objectives of the central government included: *i)* increasing the efficiency of public service delivery or economic growth; *ii)* creating fiscal frameworks that reduce cyclical fluctuations of intergovernmental grants and sub-central budgets; *iii)* providing fiscal equalisation that reduces differences in tax-raising capacity and/or service costs across jurisdictions, without compromising SCGs' incentives to develop their own fiscal base, *iv)* clarifying the allocation of responsibilities across government levels, and *v)* simplifying regulation and administration of intergovernmental grants. Moreover, central governments generally aimed to harden sub-central budget constraints, usually by tightening sub-central fiscal rules or by granting more tax autonomy to SCGs, in order to reduce sub-central deficit bias. In most cases, the various rationales for reform overlap, particularly in their mix of efficiency and equity objectives. SCGs rarely opposed such demands and in some cases even acted as early promoters. Indeed, during several of the case studies, the central government was passively reacting to sub-central demands rather than pushing its own agenda.

Opinions on reform often diverged more between SCGs than across government levels, leaving the central government to balance diverging SCG interests. SCGs with an efficient public sector preferred tax autonomy over grants and subsidies, while the less efficient jurisdictions opposed it. Poorer SCGs, often in a majority, claimed more equalisation, while wealthy SCGs tried to put limits on redistribution. SCGs with high

members of a national parliament would need votes from the entire country, they would be more inclined to adopt a “national” and aggregate view of reforms rather than defend special SCG interests.

debt and deficit levels opposed tighter fiscal rules, while those with robust fiscal positions took them more lightly. While poor SCGs tended to favour mergers with those better off, richer ones lobbied hard against such mergers because they feared that average service levels would go down or tax rates up. In some cases, conflicts between SCGs were swept under the carpet in order not to weaken negotiations with the central government. Summing up, most fiscal federalism reforms tend to entail stronger conflicts among SCGs than between the central and the sub-central level, especially when, at an early stage of the reform, the central government aligns with a few reform-minded SCGs.

Finally, the interests of individual jurisdictions or government levels have a stronger impact on the outcome of a reform than party ideologies. In the case studies, political party members often took a different position depending on whether they were acting at the central or the sub-central level. Conversely, parties of different ideological stripes aligned across levels of government to pursue a reform. In some cases, especially in reforms concerning tax autonomy or fiscal equalisation, the same political party held different views across sub-central jurisdictions, although this was not explicitly acknowledged. For a reform to be strong and sustainable, it can be helpful if the same parties or a party coalition command a majority at both levels of government, as many elements of a reform depend on political tenets reflected in party ideology.

3. TIMING AND SCOPE

3.1 Reforms often build upon earlier failures and pilot programmes

Successful reforms of fiscal relations tend to be preceded by one or several aborted attempts or even reversals. Fiscal federalism and the framework in which local governments operate are often part of the founding principles of a country. Moreover, they are very country specific, so that a blueprint for reform is rarely available. A widely shared perception that fiscal relations are not functioning properly is likely to evolve slowly. But early reform failures may raise awareness of the shortcomings of the status quo and give policy makers guidance for approaching reform. In several of the cases examined, failed attempts had built up expectations and pressure for change, until the established system had become so inefficient or inequitable that governments were ready to act quickly and comprehensively. Reform “ripeness” is to some extent endogenous, and policy makers can create a climate for reforms by pushing for them even if the initial attempts are likely to end nowhere.

Pilot programmes can help prepare the way for comprehensive reforms. The municipal reorganisation in several Nordic countries was successful because policy makers could point to successful experiments with a subset of local governments.⁷ The experiments showed the feasibility of a new approach and helped to overcome resistance. In Canada, the tax accords between the federal government and three small provinces helped pave the way for sales tax harmonisation in larger and economically more important provinces. In Australia, successful public sector reforms in individual states

⁷ However, the Finnish government did not make use of the experiment carried out in the northern part of the country but instead chose a different institutional solution to the problem of municipal fragmentation.

showed the need for reform at the central level, especially in the realm of service funding and delivery. Also, new management techniques can be used in selected policy areas before they become the rule for the rest of the intergovernmental framework. Finally, “asymmetric federalism”, *i.e.* an institutional setup in which one or a few SCGs have more prerogatives with respect to tax or spending powers than other SCGs – a common feature in OECD countries on a secular decentralisation path such as Italy or Spain – can also help start reforms. Once a reform covering selected SCGs is implemented, other SCGs may ask for equal treatment, resulting in further reforms that encompass all SCGs. In time, symmetric fiscal relations, under which all SCGs are subject to the same rules, are restored.

3.2 Bundling may be necessary to forge majorities

Most of the ten fiscal federalism reform case studies consisted of comprehensive bundles offering benefits to a large array of actors and interests. Although the inertia of fiscal federalism frameworks points at the difficulties of engineering a wide-ranging reform, a big-bang approach may prove easier to pursue than a gradual, sequential approach.⁸ Comprehensive reforms may be necessary if there are many veto players whose support is crucial for success. In many cases under scrutiny, different reform elements, each addressing a subset of actors, were bundled in order to obtain the majority needed to pass the reform. Bundling made it possible to distribute the benefits of reform more evenly across various SCGs and stakeholders. It had the additional advantage of providing governments an opportunity to offer individual actors a “take-it or leave-it” package. Bundling locked in veto players: no single actor could expect to renegotiate reform amendments once the reform proposal was anchored, because that would have threatened the position of other actors and hence the outcome of the entire reform. Bundling also allowed more emphasis to be placed on long-term efficiency. Indeed, while wide-ranging fiscal federalism reforms attempt to strike a balance between efficiency and inter-jurisdictional equity, small-scale reforms, are largely perceived as distributional.

In the reform cases under scrutiny, elements that enhanced efficiency, such as granting more tax autonomy, tightening sub-central fiscal rules, moving from specific to general-purpose grants or mergers of small municipalities, were often bundled together with distributional objectives, such as more grants for SCGs, a strengthened fiscal equalisation system, tax credits for low-income earners, service guarantees in remote areas and the like. The Swiss fiscal equalisation reform contained elements that tended to satisfy several types of SCGs, such as poor, low-cost rural as well as wealthy, high-cost urban SCGs, as they addressed both low tax capacity and a higher cost of service provision. In several cases, grant reforms, especially the move towards general-purpose grants, were met with an increase in transfers from the central government. Territorial reforms such as mergers gave the municipal level more power and responsibilities – sometimes at the expense of another territorial level – and benefitted both rural and urban areas of varying economic circumstances. A tighter sub-central fiscal rule was sometimes coupled with extra funding for highly indebted or poor jurisdictions. In some cases, the scope of the reform was widened to include other policy areas. For example, Australia’s fiscal federalism reform provided

⁸ In this respect, the political economy of comprehensive fiscal federalism reforms tends to be akin to fundamental tax reforms (Brys, in OECD 2010).

incentives to reduce barriers to interstate trade, while Denmark's was coupled with a health care reform.

One important problem with bundling is that if it goes too far and tries to satisfy too many stakeholders, the distributional aspects can detract from the efficiency-enhancing aspects of the reform. Bundling may turn into log-rolling, *i.e.* special interests joining forces at the expense of other, less well-organised groups.⁹ As mentioned above, bundling often ends up with the central government "buying" the support of opponents of reform. Although some additional transfers could be justified on the grounds that efficiency gains – such as internalised externalities or lower administrative cost – accrue to the country as a whole, the country studies suggest that fiscal relations reforms are often too costly for the central government. And even strong bundling may not achieve all the desired objectives: further sub-central tax autonomy, which is sometimes on the agenda when a reform is initiated, may be scaled back or dropped completely during the reform process. In several cases, neither the central government, reluctant to lose central budget oversight, nor sub-central governments, fearing higher uncertainty over revenue, showed sufficient interest in greater tax autonomy.

3.3 Sequencing may be an alternative strategy for some reforms

Sequencing may be an option if demands for institutional change and decentralisation are persistent and if decentralisation can be partitioned into steps. A sufficient majority must then be mustered at each step without bundling. Countries in a secular decentralisation process like Belgium, Italy or Spain follow such a pattern. Reforms start with the decentralisation of spending responsibilities, while SCG funding is ensured through a set of corresponding earmarked grants. This is followed by a move from earmarked grants to general-purpose grants and to an increase in spending autonomy, sometimes linked to more result-based regulation. At the next stage, grants tend to be replaced by tax-sharing systems and finally by autonomous taxes, thereby increasing sub-central tax autonomy. Such sequencing gives time to test the gains obtained by decentralisation, which, if considered satisfactory, create impetus for further reforms. However, further reform steps are only successful as long as the efficiency gains of decentralisation outweigh the associated distributional conflicts (Rodrik, 1999). In this respect, spending decentralisation is easier to engineer than tax decentralisation, which can arouse fears of increasing interregional disparities. In several countries, plans to devolve taxing powers to SCGs were scaled back or abandoned. In other cases, distorting SCG autonomous taxes were replaced by tax-sharing systems or intergovernmental grants, supposedly increasing the efficiency of the tax system, but reducing SCG tax autonomy.¹⁰

⁹ Log-rolling is an exchange of votes in a legislative process whereby two parties, each of whom needs a partner to push its priorities through, create a common platform. One group supports the demands of another group with which it has little common ground or that it mildly opposes, in exchange for obtaining the other group's support for its own aims. Log-rolling works if the interests of other parties are relatively weak and dispersed. The benefits of log-rolling are controversial in the economic literature: while some see it as efficiency-enhancing during a reform process, others see it as rent-extracting (Crombez, 2000).

¹⁰ In 2000, the Australian Goods and Services Tax replaced a set of inefficient state consumption taxes. Although all tax proceeds are transferred to the states, the latter have no discretion over the tax base or

In designing reforms of fiscal relations, policy makers may have to consider some trade-offs between bundling and sequencing, *i.e.* between adopting a comprehensive reform as opposed to pursuing an incremental strategy. As described above, the studied fiscal federalism reforms tended to follow the bundling approach. Most reforms studied were wide-ranging, with little relation to former reforms or reforms in adjacent policy domains. Exceptions were the Italian and Swiss reforms which had a sequential pattern, *i.e.* constitutional amendments were implemented before lower-level laws and decrees were adopted or amended. In the Australian case, certain problematic elements of the reform, such as the measurement of public sector performance, were postponed.

3.4 Speed may help, but reforms take time

Speed can provide the momentum to bring a reform to fruition and shows that a government is taking an electoral mandate seriously. Opposition may not be well organised after an electoral defeat, and policy makers can take vested interests unprepared. If a reform is adopted soon after an election, its effects have time to unfold before the next election. Moreover, speed may briefly create a “veil of ignorance” that allows stakeholders a general view of the potential effects of a reform but does not leave them time to assess how they will be affected individually. However, speed may discourage debate. The fact that fiscal relations reforms are often highly visible makes it difficult to maintain the “veil of ignorance” for long. Wide consultation with potential veto powers and fine-tuning to adapt reforms to obtain a majority may be needed. Well-prepared reform proposals that are considered impartial can sometimes even be implemented by a new government of a different political persuasion, as shown by the Canadian equalisation reform episode. The trade-off between speed and inclusion depends on the electoral mandate, the number of potential veto powers and the institutional framework to address them, but in general, the specific character of fiscal relations reforms calls for wide inclusion.

4. DESIGNING THE REFORM PROCESS

4.1 Political leadership tends to accelerate a reform

Political leadership – *i.e.* a person or a political group closely accompanying and driving the reform process – can be a significant driver of reform. In the end, it is politicians and political parties that must pass a reform and be persuaded that it is in the country’s wider interest. In a few reform case studies, best exemplified by Denmark, the involvement of a few determined individuals and political heavyweights helped the reform to succeed where earlier attempts had failed. Conversely, the lack of strong political leadership could explain setbacks that blocked some reform attempts and the inability of stakeholders to reach consensus on controversial elements. The credibility of political leadership may be enhanced if lead politicians or jurisdictions have no direct stakes in the reform and can act as honest brokers across government levels or between individual SCGs, as exemplified by the Austrian, Italian and Swiss cases. In some cases, however, the government was not driving the initiative but was passively following the advice of its administration and external experts while

tax rates. At the beginning of the 1980s, Mexico replaced a set of inefficient autonomous state taxes by a tax-sharing system that stripped the states of taxing power.

maintaining a low political profile. Such “depoliticisation”, as shown in the case of the Canadian equalisation reform, can be an alternative route to reform, and it may help avoid reversals once a government of a different political affiliation is elected.

4.2 External and independent expertise lends credibility to reforms

Experts and expert panels operating outside the direct influence of the administration have usually played a significant role in the reform process, and they can be considered a precondition for success. Given that fiscal federalism and tax reforms are often highly complex, experts provide technical expertise to assess both the status quo and the impact of reform proposals. Moreover, by providing impartial and unbiased scrutiny, independent experts were able to create and sustain political credibility among the public. Particularly in polarised political environments, when the central government was at odds with the sub-central level or when SCGs or political parties strongly disagreed among each other on the scope of a reform or even the need for it, external experts were able to unblock the situation.

In several countries, expert panels laid out the strategic reform issues, helped to consolidate and streamline the reform proposals, and designed and shaped central pillars of the reform. Government research institutions such as in Finland played a similar role, *e.g.* when their publications launched a reform or accompanied the reform process. Independent commissions provided additional input from outside the traditional realm of fiscal federalism. For example, the case for Australian reform drew on the recommendations of the Productivity Commission. In general, a strong representation of trained economists can be considered to maintain the consistency, simplicity and political feasibility of reform proposals. Conversely, a lack of independent and credible experts can be considered an impediment to reform.

4.3 Consultation should focus on a reform’s long-term impacts

Given the largely institutional character of fiscal federalism reforms, consultation and involvement of the main stakeholders is unavoidable. Comprehensive consultation can raise awareness of the reform and help build up the necessary majorities, creating a feeling of ownership. Once stakeholders feel they have participated in the design of the reform, they are more likely to defend its outcome. Consultation and involvement can also help to lock in the steps for implementing a reform. Once the different stakeholders have agreed to reform proposals in principle after extensive consultation, it is more difficult for them to contest the reform once individual impacts become more apparent, as exemplified by the sequential approach of the Italian reform. In the reform cases under scrutiny, the scope of consultation largely depended on the number of stakeholders involved. In some countries, the reform concerned mostly government levels. In some cases however, involving stakeholders outside the government sphere complicated consultation especially when sub-central tax systems or frameworks underlying the funding of earmarked grants were to be reformed.

While wide-ranging consultation is often considered necessary to bring the main stakeholders on board, it can also jeopardise reform efforts. Too much consultation can inflame opposition. From the various country studies, it appears that the most successful consultation and involvement processes were those when the government was generally parsimonious with numbers – *i.e.* rejecting a precise assessment of the short-run reform impact for individual SCGs – but insisted on presenting and

discussing the overall objectives of the reform. By doing so, governments hoped to shift the discussion away from distributional effects and onto the long-term efficiency objectives. It is true that this “veil of ignorance” is difficult to maintain in a policy environment where short-term distributional impacts are easier to quantify than long-term effects.

4.4 Transitional arrangements may be necessary

Transitional arrangements were a frequent expedient for reducing opposition while maintaining the fundamentals of a reform. In many cases, they were the ultimate resort for securing a majority. This said, transitional arrangements were usually brought in late in the day. Transitional “cohesion funds” as in the Swiss case and other entitlements ensured that hardly any SCG lost in financial terms over an extended period of time.¹¹ Job guarantees for civil servants for a limited period reduced opposition from the public administration, as was the case in the Danish reform. In several countries a gradual phasing-in of new arrangements helped to reduce sudden breaks and discontinuities in transfer flows. Grandfathering rights and similar compensation mechanisms kept short-term changes in the SCG revenue-ranking position – e.g. in terms of tax capacity or transfer size – to a minimum. Transitional arrangements have their benefits beyond securing the success of a reform: distinguishing between permanent and transitional arrangements can help ensure overall consistency of a reform, since all messy political compromises can be relegated to the transitional arrangement. However, and in most cases, transitional arrangements put a considerable burden on the central government. As many observers interviewed during the study lamented: “Central government always pays”.

In cases where a small number of stakeholders with considerable veto power – especially specific SCGs – categorically reject a reform, the right to opt out may be granted. Some case studies suggest that allowing a few SCGs to opt out can help reduce opposition to reform without much cost and without threatening the principal elements of a reform, provided that these arrangements have little impact on economic and fiscal outcomes and that they do not incur resentment among other SCGs.

4.5 The administration should speak with one voice

Organising an efficient process that structures and oversees the reforms was crucial for success. In general, fiscal relations reforms were overseen and managed by a single ministry, usually the central government’s Ministry of Finance, the Interior Ministry or a body that comprises all government levels. Given that fiscal relations reforms often had a distinct horizontal character and cut across several policy areas, various line ministries were involved, especially in cases where the allocation of intergovernmental grants was traditionally shared across ministries. Reforms tended to advance more rapidly if the administration spoke with one voice, i.e. if one ministry took the lead and relegated the other ministries to heading a working or project group. In some countries, administrative leadership was aided by the creation of new vertical and horizontal intergovernmental bodies that helped select and bundle reform

¹¹ The Swiss reforms provide for a transition period of up to 28 years during which no canton will lose in net terms. In Germany, the new sub-central fiscal rule forbidding the *Länder* from running structural deficits, which was inserted into the constitution in 2009, will be fully applicable only after 2020.

elements, while other countries explicitly pulled back from creating additional bodies on the grounds that they would procrastinate and develop their own agenda.

If administrative leadership was weak or shared between ministries, reforms were more likely to stall. Inter-ministerial infighting tended to weaken a reform. This is why several fiscal federalism reforms were enacted in conjunction with a reform of inter-ministerial financial management, or the reallocation of administrative powers and responsibilities was made part of the reform. In several cases, tasks such as the responsibility for disbursing intergovernmental grants, previously carried out by a range of different administrations, was concentrated in a single ministry. Indeed, many reforms may have resulted in a power shift from line ministries to the Ministry of Finance.

4.6 Communication should present the policy behind the numbers

Governments tended to make considerable efforts to “sell” a reform. Efforts to highlight the long-term efficiency gains helped create support from dispersed winners, who were often not fully aware of the potential gains. Communication with the public also helped identify potential problems with individual elements of a reform. In several instances, reports by expert panels were widely disseminated and discussed at public hearings, bringing the main stakeholders on board. In other cases, special seminars were held for the media to provide journalists with the broad outlines of the reform. “Stealth” reforms in which the attention of the public is not drawn to the reform may at first appear expedient, but they should be weighed against how visible the short-term impacts of the reform may be, and how such an approach could undermine a government’s credibility. The case studies indicate that the most successful efforts at communication emphasised the long-term benefits.

A strategy for presenting the reform to the public is equally important. Fiscal federalism issues are abstract, highly technical and often accessible only to experts. Voters usually care little about who is responsible for a given public service or who taxes their income and property, but they are interested in decent services, low taxes and sustainable public finances. Reformers thus have to clearly convey the policy intentions behind the formulas and numbers. In the case studies, such promotional slogans as “better services”, “more autonomy”, “save federalism”, “save the country” were invoked, or in some instances “save the reform”. Tighter sub-central fiscal rules were communicated as part of a fiscal consolidation strategy and the need for different government levels to co-ordinate their efforts in order to restore a sound fiscal position. Finally, in most cases, public relations campaigns pointed out that the reform allowed both for more efficiency and for a more equitable distribution of fiscal resources across SCGs.

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Own revenues in federations: tax powers, tax bases, tax rates and collection arrangements in five federal countries

François Vaillancourt¹

1. INTRODUCTION

The purpose of the paper is to examine the four classic aspects of revenue assignment in fiscally federal countries² : (a) how are the taxes from which subnational governments receive revenues determined, (b) how are the bases defined and shared, (c) how are the tax rates set, and (d) which level of government administers the taxes. For each issue, we frame the question using a principled approach, provide five examples of how it is done and assess when possible if there are preferable outcomes. This allows us to carry out the task assigned to us by the conference organizers that was to provide information of potential relevance to Australian policy makers. The paper is thus divided into four parts. These four choices will be guided by economic and political factors and shaped by the constitutional/legal framework. We examine the case of five countries presented in alphabetical order throughout the paper; they are: Belgium, Canada, Spain, Switzerland and the United States. They were selected since they have a per capita income similar to that of Australia, include both new (Belgium, Spain) and old federal arrangements and in some cases face geographical circumstances similar to that of Australia (size, climate diversity...). More emphasis is put on Canada than other countries as a result of both its greater historical similarity to Australia and the knowledge of the author. We present in the Appendix table basic information on these five countries and on Australia.

2. THE POWER TO TAX; ITS ORIGIN

2.1 The principles

The right to tax is one of the two key powers along with the right to use force that distinguishes a government from a private actor. It allows the government to appropriate for its own use a share of the private income or output in its territory. Dysfunctional states will see this power more or less eroded.

¹ Fellow, CIRANO and professeur honoraire, Economics Department, Université de Montréal. Paper prepared for the State Funding Forum, Canberra, September 2011. We thank Bernard Dafflon, Bob Ebel and Magali Verdonck for their help in revising this paper and Neil Warren for inviting us to this conference and for final comments on the paper

² We thus include countries that are de facto federal but that do not wish to use that term in their self-definition often for historical reasons.

Given the above, how this power is shared between more than one level of government is an important question in federal states. There does not appear to be a guiding principle as to what mechanism should be used to resolve this question. Bodies such as constitutional conventions that write the constitution of a new state need to address this question, but constitutions will evolve over time through amendments, judicial decisions and the emergence of unwritten norms. Thus at a given point in time, the taxing powers of the constituent units also referred to as subnational governments of a federation will be the result of a combination of these forces. This natural evolution is not to be decried as it allows adjustments for changes in economic realities such as a shift from a goods producing to a services producing economy (McClure, 2001). Guiding principles of constitutional conventions could be:

- a reasonable relationship between responsibilities and thus outputs of constituent units and revenues. We use outputs to cover three items: budgetary spending on goods and services and on transfers; tax spending through tax expenditures; and regulated mandatory private spending that substitutes for the other two spending and thus while a cost to society does not appear as government expenditure. This creates an indirect link between the principle of subsidiarity used to allocate responsibilities and the allocation of taxing powers;
- taking into account subsidiarity explicitly when making tax choices. Thus taxes that can be best levied at the non central level, best being defined in terms of economic (not administrative) efficiency, should be thus levied at that level. Given what the appropriate distribution of output responsibilities is likely to be, one is usually left with a vertical fiscal imbalance with the non-central constituent units in need of transfers from the central government.

Brennan and Buchanan (1980), treating the state not as a benign body pursuing the welfare of its residents but as a leviathan, argue for a large number of subnational units to facilitate mobility of taxpayers and reduce the tax collusion between tax units (p180). They argue that, 'At the lowest level of government, access to even minimally distorting taxes may be appropriate, because the discipline of mobility restricts the capacity of government'. At the central level, specific taxes such as excises and tax limiting rules are preferable to limit the rapacious leviathan. They favour tax competition between SNGs (subnational governments).

Wibbels (2005), on the other hand, argues that historical factors such as the differences in economic circumstances between regions at the origin of a federation explain the current distribution of tax power: the more regional elites have to lose, the less powers they want to see at the center.

2.2 The practice

Belgium

Belgium is a new federal country³ (formally created in 1993) with two major sets of non-central constituent units: three regions that have some tax powers and three linguistic communities that do not. The Constitution does not list the specific taxes available to regions: article 177 states: *A law adopted by special majority vote as described in Article 4⁴, last paragraph, fixes the methods of financing for regions.*

The tax powers of regions are the result of political bargaining between the majority richer Flemish group and the minority poorer French speaking group (Brussels and Wallonia) within an existing constitution. The first transfer of tax powers occurred in 1988 (Gérard, 2002). Flanders wants more decentralized tax power but this is opposed by Brussels and Wallonia who fear tax competition and a weakening of inter-regional solidarity. There has been no constitutional convention and judicial decisions do not appear to have played an important role, perhaps because the tax powers being shared are modern ones. The last agreement on sharing tax powers was reached in October 2011 as part of the political bargaining to form a central government.

Canada

Canada is an older federation (1867). The Constitution was the result of a joint proposal following several meetings (1864-1867) akin to a constitutional convention, by the political leaders of three British colonies (Canada which regrouped Ontario and Québec, New Brunswick and Nova Scotia) adopted by the British parliament as the British North America (BNA) Act. The central government can levy any kind of taxes: article 91.3 gives it the power of *The raising of Money by any Mode or System of Taxation* while the provincial governments were restricted to direct taxes: article 92.2 states they can use *Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes*. A key judicial decision on the meaning of direct taxation allowed them to levy retail sales taxes in the 1930s⁵.

Amusingly enough, when the federal government chose in 1991 to replace a manufacturer's sales tax by a VAT, namely the Goods and Services Tax (GST), some provinces went to court to stop this, arguing this was a taxation field reserved for the provinces - they lost⁶. The only areas of taxation solely reserved to the federal government are custom duties and excise duties (as opposed to excise taxes). Thus in the case of Canada, it is a combination of constitutional provisions and judicial interpretation that determines tax powers.

³ For a brief outline of the steps beginning in 1970 see

http://www.belgium.be/en/about_belgium/country/history/belgium_from_1830/formation_federal_state/

⁴ A double majority: a simple majority in each of the linguistic groups and 2/3 of the linguistic groups together.

⁵ Privy Council decision of 1936 Attorney General of BC v Kingcome Navigation. A resolution was introduced in 1936 in the House of Commons by the federal government to amend section 92 of the BNA to make this power more certain. It was approved by the House but it was defeated in the Senate and thus not sent to Westminster.

⁶ See Supreme Court of Canada June 25th 1991 SRC 445

<https://www.lexum.org/en/1992/1992scr2-445/1992scr2-445.html>

Spain

The post-Franco constitution allowed provinces to unite into autonomous communities (AC) but restricted these communities to tax fields not occupied by existing units (municipalities, provinces, and central government). This left them with little tax powers; over time, political agreements led to ACs first to receive revenue collected in their territories by the central government from a subset of taxes and then to obtain some powers with respect to these taxes. Thus in this case political negotiations played a key role.

Switzerland

The Swiss confederation became somewhat more centralized following a civil war in the 19th century but tax powers have remained highly decentralized and jealously guarded by the cantons. It was only in 1934 that an agreement was reached on sharing direct (income) taxation with the central (confederation) government with the cantons retaining 30% of revenues on a derivation basis at that time. In 2004, the cantons for the first time in Swiss history⁷ initiated a referendum to defeat a proposed change in federal tax laws that would have reduced their revenues. Articles 126-135 set out the tax powers including the tax rates of the federal government. For example article 128 states:

1 The Confederation may levy a direct tax:

- a. of a maximum of 11.5 per cent on the income of private individuals*
- b. of a maximum of 8.5 per cent of the net profit of legal entities;*

2 The Confederation, in fixing the taxation rates, shall take account of the burden of direct taxation imposed by the Cantons and communes.

3 In relation to the tax on the income of private individuals, regular revisions shall be made to compensate for the consequences of an increased tax burden due to inflation.

4 The tax shall be assessed and collected by the Cantons. A minimum of 17 per cent of the gross revenue from taxation shall be allocated to the Cantons. This share may be reduced to 15 per cent if the consequences of financial equalisation so require.

One interesting aspect is that the access of the central government to the direct taxation field is subject to a time limit; it currently ends in 2020 (article 196-13 of the Constitution).

Hence in this case, precise tax powers are the result of an ongoing popular constitutional convention making decisions through a referendum mechanism.

⁷ <http://aceproject.org/ace-en/focus/direct-democracy/cs-swiss>

United States

The tax provisions of the Constitution have been subjected to numerous reviews by the courts over time⁸. On one hand section 8, clause 1 states that (the central government) *The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States*, while on the other section 9, clause 4 states that *No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken*. Because of this clause and its interpretation by the Supreme Court, it was felt necessary to base the personal income tax on a constitutional amendment (XVI introduced in 1913): *The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration*⁹.

States are prohibited from taxing international trade (section 10, clause 2) and inter-state trade through a judicial interpretation of the Commerce clause (section 8, clause 3). Thus in this case, the courts played a key role in broadening central government taxation with a key issue (similar to the case of Canada) being the interpretation of the term direct taxes.

2.3 An assessment

It is not feasible to assess if the two principles outlined above were used or not in the process that led to the tax sharing processes described above. But the answer for the older federations is most likely no, with issues of interpretation of imprecise terms such as direct taxes playing a greater role. In the more recent federation, political bargains with the macro dimensions dominating the discussions seem to have occurred.

3. ASSIGNING AND DEFINING TAX BASES

3.1 Principles

The following principles seem to be appropriate:

1. Constituent units should not be allowed to levy custom duties. To allow this would negate the national control of international borders, a key aspect of sovereign states, and would be difficult to administer in practice. It could also lead to border constituent units setting duties to gain from imports mainly used in other constituent units¹⁰.
2. Constituent units should not be allowed to tax trade between constituent units. To allow this would in some sense put within country trade on the same footing as international trade which is subject to national duties. This goes against the

⁸ See the relevant discussion in <http://www.law.cornell.edu/anncon/>

⁹ Even though a similar tax had been used to finance the Civil War.

¹⁰ We know of only one country, Tanzania, where this behavior is in practice allowed with the rates of some custom duties levied in Zanzibar differing from those in the mainland (in 2007).

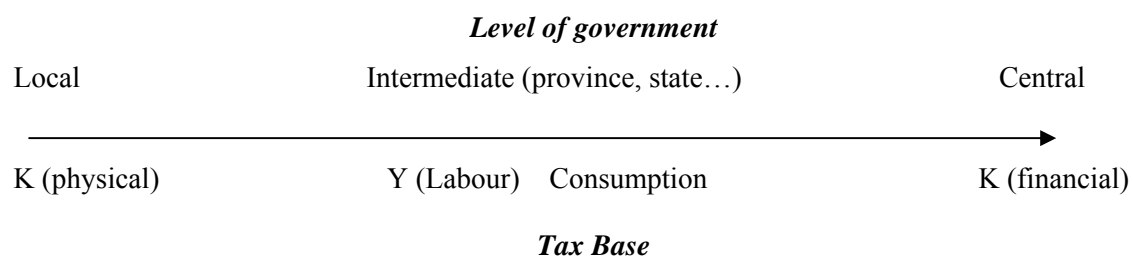
notion of a single country and a single market that is one of the aims of federal states.

3. Natural resources such as energy should be taxed at the central level to avoid inefficient labour mobility associated with rent seeking behavior linked with either lower taxes or higher provision of goods and services by the constituent units where the resources are located.
4. Given the preceding three principles, the taxation of capital (K: stock and income), consumption and labour income should take into account the geographic area of units at various levels of governments and the geographic mobility of the tax bases. Figure 1 outlines this relationship.

There are three standard ways of sharing tax bases: full autonomy by constituent units within constitutional/legal parameters; subnational surcharges on a common base with tax rates set by the constituent units; and sharing of tax revenues between the central government and subnational governments. These approaches differ in the degree of fiscal autonomy they provide to subnational governments, the ease of compliance and administration, the fairness and neutrality they are likely to produce, and the degree of inter-jurisdictional redistribution they can accommodate.

The first approach uses independent subnational legislation; subnational governments choose the taxes they levy and define their tax bases and as a consequence set the tax rates and administer the taxes.¹¹ This is the approach followed in Canada (although with some central government collection of the provincial Personal Income Taxes (PIT) and Corporate Income Taxes (CIT) Switzerland, and the United States. Choices are subject only to general constitutional or legal limitations. This approach can lead to high complexity of compliance and administration. This can occur if neighbouring jurisdictions choose different taxes (for example, if some levy retail sales taxes, but others levy VATs as is the case in Canada) or define their tax bases in different ways (as in the case of state CITs in the United States). Economic distortions can also occur if the tax systems of various subnational constituent units do not mesh, resulting in gaps or overlaps in taxation. These problems differ in importance from tax to tax; they can be tolerated if their costs are smaller than the benefits of decentralized government thus gained. Costs can be minimized through inter-governmental agreements among subnational constituent units or the imposition of national rules by a higher level of government on, for example, the definition and the allocation of the corporate income tax base.

¹¹ Subnational constitutions or laws may limit any of these, but self-imposed restrictions in the constitutions of subnational governments differ from restrictions imposed from above by law or as part of a national constitution.

Figure 1: Relationship between levels of government and tax bases

Note: tax bases are ordered from lowest to highest mobility while levels of governments are ordered by increasing size

A second approach is subnational surcharges. Under this approach, a higher level of government defines the tax base and collects both its own tax and surcharges set by subnational constituent units. If subnational units set no tax rates (thus zero), no income is collected. This approach avoids the problems that occur when different subnational jurisdictions define the tax base in conflicting ways, use different apportionment formulas, and administer the tax in different ways. Because of their power to set surcharge rates, subnational constituent units retain the most important attribute of fiscal sovereignty in the tax field. The ability to define the tax base and administer taxes is less important. A problem does exist, though, with providing incentives for the central government to collect a tax that it does not keep and, indeed, of trusting it not to keep the revenues it ostensibly collects for subnational constituent units. This is the approach in place in Belgium, while a variant has been used in Spain since 2011; such an approach was used de facto in Canada until 2000 for nine out of ten provinces.

The third approach, tax sharing, is akin to a transfer. Under this approach subnational governments receive fixed fractions of revenues from specific national taxes originating within their boundaries. The sharing rates are usually uniform across jurisdictions but often differ across taxes. Individual subnational constituent units do not have the power to alter the amount of revenue they receive from shared taxes. Although all subnational governments, acting as a group, can attempt to influence their share of revenues from these taxes, no subnational government, acting unilaterally, can hope to do so unless it is very large in a demographic, economic or political sense.

Finally, we should address the issue of tax base interactions. This occurs when the amount paid by a taxpayer for one tax affects the amount of another tax. For example, payroll taxes are usually a deductible expense in the calculation of corporate income and thus of corporate income tax. This also holds for natural resource royalties and in some cases taxes are levied on other taxes usually implicitly but sometimes explicitly.

3.2 The practice

Belgium

The regions of Belgium have access since 1989 to some own taxes and since 2002 to both own taxes and surcharges. The VAT and the CIT are solely central taxes while the regions can vary slightly the PIT rate but without changing the overall

progressivity. They fully control taxes such as amusement and gambling taxes and set the rates of the inheritance tax with some control over its base (Verdonck, 2010). Changes have been negotiated in 2011 but their implementation is not done as of February 2012.

Canada

Canadian provinces have access to own taxes such as the PIT, the CIT, VAT type (QST or HST) or retail sales taxes, as well as excises (tobacco, alcohol, fuel, ...), and payroll taxes. They can set the bases, the rates and collect them. In 2011:

- Nine provinces use the federal PIT income as their tax base and thus have the federal government collect it for them;
- Eight provinces have the federal government collect their CIT;
- Five¹² provinces use the Harmonized Sale Tax, a VAT with one rate split between Ottawa and the provinces with each province setting its own rate and the collection done at the federal level. Three provinces levy a RST, one (Québec) levies its own VAT (the QST) and collects the GST for the federal government, and one levies no consumption tax¹³.

Thus there is de facto harmonization of bases through collection agreements. Such a situation can be explained in part by the 1942 Wartime Tax Agreements (the so-called “tax rental” agreements) by which the provinces surrendered (“rented”) all rights to impose three taxes to the federal government in exchange for fixed annual payments.¹⁴ Such an outcome agreed with the recommendations of the Royal Commission of Dominion-Provincial Relations (commonly called the Rowell-Sirois Commission) that reported in 1940 and recommended, in order to avoid issues that arose from the Great Depression, that taxing powers and debt be centralized.

The PIT base was progressively shared after WWII, as shown in Table 1. One determinant of the shares shown in that table was that “opting-out” (also referred to as “contracting-out”) was introduced in 1964. What this meant was that provinces that wished to do so would have a reduced federal PIT in lieu of transfers, provided they agreed to maintain the same programs as those financed by transfers. Only Québec proceeded to “opt-out” with the result that the federal income tax imposed in that province is lower than that imposed in the “rest of Canada” (ROC). Opting-out does not increase or decrease the revenues of Québec since transfers are reduced by an equivalent amount. It does, however, allow Québec to reflect its own preferences in tax matters over a greater share of personal income than other provinces (Lachance and Vaillancourt, 2001).

Payroll taxes and resource royalties, two sources of revenues for provinces, are deductible in the calculation of the federal CIT. Hence an increase in provincial payroll taxes reduces federal revenues while increasing its spending, since by

¹² The results of a mail-in referendum held in early August 2011 were released on August 26th. The HST was rejected by a margin of 55% to 45%. As a consequence, a combined PST+GST should again be in place in April 2013.

See http://www.theglobeandmail.com/news/national/british-columbia/gary_mason/hst-defeat-brings-back-harder-edge-of-bcs-protest-politics/article2144389/ and <http://www.fin.gov.bc.ca/pst-return.htm>

¹³ See Bird and Gendron (2010) for more on this

¹⁴ Succession duties (inheritance taxes) were also included in these arrangements. The disappearance of death taxes as a result of inter-provincial tax competition in Canada following their abolition at the federal level is discussed in Bird (1978).

convention¹⁵ the federal government pays such taxes. Also of interest is that Québec's VAT (QST) is levied on the sales price + the federal GST; thus a change in the GST rate directly affects QST revenues.

Table 1: Personal Income Tax (PIT) Revenues in Canada selected years 1947-2000

	Total PIT (\$millions)	Federal % of PIT	% Federal in Québec	% Federal R.O.C. ^b	PIT as % GDP	% PIT ceded-ROC	% PIT ceded - Québec
1947 ^a	660	100.0%	100.0%	100.0%	5.4%	5	5
1952	1,225	100.0%	100.0%	100.0%	5.5%	5	5
1954	1,309	98.1%	n/a	100.0%	5.6%	10	10
1957	1,676	97.6%	n/a	100.0%	5.6%	10	10
1962	2,378	84.9%	83.5%	87.0%	6.2%	13	13
1967	5,112	71.4%	55.9%	75.8%	7.3%	28	52
1972	11,385	69.3%	50.7%	75.8%	10.3%	30	54
1977	23,656	60.4%	40.6%	69.0%	10.7%	39	55
1982	43,932	58.6%	38.1%	66.8%	11.6%	39	55
1987	70,333	59.3%	41.4%	66.0%	12.6%	39	55
1992	101,226	58.7%	43.0%	64.1%	14.5%	39	55
1997	120,956	60.6%	47.8%	64.5%	13.8%	39	55
2000	143,514	62.4%	48.4%	65.4%	13.6%	39	55

SOURCE: Bird and Vaillancourt, 2006.

Notes: a. Figures for year ending December 31.; b. ROC is Rest of Canada without Québec

Finally, one aspect of tax base sharing appears unique to Canada. The provinces operate provincial or regional (five in total) lotteries. The lotteries pay an annual amount to the federal government in exchange for it agreeing not to operate a national lottery; provincial lotteries were initiated in 1970 in Québec while Lotto-Canada existed from 1976 to 1979.

Spain

Spanish ACs operate under two tax regimes; the foral regime for the Navarra and Basque ACs and the common regime for the other fifteen ACs. Our discussion is focused on the common system. ACs do not levy a VAT or a CIT. ACs have access to 50% of the PIT base. Until 2010, they could set their own rate or by doing nothing see the central government rate used; since 2011 they must set a rate. They also have rate setting powers with respect to death and gift and gambling taxes (base setting also).

Switzerland

Swiss cantons levy their own PIT and CIT along with other taxes while the VAT is a federal tax. They collect the federal PIT and CIT. Gilardi et al (2010) note that the only limitation to cantonal tax autonomy is a provision in the federal constitution stipulating that the tax burden on the taxpayer should be commensurate with his or her economic capacity. This, along with a 2006 federal court decision prohibiting a

¹⁵ Article 125 of the Constitution states that: *No Lands or Property belonging to Canada or any Province shall be liable to Taxation.* The federal government pays the equivalent of property taxes through Payments in Lieu of Taxes (PILT) <http://www.tpsgc-pwgsc.gc.ca/biens-property/peri-pilt/index-eng.html>

regressive personal income tax schedule put forward by the canton of Obwalden, precludes a declining tax rate schedule. Also, pursuant to article 129 of the Constitution, federal legislation that took effect in 1993 aimed at harmonizing the cantonal PITs, the cantons were given a transitory period of eight years to adapt their tax laws to the new standard set out in the federal law. A significant amount of tax harmonization was achieved at the end of 2000.¹⁶ This harmonization means cantons must levy some taxes (article 2 of federal law: income and wealth taxes on individuals, profits and capital taxes on corporations); but since rates are not bound by a minimum, this is a weak constraint. Both the confederation and the cantons use a common tax base and a common list of tax exemptions/ deductions; however, the amount of each deduction/exemption is set independently by the confederation and each canton. There is no requirement for a harmonization of rates.

United States

American states can levy their own PIT and CIT as does the federal government; they also levy RST (VAT is not used) while the federal government does not levy a goods and services tax. They also levy various excises and payroll taxes. States collect their own taxes. There has never been federal collection of state taxes in the USA; for the PITs this was offered from 1972¹⁷ to 1990¹⁸ (see Stolz and Purdy, 1977) for a discussion of this proposal). The first state PIT and CIT were levied in 1911 in Wisconsin (Cordes and Juffras, 2012; Brunori, 2012).

3.3 An evaluation

One can distinguish here between the old (Canada, Switzerland, USA) and new (Belgium, Spain) federations. In the old federations, the distribution of tax powers does not respect the principles outlined above. In particular, the taxation of corporate income at the subnational level is not a recommended outcome. Attempts are made to mitigate this by using allocation formulas to attribute national profits between subnational tax units. In the new federations, the powers of the subnational governments appear more in line with the principles outlined above but a bit weak; the recent reform in Spain requiring ACs to set their own tax rates for PIT are a welcome step. There is no reason why progressivity must follow a national norm.

4. TAX RATES

4.1 Principles

From the viewpoint of subnational fiscal sovereignty, the capacity to set rates is clearly the most important power to have. The choice of rates is what allows subnational governments to choose at least at the margin the level of public services. This power rather than the one to set tax bases minimizes the compliance costs associated with collecting the required revenues since too much subnational latitude in

¹⁶ Loi fédérale sur l'harmonisation des impôts directs des cantons et des communes (federal law on the harmonisation of cantonal and communal direct taxes)
http://www.admin.ch/ch/f/rs/642_14/index.html#id-8

¹⁷ This is a provision of the 1972 General Revenue Sharing Bill, modified by the 1976 Tax Reform Act (IRC 6361-6362).

¹⁸ See <http://www.fourmilab.ch/ustax/www/t26-F-64-E-6361-6365.html> for repeal details.

the choice of tax bases and in tax administration can create complexity and administrative and compliance burdens.

In this part of the paper, we focus on the personal income tax since it is in our opinion, the best tax for subnational constituent units given the mobility of tax bases and the type of services they provide.

4.2 The practice for the PIT

Belgium

The personal income tax is federal, but a positive or negative piggy-back tax can be used by the Regions. The Flemish Region is the only one to have used that possibility, through a lump-sum reduction of €125, introduced in 2006 for the tax year of 2008 (2007 income) for taxpayers with market incomes above €5,500 and below €21,000. If this income was above €21,000 and below €22,500, then this non-refundable credit was reduced by 10 cents for each additional euro, and thus tapered off at €22,250.¹⁹

This lump-sum amount increased over time reaching a maximum of €300 for 2009. For 2010 incomes (2011 tax collection), it was reduced to €125 for incomes between €5,500 and €17,250 with a 10% reduction applying to incomes above €17,250 and thus tapering off at €18,500²⁰. It has been abolished for income year 2011²¹. Two reasons appear to have motivated this: the need to reach budget equilibrium and the objection by the European Commission in October 2010 that such a reduction was discriminatory against non-resident workers. Rather than fight this, the lump-sum reduction was abolished²².

There are also regional investment incentives²³:

- The Win-Win loan from an individual to a Small or Medium Enterprise with both located in Flanders. The maximum loan is €50,000 for a maximum term of eight years; 2.5% of the loan (maximum €1,250) can be claimed as a credit against tax payable each year;
- Investments in the Caisse d'investissement de Wallonie with an annual reduction in PIT of 3.10% of the amount of bonds purchased with a maximum purchase of €2,500 (5x500);
- Loans between individuals for housing renovations up to €25,000 in Flanders with a 2.5% annual tax credit and a maximum loan period of 30 years.

So, overall, Belgian regions make little use of their limited tax rate setting powers. On October 11th 2011 an agreement has been reached by the various political parties on the sixth institutional reform but it has yet to be adopted by the Parliament.²⁴ One chapter of the agreement is dedicated to the increase in tax autonomy for the Regions. The most important federal grant to the Regions is withdrawn while the federal income tax is reduced by an equivalent amount, leaving tax room (about 25% of the base) for the Regions that they will need to use to maintain revenues through a piggy-

¹⁹ Moniteur Belge 26 09 2006 p 50043

²⁰ <http://fiscus.fgov.be/interfaoiffir/Sleutelformule/fc2010-0636.pdf>

²¹ <http://fiscus.fgov.be/interfafznl/fr/downloads/fc2010-0542-1.pdf>

²² http://ec.europa.eu/taxation_customs/resources/documents/common/infringements/factsheet/2010/10/2010-10-1403-be-tax-personal_regio_fr.pdf

²³ http://docufin.fgov.be/intersalgfr/thema/publicaties/memento/pdf/MF2011_V01_partie1.pdf

²⁴ http://www.lachambre.be/kvvcr/pdf_sections/home/FRtexte%20dirrupo.pdf

back tax. Regions may differentiate tax rates across tax brackets, but their autonomy is limited in order to prevent tax competition. The progressivity of the federal income tax may not be reduced by the regional piggy-back tax except if the value of the reduction in progressivity does not exceed 1000 euro per year and per taxpayer.

Canada

Canadian provinces make full use of their tax rate setting powers. We will illustrate this in some detail for the PIT. We do this for the post-2000 period since the federal government modified the PIT rules in 1999. Starting in 2000, provinces were required to set their own tax brackets and tax rates, moving from a “tax on tax” system where they levied surcharges using the federal brackets and rates to a tax on income system²⁵. We first examine the Canadian situation in 2008 (Guimond and Vaillancourt, 2010).

One can characterize a PIT system by either its formal or statutory attributes, or by its outcomes. The formal attributes are the number of steps in the tax schedule, the boundaries of such steps and the tax rates associated with each step. One outcome is the income tax payable at a given income level. We present information on both statutory aspects and outcomes of provincial PITs in Canada for 2008 in Table 2. We present information first for the nine provinces that use the Canada Revenue Agency to collect their PIT including the relevant mean, standard deviation and coefficient of variation. Information on Québec and the federal government follows for comparison purposes.

Table 2 shows that:

1. eight of the nine ROC provinces use from three to five brackets for PIT in 2008. Alberta has only one;
2. the minimum income for the first step up (2nd bracket) varies from \$29,591 to \$39,136. No province uses the federal step up value, with all except Saskatchewan below it;
3. the coefficient of variation (CV) for the first step up is smaller than the other two CVs. The province with the step up values closest to those of the federal government is surprisingly Québec;
4. the rate for the lowest bracket varies from 6.05 to 11%; this last rate for Saskatchewan is very close to that of its neighbouring province Alberta which uses a flat rate of 10%;
5. progressivity varies from province to province. Saskatchewan has the lowest progressivity of non-flat tax provinces and BC the highest;
6. the variation (CV) in the tax burden goes down as income goes up (from 0.10 to 0.06), indicating perhaps greater concern for tax competition and tax induced mobility as income goes up;

²⁵ Sometimes Referred To As Tax On Income Or Toni

7. effective progressivity measured by the ratio of the PIT for an income of \$200,000 / PIT for an income of \$5,000 does not vary much, being highest in the two distinct (non tax) societies of Québec (language) and BC (climate)²⁶;
8. for high income individuals, the highest tax burden is found in Québec and the lowest in Alberta; while for low income individuals, Manitoba has the highest and Alberta the lowest tax burden.

Table 2: Rates per bracket, progressivity of rates, income threshold for the 2nd and last bracket, and effective tax burden as % of income, provincial PITs, Canada, 2008

2008-Marginal tax rate (%) rate per bracket	First bracket	Second	Third	Fourth	Progressivity highest/lowest rate	Income threshold for 2 nd bracket	Income threshold for top bracket	PIT for 25000\$ income	PIT for 200000\$ income/ PIT for 25000\$ income	PIT for 200000\$ income/ mean PIT for this income
Newfoundland	8.2	13.3	16	n.a.	1.95	30216	60430	3242	23.0	101.7%
Prince Edward Island	9.8	13.8	16.7	n.a.	1.70	31985	63970	3483	22.3	109.3%
Nova Scotia	8.79	14.95	16.67	17.5	1.99	29591	93001	3322	23.5	104.2%
New Brunswick	10.12	15.48	16.8	17.95	1.77	34837	113274	3464	22.3	108.7%
Ontario	6.05	9.15	11.16	n.a.	1.84	36021	72042	3132	23.7	98.2%
Manitoba	10.9	12.75	17.4	n.a.	1.60	30545	66001	3622	21.2	113.6%
Saskatchewan	11	13	15	n.a.	1.36	39136	111815	3097	23.2	97.1%
Alberta	10	10	10	10	1.00	flat	flat	2670	24.2	83.8%
British Columbia*	5.06	7.7	10.5	12.29	2.9*	35017	97637	2659	25.9	83.4%
Statistics for nine provinces										
Mean	8.88	12.24	14.47	14.44	1.79	33419	95561	3188	23.1	-
Standard deviation	2.10	2.68	3.02	3.92	0.52	3365	16582	341.3	1.3	-
CV	0.237	0.219	0.209	0.271	0.289	0.101	0.174	0.107	0.6	-
Québec	16	20	24	n.a.	1.50	37501	75 001	3174	25.2	-
Federal	15	22	26	29	1.96	37886	123185	1935	24.1	-

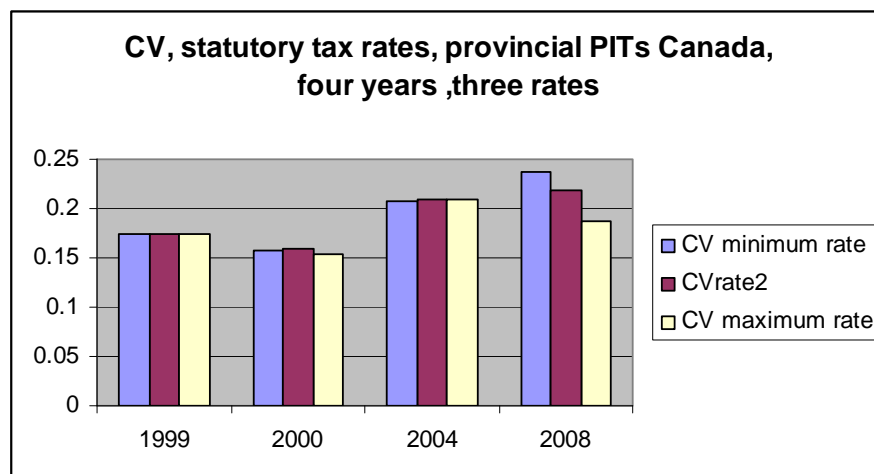
SOURCE FOR TABLE 3: Guimond and Vaillancourt, 2010 CV Coefficient of variation =standard deviation/mean.

Note: * the rate for the fifth bracket in British Columbia is 14.7%; n.a not applicable as no bracket and thus no such rate

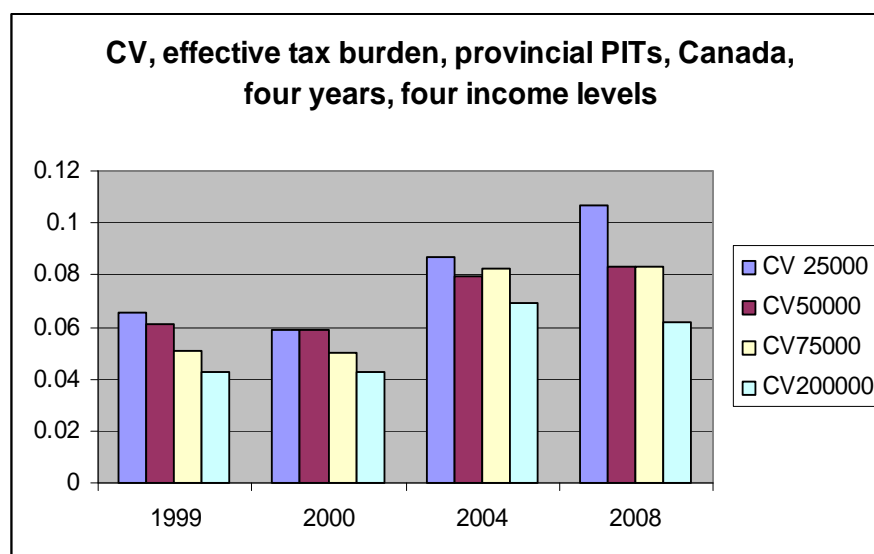
How one reached the situation of 2008 can also be of some interest.

Figures 2 and 3 present the evolution over four years of the statutory tax rates and effective tax burdens for Canada. Both figures show higher CVs in 2008 than in 1999. Thus it appears that tax rate setting freedom allowed provinces to express their differing preferences for various degrees of progressivity more clearly as the time period over which this freedom was available lengthened.

²⁶ Tax wise Alberta with no provincial goods and services tax and a flat provincial PIT is the most distinct province

Figure 2

SOURCE: Guimond and Vaillancourt, 2010 Chart 2. The CVs are for the minimum, the second and the highest statutory rate.

Figure 3

SOURCE: Guimond and Vaillancourt, 2010, Chart 3. The CVs are for incomes of \$25,000, 50,000, 75,000 and 200,000.

Spain

The ACs have been able to offer various tax credits and to modify their tax rate on their share of the PIT since the 1990s. However, the tax rates established by the ACs must follow the same progressivity pattern as those of the central government and they must use the same number of brackets. But establishing a surcharge can circumvent this. Also, they may only establish tax credits in certain areas or for certain items: family and personal situation of tax payers, non-entrepreneurial investments and donations or gifts (Ruiz Almendral and Vaillancourt, 2006).

For 2011, four ACs (Andalusia, Asturias, Catalonia, and Extremadura) implemented PIT rates different and higher than the central ones. For example, in Catalonia, the community tax rate will increase to 23.5% for income between €120,000 and €175,000 and to 25.5% for income over €175,000. Andalucía has raised its community tax rate to 22.5% for income between €80,000 and €100,000 and to 23.5% for income between €100,000 and €120,000²⁷.

Ruiz Almendral and Vaillancourt (2006) presents the use of various tax credits by the ACs in 2005. We summarize it in Table 3.

Table 3 Main tax credits, Spanish autonomous communities, 2005

AC	Child related	Age related	Disability	Housing purchase	Entrepreneurial start-up	University attendance
Andalusia	√ BB	√	√	√	√	
Aragon	√ BB					
Asturias		√		√	√	
Balearic	√ CC	√	√			√
Canarias						√
Cantabria	√					
Castilla la Mancha						
Castilla leon	√ AR+BB+CC		√ 65+			
Catalonia	√ BB			√		√
Extramadura				√		
Galicia	√ AR+BB					
Madrid	√ BB	√	√			
Murcia	√ CC			√		
La Rioja	√ BB			√		
Valencia	√ AR+BB		√ 65+	√		

Notes: AR: Annual reduction; BB: baby bonus; CC: Child care expenses

Source : Ruiz Almendral and Vaillancourt (2006) table 6

Switzerland

Swiss cantons have full autonomy in setting their tax rates. Table 4, derived from Gilardi et al (2010), shows the result of this for the PIT for two income levels. As the table illustrates, effective marginal tax rates vary substantially within each income level. For married individuals with an income of 50,000 CHF, tax rates range between 1% and 4%. Results not shown here indicate a tighter range at the 25,000 income level (0-2.1%) The tax rates vary more widely for higher income levels too. For individuals with annual incomes of CHF 200,000, the tax rate was slightly more than 4% in

²⁷

https://outlook.umontreal.ca/exchweb/bin/redir.asp?URL=http://www.fitchratings.es/adjuntos/382_fitc_h_-spanish_autonomous_communities_-_2011_draft_budgets.pdf
<https://outlook.umontreal.ca/exchweb/bin/redir.asp?URL=http://www.euroweeklynews.com/money/ask-the-expert/tax-hikes-for-wealthy-in-spains-2011-budget.html>

Schwyz, Zug, and Obwalden, but the rate was more than 12% in Glarus, Geneva, and Neuchâtel.²⁸ One should note that this neglects communal taxation of income.

Cantons also differ greatly in the progressivity levels of their tax rates, that is in the differences between tax rates for different income categories. The last column of Table 4 displays the ratio of the tax rates for annual incomes of CHF 200,000 and CHF 50,000, again from Gilardi et al (2010). On average, the tax rate for an annual income of CHF 200,000 is 3.43 times higher than the tax rate for an annual income of CHF 50,000. Basle-Country, Ticino and Geneva have the most progressive tax systems with a ratio above 6. Obwalden is the canton with the lowest progressivity with a ratio of just 1.68.

Table 4 Cantonal effective marginal PIT rates for a married childless individual, two income levels (CHF), Switzerland, 2007

Canton	50 000	200 000	Ratio of two rates
Zurich	1.93	5.74	2.97
Berne	3.78	11.15	2.95
Lucerne	2.70	6.70	2.48
Uri	2.64	11.34	4.29
Schwyz	1.81	4.24	2.35
Obwalden	2.57	4.31	1.68
Nidwalden	1.90	5.41	2.84
Glarus	5.34	12.46	2.34
Zug	1.20	4.30	3.58
Fribourg	3.74	9.48	2.54
Solothurn	2.67	7.71	2.89
Basle-City	3.21	8.94	2.78
Basle-Country	1.58	9.51	6.01
Schaffhouse	2.84	7.16	2.52
Appenzell Outer-Rhodes	2.76	6.28	2.28
Appenzell Inner-Rhodes	2.11	5.32	2.52
St. Gall	2.23	7.01	3.15
Grisons	2.12	7.64	3.60
Aargau	1.81	7.25	4.00
Thurgau	1.68	6.62	3.93
Ticino	1.23	7.83	6.35
Vaud	2.97	11.21	3.78
Valais	2.91	7.54	2.59
Neuchâtel	3.66	13.33	3.64
Geneva	1.61	13.17	8.17
Jura	3.71	10.71	2.88
Mean	2.577	8.17	3.43

SOURCE: Gilardi et al. (2010)

²⁸ Wealthy foreigners with residency but no occupation in Switzerland can apply for lump-sum taxation, which is typically very advantageous and also varies between cantons. In February 2009, the electorate of the canton of Zurich abandoned this tax practice in a referendum. Other cantons might follow.

How stable are these tax rates or put differently is there a race to the bottom? Gilardi et al (2010) find that:

- For low incomes there has been convergence towards a lower taxation level, or, in other words, a race to the bottom.
- For high incomes the majority of cantons decreased tax rates but a significant number of cantons increased tax rates since 1990. Hence, convergence towards a lower level of taxation did not occur.

United States

American states decide to levy or not a PIT and if they do, set the steps, rates, credits and so forth. We present evidence on their choices in Table 5. One should note:

1. The use by 43 states of a PIT with 41 levying it on a broad base and two(New Hampshire and Tennessee) only on interest and dividend income (Cordes and Juffras, 2012);
2. The non-use by seven American states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) of the PIT;
3. The wide use by the 41 broad base states of federal AGI (Cordes and Juffras, 2012); only five start off using their own definition of income. This last point is noteworthy, given as noted above that there has never been federal collection of state PITs in the USA;
4. The use by seven states of a flat tax rate on a broad income base;
5. The variation in the number of brackets from 1 to 10 and in the bracket.
6. The variability in tax rates - either minimum or maximum, with a CV of 0.64 and 0.63.

Cordes and Juffras (2012) report that as a consequence of the Great Recession, some states increased their income tax rates or broadened their base, but some also increased the threshold above which the highest rate applies.

4.3 An assessment

One sees a large variation in the use of subnational tax powers:

- Regions of Belgium use very little of the freedom they have. One wonders if the European Commission request was a sensible one or not;
- ACs of Spain use their powers more and more over an increasing share of the PIT; this increase may make this use more interesting;
- provinces, cantons and states fully use their tax rate setting powers in Canada, Switzerland and the USA. There is little evidence of a race to the bottom result.

There is little evidence that restricting subnational governments to using national progressivity is appropriate.

Table 5: # of brackets, first and highest statutory tax rates and threshold income to highest rate, American states PIT, 2008

State	No. of Brackets	First tax rate (%)	Highest tax rate (%)	Threshold income to highest rate
Alabama	3	2.00	5.00	\$3,000
Alaska	n.a.	no PIT		n.a.
Arizona	5	2.59	4.54	\$150,000
Arkansas	6	1.00	7.00	\$30,000
California	7	1.00	10.30	\$1,000,000
Colorado	1	4.63		n.a.
Connecticut	2	3.00	5.00	\$10,000
Delaware	7	2.20	5.95	\$60,000
Florida	n.a.	no PIT		n.a.
Georgia	6	1.00	6.00	\$7,000
Hawaii	9	1.40	8.25	\$48,000
Idaho	8	1.60	7.80	\$23,963
Illinois	1	3.00		n.a.
Indiana	1	3.40		n.a.
Iowa	9	0.36	8.98	\$60,435
Kansas	3	3.50	6.45	\$30,000
Kentucky	6	2.00	6.00	\$75,000
Louisiana	3	2.00	6.00	\$50,000
Maine	4	2.00	8.50	\$18,950
Maryland	7	2.00	5.75	\$200,000
Massachusetts	1	5.30		n.a.
Michigan	1	4.35		n.a.
Minnesota	3	5.35	7.85	\$69,990
Mississippi	3	3.00	5.00	\$10,000
Missouri	10	1.50	6.00	\$9,000
Montana	7	1.00	6.90	\$14,899
Nebraska	4	2.56	6.84	\$27,000
Nevada	n.a.	no PIT		n.a.
New Hampshire	1	5.00		n.a.
New Jersey	6	1.40	8.97	\$500,000
New Mexico	4	1.70	4.90	\$16,000
New York	5	4.00	6.85	\$20,000
North Carolina	4	6.00	7.75	\$120,000
North Dakota	5	2.10	5.54	\$349,700
Ohio	9	0.649	6.555	\$200,000
Oklahoma	7	0.50	5.50	\$8,700
Oregon	3	5.00	9.00	\$7,150
Pennsylvania	1	3.07		n.a.
Rhode Island	5	3.75	9.90	\$349,700
South Carolina	6	0.00	7.00	\$13,150
South Dakota	n.a.	no PIT		n.a.
Tennessee	1	6.00		n.a.
Texas	n.a.	no PIT		n.a.
Utah	1	5.00		n.a.
Vermont	5	3.60	9.50	\$349,700
Virginia	4	2.00	5.75	\$17,000
Washington	n.a.	no PIT		n.a.
West Virginia	5	3.00	6.50	\$60,000
Wisconsin	4	4.60	6.75	\$142,650
Wyoming	n.a.	no PIT		n.a.
D.C.	3	4.00	8.50	\$40,000
Federal	6	10.00	35.00	\$178,850
Average (%) 50 states	4.93	2.96	7.72	118606.58
Std Dev 50 states	2.28	1.90	4.85	190956.94

SOURCE: Tables 5 and 6, Guimond and Vaillancourt, 2010

5. TAX COLLECTION

5.1 The principles

The following factors play or should play a role in determining what level of government collects a given tax:

1. What government originated the tax? In general the level that originated the tax will collect it and even if it is later shared with other levels they may still collect it;
2. What is the degree of trust in financial matters between levels of governments? Can one level of government be trusted to remit amounts collected on behalf of another? This type of issue is particularly relevant in a single treasury system as in France;
3. What are the administrative costs of one or another arrangement? Are there economies of scale or scope with information cross-checking increasing revenues and reducing tax evasion?
4. What are the compliance costs associated with various administrative arrangements?

Overall, one wants a set of arrangements that minimizes administrative and compliance costs for an agreed to level of autonomy.

5.2 The practice

Belgium

Most taxes are collected free of charge by the central government with little debate on this point.

Canada

The PIT is collected free of charge by the federal government for nine provinces; Québec collects its own PIT. Over time collection arrangements have evolved to give more freedom to provinces in expressing their tax preferences. Québec which replaces \$ for \$ federal transfers by more tax room has a more child friendly PIT than ROC.

The CIT is collected free of charge by the federal government for eight provinces; Alberta and Québec collect their own.

The collection arrangements for the general tax on goods and services are:

- A Harmonized Sales Tax composed of the federal GST and a provincial equivalent with a provincially set rate is collected free of charge by the federal government in five provinces: British Columbia, Ontario, New Brunswick, Nova Scotia and Newfoundland;
- The federal GST and the provincial QST are collected by the Québec government with a payment of collection costs by the federal government;
- A provincial sales tax is collected by the province in Prince Edward Island, Manitoba and Saskatchewan.

All other provincial taxes (excises...) are collected provincially.

Spain

All major taxes are collected by the central government with when relevant no costs to autonomous communities.

Switzerland

All cantonal taxes are collected by the cantonal governments who also act as tax collectors for the central government for direct taxes (article 128 of the Constitution); they do not collect the VAT or other consumption taxes. Communes are responsible for collecting their own taxes but can pay cantons to do this for them.

United States

States collect their own taxes as does the federal government; there are no collection agreements or arrangements between levels of government.

5.3 An assessment

Arrangements range from central control to full autonomy with various forms of cooperation in between. There does not appear to have been studies of the optimal arrangements. We would argue that an independent agency jointly owned/managed by both levels of government would probably be the best combination of autonomy and low administrative and compliance costs.

6. CONCLUSION

We have shown above a fair amount of diversity in tax arrangements across five federations: two new ones and three old ones.

Tax arrangements were shown to be determined by a mix of constitutional conventions, legal decisions and political bargaining. Older federations showed a larger role of legal decisions in the allocation of tax bases than younger ones. These older federations also have a misallocation of capital taxation at the sub national level, reflecting the lower mobility of this factor at the inception of these federations.

Adapting constitutions to modern capital movements can be difficult as the recent ruling of the Supreme Court of Canada confirming the provincial jurisdiction over Securities and Exchange Commissions shows²⁹.

A recent(2000+) change in federal financial arrangements has been the greater role subnational governments in the taxation of personal income, the tax base most closely related to the public outputs they produce .This is the case in Belgium (2011), Canada(2000) and Spain (2010) as well as Scotland(2012) .While constituent units may prefer to spend the taxes levied by others and received by them as transfers , requiring them to be exercise more responsibility in setting rates and thus tax burdens increases their accountability to their electorate.

Finally it appears that diversity in the tax behaviour of constituent units even as extreme as that found in the USA does not appear to cause harm to federal states. Thus some diversity in the tax behaviour in major tax fields such as the personal income tax could be appropriate for Australian states.

²⁹ See REFERENCE RE *SECURITIES ACT*, 2011 SCC 66
<http://scc.lexum.org/en/2011/2011scc66/2011scc66.html>

APPENDIX - BASIC COMPARISON OF SIX FEDERAL STATES, 2008

	Australia	Belgium	Canada	Spain	Switzerland	USA
Population	21 015 690	10 516 660	33 316 000	44 310 870	7 583 861	304 228 300
Land mass	7 692 024	30 528	9 984 670	505 992	41 277	9 629 091
Density	2.73	344.49	3.34	87.57	183.73	31.59
GDP US\$ PPP	831 247 090 050	377 861 664 400	1 300 243 994 930	1 434 159 454 650	329 853 279 130	14 369 400 000 000
GDP \$ per capita PPP	39 553,64	35 929,82	39 027,61	32365,86	43494,11	47232,29
Largest SNG population	6 984 172 (New South Wales)	6 161 600 (Flanders)	12 936 296 (Ontario)	8 046 131 (Andalucia)	1 295 800 (Zurich)	36 756 666 (California)
Smallest SNG population	219 818 (Northern Territory)	1 048 491 (Brussels-Capital)	139 451 (Prince Edward Island)	311 773 (Rioja)	15 400 (Appenzel Rhodes-Intérieur)	532 668 (Wyoming)
Population L/S	31.77	5.88	92.77	25.81	84.14	69.00
Highest SNG GDP pc*	48 724.35 (Northern Territory)	66 154.27 ³⁰ (Brussels-Capital)	65 819.43 (Alberta)	40937.53 ¹ (Madrid)	66 089.74 (Basel-City)	70 814.99 (Delaware)
Smallest SNG GDP pc*	30 179.53 (Tasmania)	24 864.21 ¹ (Wallonia)	26 945.06 (Prince Edward Island)	21 682.29 ¹ (Extremadura)	21 844.68 (Jura)	31 233.05 (Mississippi)
GDP L/S	1.61	2.66 ¹	2.44	1.89 ¹	3.03	2.27
% transfers to SNGs in central G budget	25.98	34.95	18.72	24.51	10.91	15.80 ¹
% transfers from central in SNGs budget	45.89	69.30	14.10	29.57	10.21	26.76
% highest transfers in SNGs budget	78.0 (Northern Territory)	65 Wallonia(2006)	28.8 (Prince Edward Island)	49.9 (Galicia)	58.6 (Uri)	47.69 (Louisiana)
% lowest transfers in SNGs budget	40.9 (Australian Capital Territory)	47 Brussels(2006)	7.7 (Alberta)	-0.59 (Balearic Islands)	17.8 (Geneva)	18.19 (Delaware)
Structure of SNG	6 States and 2 Territories	3 Regions % 3 linguistic communities	10 Provinces and 3 territories	17 Autonomous Communities (2 foral) and 2 autonomous cities	26 Cantons	50 States and 1 Federal District

Note: GDP per canton not available for Switzerland; personal income is used instead

Excluded from largest/smallest GDP and lowest/highest transfers: Canada: 3 territories; USA: District of Columbia; Spain: 2 autonomous cities, Community of Navarre and Basque Country.

SOURCES: OECD, Australian Bureau of Statistics, National Bank of Belgium, Department of Finance of Canada, Statistics Canada, Secretaría General de Presupuestos y Gastos de España, Secretaría de Estado de Hacienda y Presupuestos de España, Federal Department of Finance of Swiss, Federal Finance Administration of Swiss, US Census Bureau and Verdonck (2010)

³⁰ 2007 data

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Sharing Taxes and Sharing the Deficit in Spanish Fiscal Federalism

Violeta Ruiz Almendral¹

1. INTRODUCTION

The economic downturn occurring in Spain since 2008 has created different sources of stress for fiscal federalism. Among other things, the crisis has brought to the forefront the vast differences in income and indebtedness among Autonomous Communities as well as the unpredictable impact of the economic crisis on their financing system. It is now the subject of discussion among policy makers and analysts as to what extent the Central Government may limit indebtedness of Autonomous Communities or force them to increase their tax pressure (for example by modifying personal income tax rates) in order to curb the deficit. The underlying debate is whether the debt/deficit limits will end up promoting a re-centralization process of public spending first, and of authority later. It could be argued that the speed at which the decentralization process in Spain has developed has been too fast in order to be adequately “digested” by the institutions. A rebalancing of powers, taking into account the obvious centralization force of entering the European Union, cannot be completely ruled out.

This debate became more intense, and interesting, during the months of July through December 2011. Four legal or regulatory changes happened that have substantially transformed the framework of Spanish fiscal federalism in probably more ways than I will be able to convey in this short paper: first, in July the Government amended the Stability Act (a Law to curb the deficit) in order to establish a debt ceiling for the central government. Then, also in July the Constitutional Court decided on the constitutionality of the Stability Act, which had been contested since it was first approved, in 1997². Third, on September 2nd, 2011 article 135 of the Spanish Constitution was reformed in order to include a debt and deficit ceiling. Fourth, on September 28th the European Union approved a new set of regulations (the so-called *Six Pack*³), designed to make the Stability Pact substantially stricter⁴. Finally, on

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² Opinion 134/2011, of 20 July 2011 (all the Court’s Rulings are publicly available at www.tribunalconstitucional.es).

³ See: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm (access 16.11.2011).

⁴ I have dealt with this reform at: “Estabilidad Presupuestaria y Reforma Constitucional”. *Revista Española de Derecho Europeo* (Civitas), *Revista Española de Derecho Europeo*, March 2012 (forthcoming).

December 9th 2011, a reform of the Treaties was announced, which is bound to limit the deficit to a maximum of 0.5 per cent⁵.

Spain has undergone a complicated process of fiscal decentralization in a relatively short time span. From a fully centralized country in 1978, it was divided into seventeen Autonomous Communities by 1982. At the same time, an arduous process of regime change (from Franco's 1939-1975 dictatorship to the approval of a Constitution in 1978 and the entry in the European Union in 1986) brought about substantial legislative reform. This also meant introducing a new tax system.

From a fiscal federalism perspective, the high vertical fiscal imbalance (VFI) with which Communities started off in 1982 has been (partially) resolved by transfers (both conditional and unconditional) as well as mechanisms of sharing taxes. Since 1997 this includes sharing the personal income tax, what in practice means that Communities perceive a percentage (currently 50 per cent) of the revenue accrued in their territory and may also establish the tax rates to be applicable in their territory introduce new tax credits or increase/decrease those established by the Central government. Fourteen years on since that system, which was partially amended in 2002 and 2010, was implemented it is possible to assess its results from different perspectives: has VFI decreased? Have Communities become more fiscally responsible?

The aim of this paper is to present a frozen image of the current Spanish system of fiscal federalism, in light of the tensions that the economic situation, has brought about. With this purpose, I will first broadly offer an outline of how decentralized Spain actually works, and how the decentralization process was brought about. Then I will focus on how the financing system works for most Autonomous Communities. Finally, I will attempt a preliminary analysis of the recent constitutional reform. A main conclusion of this paper is that fiscal federalism in Spain is, in fact, a work in progress.

2. THE SPANISH “ESTADO DE LAS AUTONOMÍAS”

2.1 Becoming a Democracy

The existence of Spain as a country, was the result of a long process that combined several kingdoms. One important step towards the creation of Spain was the unification by marriage of the Kingdom of Castilla with the Kingdom of Aragón in the late 15th century⁶. More recently, on November 20th 1975 Francisco Franco (the last

⁵ There is no official draft version, but the EU fiscal draft has been leaked and can be found in these pages: <http://www.openeurope.org.uk/research/100112fiscalpactdraft.pdf>, access 16.01.2012), and here: <http://www.telegraph.co.uk/finance/financialcrisis/9026142/The-EU-fiscal-draft-treaty-in-full.html> (access 20.01.2012).

⁶ In the early 1700s, King Felipe V, with the so-called “Decretos de Nueva Planta,” abolished the political and administrative autonomy of Aragón, Catalonia, Mallorca and Valencia, in order to centralize and unify political power. It is interesting to note that the very special political and economic organization of the three provinces of the Basque Country and of Navarra, the “fueros,” partially survived this centralizing attempt by the Spanish kingdom. The reasons are linked to the support that these provinces provided to the King in his political conflicts. The special arrangement for these provinces allowed them to keep a wide range of autonomy, with a semi-independent fiscal authority that prevailed until the mid-1800s. Although they lost some of their political autonomy in the late 1800s, they kept a special fiscal

Spanish dictator in power since 1939), died. Three years later, on the 6th of December 1978, Spaniards voted in favour of as of 2011 the longest lasting Constitution in their history. On the first of January 1986, Spain became a Member of the European Union. In less than ten years, Spain was radically transformed.

A salient element of the Spanish transition towards democracy is that it took place without any major breakthrough or revolution. In fact, what happened in Spain was more what has been often called a “legal revolution”⁷, characterized by two elements:

First, the existing legal framework -the set of laws approved under the Franco regime, was taken as a departure point. There was a prevailing political will to achieve a maximum degree of consensus among Spain’s political and social forces. Following this principle of respect for legality, beginning in 1976, a government designated by the King of Spain (Juan Carlos I), still under the laws of the Franco regime, first initiated a series of legal reforms that made it possible to exercise previously prohibited political rights (among other things, the Communist Party was legalized) and, subsequently, held free elections under these new laws. Finally, in a third phase, the new Constitution was ratified.

A second element was the constitutional consensus: the political will to seek a maximum degree of consensus among the diverse political and social forces in Spain on the basic aspects of the process, an agreement not only on decision-making procedures, but on the decision themselves.

One of the challenges of the new democratic era was the regional question. Solving it was intimately linked to attaining democracy, as consensus could not be obtained without the nationalist or autonomist movements. A decentralization process would also make it harder for Spain to undergo changes that would result in a new dictatorship. Simply put, it is harder for a Coup d’Etat to be successful when power is substantially decentralized. As López Guerra put it “with the creation of regional governments in the autonomous communities, power centres independent of the majority party have developed. These help to establish the balance of power so necessary in a country like Spain, which has such scant democratic tradition”⁸.

arrangement that prevailed until Franco's Dictatorship, and that for Navarra and Álava even remained (to a certain extent) during that very centralized period.

⁷ See Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court”, in Andrew Le Sueur (ed.), *Building the UK's New Supreme Court: National and Comparative Perspectives*, 2004, pp. 149 et seq.

See also: López Guerra, L.: ‘The development of the Spanish ‘State of Autonomies’ 1978-1992. At: JJ. Kramer (Hrsg.): *Föderalismus zwischen Integration und Sezession*. Baden-Baden: Nomos Verlagsgesellschaft, 1993; and López Guerra, L.: ‘Regions and Nationalities in Spain: the autonomous communities’. At: G. Färber; M. Forsyth (hrsg.): *The Regions -Factors of Integration or Disintegration in Europe?*. Baden-Baden: Nomos Verlagsgesellschaft, 1996.

⁸ López Guerra, L.: “National and Regional Pluralism in Contemporary Spain”. At (R. Herr; J. H. R. Polt, Eds): *Iberian Identity, Essays on the Nature of Identity in Portugal and Spain*. Institute of International Studies, University of California, Berkeley, 1989, p. 28.

2.2 The Design and the Functioning of the “Estado de las Autonomías”

2.2.1 Deciding on a model

One of the main challenges to design a coherent decentralization system in 1975 was the fact that the intensity of regional identity differs greatly from one region of Spain to another. Article 2 of the 1978 Constitution even distinguishes between “regions” and “nationalities”. The difference between these terms is not always clear, but the fact that the Constitution uses these two words reflects that regional identity and sentiments regarding autonomy are stronger in some regions than in others. Historically, Catalonia and the Basque Country have most actively sought a higher degree of autonomy and political identity. In contrast, other regions such as Extremadura or Murcia have only later on shown a desire for greater political autonomy. This varying intensity of regional sentiments is clearly reflected in the type and strength of local political parties. In both Catalonia and Basque Country specifically nationalist regional political parties have won majorities in the respective community governments⁹. It is important to note that the Spanish case shows that it is not only political motivations, or economic incentives, that drive decentralization, but a number of closely intertwined factors¹⁰.

In this context, it was difficult to decide which was to be the final model of decentralization. The solution finally adopted was akin to an asymmetric federalism system, at least in its initial design. The Constitution met the challenge by not defining the new system, but by establishing a procedural framework instead. Thus, what the Constitution does is to establish an “optional autonomy system” (the so-called ‘*principio dispositivo*’) which entails the possibility of asymmetry, as it does not force decentralization¹¹.

Soon after the Constitution was ratified, almost all of the regions expressed a desire to obtain the higher degree of autonomy, seeking the same powers as those granted to Galicia, Catalonia and the Basque Country. Granting the higher degree to all regions at once would have necessitated the immediate creation of a federal system, and Spain’s administrative and political structure made that impossible or at least impractical. It took then three years, and an attempted *Coup d’État* in 1981 (23 February) for the political parties to finally agree on a regional structure for the country. Seven regions would immediately attain the higher degree of autonomy (Catalonia, Galicia, the Basque Country, Andalusia –which held a referendum to choose this- Valencia, the Canary Islands and Navarra. The other ten chose the lesser degree of autonomy.

⁹ Another significant feature of the Spanish political system is the coexistence in parliaments of both political parties organized nationwide and regional parties which are nationalist. Furthermore, there have always been separatist movements or parties that seek the total independence of the region-autonomy. See: López Guerra, L.: “National and Regional Pluralism in Contemporary Spain...cit. pp. 20 et seq.

¹⁰ See the sophisticated model proposed by León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autonòmics, 2007, pp. 59 et seq.

¹¹ López Guerra, L.: “El modelo autonómico”. *Revista Catalana de Derecho Público, Autonomies*, n. 20/1995, p. 171.

This process has given rise to a form of State that, albeit still not quite defined, probably falls, together with Belgium, Germany, Austria and the United Kingdom, into the category of a “decentralized State”. However, when one takes a closer look at the broad scope of decentralization in Spain and at the authority gained by the Communities over the past twenty years, one has to conclude that – and this has become quite a controversial issue – Spain is, in practice if not in legal form, a federal state¹².

One of the most important features of this model of State is its asymmetry. There are two reasons why the State of Autonomies is asymmetrical:

The first lies in the procedural framework established by the Constitution. The original idea of the framers of the Constitution was that some Communities with past experience of self-government should be given the opportunity to become fast laners from the beginning, while the rest would have to start by being slow laners. Hence the second transitional provision of the Constitution, which establishes fast access to autonomy for those Communities which had approved self-government statutes in the past (ie during the Second Republic). These were to be Catalonia, the Basque Country and Galicia, which had not only had brief access to autonomy in the years of the Republic but also had more or less in common a strong nationalist sentiment fuelled by the existence of different languages. In the end, however, seven Communities became fast laners: in addition to the aforementioned three, Andalusia, Navarra, Valencia and the Canary Islands adopted the higher level of autonomy. The other ten Communities remained with a lower level of autonomy until 2002, when they ‘caught up’ with the fast laners.

The second explanation for asymmetry lies in the recognition of the historic rights of some regions, enshrined in the first additional provision of the Spanish Constitution. This has resulted in the Basque Country and Navarra having a much greater level of authority, especially in fiscal matters. The first type of asymmetry can be categorized as *de facto* or *transitory*; it refers only to the initial process, but does not prevent all Communities from eventually gaining access to the same level of authority. The second type is embedded in the Constitution, and of a much more controversial nature.

2.2.2 The legal structure (and challenges) of the devolution process

The process by which Autonomous Communities were formed is relatively easy to explain. Certain groups of provinces, provided that they have common historical, cultural and economic characteristics, have the right to decide whether they want to become an AC (section 143 of the Constitution). If they decide to do so, they then have to choose which matters they want to be in charge of. In other words, this is autonomy “à la carte” or a “cheese platter” system.

¹² This has been a highly contested area among Spanish constitutional scholars. It has been pointed out that there is no general theory of what the “Estado de las Autonomías” is (in this regard Aja Fernández, E.: *El Estado autonómico. Federalismo y hechos diferenciales*. Madrid: Alianza Editorial, 1999, pp. 33 et seq). Furthermore, not only different countries, but also different fields –economics, political sciences, law- bestow different meaning to what the word *Federal* means and should entail. See: Beer, S. H.: “A Political Scientist’s View of Fiscal Federalism”; en: AA.VV. (Ed.: Oates, W. E.): *The Political Economy of Fiscal Federalism*. Toronto: Lexington Books, 1997, pp. 21 et seq.

In fact, the Constitution does not assign explicit authority to Communities, but affords them the possibility of taking authority over a group of matters listed in sections 148 and 149. It does, however, reserve special functions for the State. Thus, for example, the State is in charge of “regulating the basic conditions to ensure the equality of all Spaniards in the exercise of their rights and the fulfillment of their obligations” (Section 149.1.1^a), and is assigned exclusive authority for “coordination of the economy” (Section 149.1.13^a)¹³.

Despite the existence of two lists of areas of authority in the Constitution – those for Communities to choose from, and those for the State to undertake – the design does not end there, as section 149.3 establishes a series of provisions that could eventually change the actual distribution of authority. Thus, Communities may take on the authority not expressly assigned to the State by the Constitution and the State may take on the authority not taken on by Communities. In the case of a conflict over which tier should be assigned a given matter, the laws enacted by the State will prevail over the Communities. Lastly, section 149.3 establishes that the laws of the State will at any rate be supplementary to the Communities’ (eg in the case of legal gaps or loopholes, or where an AC’s regulation is incomplete or unclear). This last provision has been the object of much controversy, as the Constitutional Court has radically changed its interpretation to avoid its use as an indirect means for the State to retrieve authority from Communities. This change of the Court’s case law took place in Opinions 118/1996 and 61/1997.

The Constitution also allows the State to control Communities in some cases (eg Sections 150.3, 153 and 155). In practice, these provisions have never been invoked. Instead, the numerous conflicts have been solved – or are in the process of being solved – through politically negotiated agreements.

One relevant feature of the Constitutional design of the State is the strong role that the State is bound to play in the distribution of authority. This can be explained by the co-existence of the principle of autonomy and the principle of unity. They are both expressed in Section 2: ‘The Constitution is grounded on the indissoluble unity of the Spanish Nation... and guarantees and recognizes the right to autonomy of its regions...’. This apparent oxymoron has been the subject of many decisions of the Constitutional Court, which has repeatedly stated that it is within the unity of the State that autonomy can find its being.

From a legal perspective, Communities “assume” or take on their authority via a Statute of Autonomy (“*Estatuto de Autonomia*”)¹⁴, which acts as the supreme norm, or effective constitution, of each Community. Statutes have a legally complicated double status: they are both the maximum norm of a region and a Government’s law, as they are also subject to the Constitution (and to the Constitutional Court’s scrutiny). This double nature explains why a reform of a Statute needs to be approved both by the central Parliament and by the Autonomous Communities. In the case of “fast lane” Communities (those that accessed this status earlier), there must also be a referendum in the Community. Potentially, this system could have led to a fully asymmetrical

¹³ See Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 151-157.

¹⁴ Again, Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 152 et seq.

federal system. In practice, a completely asymmetrical system was never considered desirable, and a set of political agreements and laws contributed to *harmonize* the levels of authority of Communities. Today, all Communities have a similar degree of responsibility, the main differences lying in the financing systems (*foral* vs. *Common system*, as we will see). The result is a system very similar to a Federation.

Between 2006 and 2009 most Statutes of Autonomy were reformed. While most of the reforms merely reflected what already was a reality, in some cases the reforms have been highly contested. Such was the case of the Catalan Statute that was challenged before the Constitutional Court and was the object of severe political turmoil. On June 28th 2010, the Spanish Constitutional Court ruled that part of the Catalanian Statute of Autonomy¹⁵ is unconstitutional¹⁶. While from a formal perspective Catalonia has the same powers as the other Communities, it has traditionally played a leading role in the devolution process. This explains why many other Communities (such as Andalusia or Valencia) had reformed their Statutes partially following the Catalanian model. Their laws are also affected now. In a very long ruling (the longest ever in Spanish history, with almost a thousand pages), the Court struck down 14 of the 113 articles that the People's Party (PP) argued were unconstitutional, while reinterpreting a further 23 articles¹⁷.

Fiscal federalism, normally a contested area, was barely touched by the Court's Ruling. This is partly explained by the fact that the current financing model of Autonomous Communities, which entered into force in January 2010, via a Central Government law¹⁸, closely followed some of the provisions of the Catalanian Statute.

In effect, the Court has merely softened some sections of fiscal federalism, such as the obligation for the Centre to invest in Catalonia, or the obligation to transfer certain taxes, which according to the Court are within the authority of the Centre and cannot be unilaterally determined by Communities.

2.2.3 Institutional elements of the system: the roles of intergovernmental agreements, the Senate and the Constitutional Court

1. Bilateral and multilateral agreements have played a very important role in the assignment of authority. Multilateral agreements have coexisted with bilateral agreements and have served to greatly unify the policy competences of the Communities. The role of political agreements has also been very relevant in the process of allocation of resources between the different tiers of government. This is

¹⁵The Statute is available in English: http://www.parlament-cat.net/porteso/estatut/estatut_angles_100506.pdf.

¹⁶Note that the decision to strike down a Statute of Autonomy is unprecedented in Spanish Democracy, but then so are the rest of the elements surrounding it: a Court deciding with only 10 out of its 12 members, as one passed away and another (Pablo Perez Tremps) was recused, and one of the worst political rows in recent history. The Court was divided and had been unable to agree on a ruling for almost 4 years. Finally, in June 2010 the much expected ruling was approved by a majority of 6 to 4.

¹⁷As interesting as the list of articles annulled, or even more, are the areas that were declared valid, as some of them were also largely contested. Among other, the duty to know the Catalan language (sections 34 or 50.5) was merely softened by adding that it shall not imply a prohibition to use the Spanish language or an obligation to use Catalan.

¹⁸Ley 22/2009, de 18 de diciembre, por la que se regula el sistema de financiación de las Comunidades Autónomas de régimen común y Ciudades con Estatuto de Autonomía y se modifican determinadas normas tributarias.

quite a politicized issue in Spain that has been the cause of much stress between the state and some Communities (especially Catalonia and the Basque Country). There are two major types of agreements, which are closely related: agreement between different political parties and negotiations between the State and the Communities (both bilateral and multilateral).

The process usually unfolds as follows: First, a multilateral agreement between the State and all the Communities is reached. This is done in the Finance and Tax Policy Council (*Consejo de Política Fiscal y Financiera*), where the finance ministers of all Communities and the state are represented. Once an agreement has been approved, bilateral agreements with the state are signed. This is done in the “Mixed Commissions” (*Comisiones mixtas*)¹⁹.

This agreement system serves to give weight to the Communities’ opinions on the allocation of resources. It has been broadly criticized, however, for its lack of transparency, as the agreements take place behind closed doors and the results are only partially made public, which results in a restriction of democracy²⁰.

2. Autonomous Communities are represented at the Senate, which operates as a second Chamber that revises legislation. However, so far the Senate is only in theory a representative Chamber of the Communities. The main cause for this lays in two reasons: First, the fact that most senators are elected by universal suffrage from provincial voting districts, while only a minority (46 out of 253) are appointed by the Parliaments of the Autonomous Communities. Thus, according to section 69 of the Constitution and section 165 of the Law of General Elections (Organic Law 5/1985, June 19th), there are four Senators per Province that will be elected directly by citizens. Then, every Community may choose one Senator, plus one more for every million inhabitants in the Community. Second, the Senate has very limited powers in making State laws. One of the proposals on the Socialist government agenda when it entered into power in 2004 was the reform of the Senate. This was never attained. A strong Senate would promote multilateral action, and some Communities still prefer to relate to the centre on a bilateral basis. This is certainly the case for Catalonia and the Basque Country.

3. Finally, the rulings of the Constitutional Court have played, and still play, a significant role in the definition of authority in the Statutes of Autonomies²¹. Taking into account that the vast majority of the matters listed in the Constitution are actually shared between the Central Government and the Communities, it is not hard to

¹⁹ See J. Ramallo Massanet and J.J. Zornoza Pérez: “El Consejo de Política Fiscal y Financiera y las Comisiones mixtas en la financiación de las Comunidades Autónomas, *Papeles de Economía Española* 83 (2000).

²⁰ In fact, not all CPFF agreements are published (see a full list of those that are available at: <http://www.meh.es/es-ES/Areas%20Tematicas/Financiacion%20Autonomica/Paginas/Acuerdos%20del%20Consejo%20de%20Politica%20Fiscal%20y%20Financiera.aspx>).

See this argument, referring to the Canadian system but perfectly applicable to the Spanish case at: Smiley, D. V.: *The federal condition in Canada*. Toronto: McGraw-Hill Ryerson Limited, 1987, pp. 20 et seq; Cameron, D.; Simeon, R.: “Intergovernmental Relations and Democracy: An Oxymoron if There Ever Was One?”. AA.VV.: (Eds.: H. Bakuis; G. Skogstad): *Canadian Federalism: Performance, Effectiveness and Legitimacy*. Don Mills: Oxford University Press, 2002, pp. 278 et seq and 282.

²¹ Borrajo Inieta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 157 et seq.

imagine that this has been a source of permanent conflict between these two tiers of government. The Court, as the only body competent to resolve such conflicts, has undertaken a very important task in the evolution of the Statutes of Autonomies²². Of course this role has been reinforced by the “unfinished” nature of the different provisions regarding regional autonomy established in the Constitution, and by a certain ‘didactic’ tendency of the Court to fully explain and thus to clarify the rules governing the Statutes of Autonomies. Moreover, the Court has often ruled in favour of the Communities, which in the first years of the decentralized model was almost revolutionary in a country with such a long tradition of centralization²³. However, it is probably time that it played a secondary role in the shaping of the State of Autonomies, in favour of a stronger role for the Senate. At present, the following statement dating back to 1998 is still true: “it is becoming almost routine in Spain to discuss any Law of certain importance in two forums, a first debate in the Parliament, and a second, and decisive one, in the Constitutional Court”²⁴. In fiscal federalism matters, there have been many relevant Constitutional Court’s Opinions that have reinforced the Communities’ spending power, declared void AC taxes because they were similar to State or municipal taxes and asserted the right of Communities to establish taxes, provided they do so in matters that fall within their scope of competence²⁵.

2.3 Rethinking the model after the financial crisis?

The financial crisis has brought to the forefront different structural problems in the Spanish State of Autonomy, namely the growth of indebtedness in Autonomous Communities²⁶ and their inability to fully develop a sound revenue system by using the taxing powers that they have.

A recentralization of authority, an unthinkable idea until not long ago, has been proposed by different politicians, including those from the PP (People’s party), which now holds since November 2011 an absolute majority at the State level.

3. FINANCING AUTONOMOUS COMMUNITIES

There are currently two systems to finance Autonomous Communities, the “common system” and the “foral regimes” (also known as “cupo” or “quota”; the regimes applied to Basque Country and Navarra). I will focus on the first in this paper, with only some limited references to the foral regimes.

²² López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain”, in: D’Atena (Ed.): *Federalism and regionalism in Europe*. Napoli: Editoriale Scientifica, 1998.

²³ López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain...cit.

²⁴ López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain...cit. p. 263.

²⁵ Among the leading Constitutional Court’s cases (not available in English), see: SSTC 37/1987, de 26 de marzo; 186/1993, de 7 de junio; 49/1995, de 16 de febrero; 289/2000, de 30 de noviembre; 168/2004, de 6 de octubre; 179/2006, de 13 de junio y AATC 417/2005, de 22 de noviembre y 456/2007, de 12 de diciembre (all available at the web site: www.tribunalconstitucional.es).

²⁶ Pointed out, recently, by CUENCA, A.: “Estabilidad presupuestaria y endeudamiento autonómico”. *Cuadernos de Derecho Público*, May 2012.

3.1 Taxing Democracy and Financing the Decentralization Process

It is not an exaggeration to say that until the late 1970s Spain did not have a *Tax system* as such, at least not one that was generally implemented (the levels of tax fraud under Franco's dictatorship cannot be overstated) or that followed the general structure of the tax systems of other OECD countries. The first modern personal income tax (PIT, hereafter) was established in 1978, as was the first corporation income tax (CIT, hereafter). The tax reform undertaken between 1978 and 1985 entailed a substantial increase of the tax pressure. Tax revenues in fact quadrupled between 1975 and 1980²⁷ and yet it was generally accepted by citizens, at least measured by the fact that there was no tax revolt. It can be argued that most taxpayers footed the bill as part of the price to pay for democracy.

Part of the reform of the tax system was a direct consequence of joining the European Union, which was also of paramount importance for Spain²⁸. Finally, and at the same time, Spain underwent a decentralization process between 1978 and 1982 that ended up with seventeen Autonomous Communities²⁹. One of the most striking aspects of Spain's decentralization is the speed at which it has developed, as can be seen below.

Table 1: Decentralization in Spain (public spending)
(% share of total public expenditure)

	1982	1996	2009
Central Government	53	37.5	20.9
Social Security³⁰	32.5	29.2	29.9
Autonomous Communities	3.6	22.3	35.6
Municipalities	10.6	11.6	13.6

Part of the process of creating a tax system in Spain entailed substantially reforming its tax administration. This process took some years and it was finalized with the creation of a new administrative body in 1990 the National Tax Collection Agency ("*Agencia Estatal de Administración Tributaria*", AEAT hereinafter), which is in charge of collecting the main taxes of the system, including the PIT, CIT and the Value Added Tax (VAT).

²⁷ OECD: "Revenue Statistics: Spain", OECD Tax Statistics (database).

doi: [10.1787/data-00253-en](https://doi.org/10.1787/data-00253-en) (Accessed on 30 May 2011).

²⁸ See in this regard: C. Closa and P. M. Heywood, *Spain and the European Union*, Palgrave Macmillan, 2004 (as the authors argue, entering the EU was Spain's main project).

²⁹ Andalusia, Aragon, Asturias, the Balearic Islands, the Basque Country, the Canary Islands, Cantabria, Castilla-La Mancha, Castilla-Leon, Catalonia, Extremadura, Galicia, Madrid, Murcia, Navarre, La Rioja, and Valencia. Basque Country and Navarra have broader tax powers than the rest of the regions. In the case of the Basque country, these powers rest in the provincias (Álava, Guipúzcoa and Vizcaya) that hold tax powers to regulate the Corporate Income Tax Law and the Personal Income Tax, among other taxes. The attribution of tax powers rests on a mixture of domicile and source, so that for instance regional tax provisions will apply when a company is domiciled in those territories but only if at least 25 per cent of its turnover is also derived there (unless turnover is lower than €7 million).

³⁰ Social Security is controlled by the central Government, but it is a separate entity from a budgetary perspective.

Box 1: National Tax Collection Agency: the big numbers

- The Agency³¹ had a 2009 budget of €1,414.3 million and a total of 27,755 employees.
- The total number of registered taxpayers is 47,999,499, of which: 1,682,509 are registered as small companies (revenue does not exceed € 8 million), 5,154,706 are individual business people and professionals and 41,477 are large companies.
- The AEAT's results of 2009 were a total net collection of €144,023 million for a public collection cost of 1% of revenue collected
- The number of tax returns processed in 2009 for the main taxes of the system (i.e., in terms of revenue) were:
 - Personal Income Tax: 19,467,138
 - Corporation Income Tax: 1,389,514
 - Value Added Tax: 3,525,821
 - Excise Duties: 9,130,549

Source: the author and *Memoria AEAT 2009*³²

3.2 Outline of the System: Taxes and Transfers

1. It is commonplace in the fiscal federalism literature to refer to “Vertical Fiscal Imbalance”, abbreviated as VFI³³ as the situation that arises when one tier of government – usually the Central Government – has a greater power to obtain revenues than it actually needs for the exercise of its assigned level of authority, while the other – usually sub-national governments – is in the opposite situation. This creates an imbalance that must be resolved in order to guarantee to the sub-national governments the autonomy required for the exercise of their authority. Ultimately VFI needs to be addressed in order to protect the citizen's right to obtain the services they pay for via taxation. This means that at least *some* distribution of resources needs to take place following a decentralization process.

The problem is easily understood and conflicting parties – the State and sub-national governments – normally agree that it must be resolved and that the allocation of resources must be “re-balanced”. Conflict usually arises when deciding which of the different possible solutions should be used. VFI imbalance can be solved either through transfers from the State or through a reassignment of taxation powers. In practice, a mix of the two will be used, so that most sub-national governments receive financing in the form of both transfers and own taxes. When sub-national governments receive financing almost exclusively in the form of transfers, an incentive is created to spend those monies in a less responsible way. The idea is simple and similar to the ‘moral hazard’ problem. It is easier for governments to spend money when (a) they do not shoulder the political burden of having to raise it (ie establishing or raising taxes),

³¹ The Agency collects all taxes, including ceded taxes (and only included taxes created by the Autonomous Communities, which are really minor).

³² Latest available complete data, at: AEAT Report 2009, “Key figures for 2009”, pp. 7 et seq. Available online (English version): www.aeat.es.

³³ Also known as *fiscal mismatch*, “*fiscal gap*” o del “*revenue gap*”; See: Oates, W. E.: “An Economist's Perspective on Fiscal Federalism”, at (Ed. Oates, W. E): *The Political Economy of Fiscal Federalism*. Toronto: Lexington Books, 1977, p. 16; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada*. Canadian Tax Papers, no. 96. Toronto: CTF, 1993, pp. 28 et seq and 77 et seq.

and (b) there is no need for them to explain to voters/taxpayers the relationship between monies raised and monies spent. In other words, the situation creates a lack of accountability that may not be advisable. This has been, and to a certain extent still is, the situation for common-system Communities.

Horizontal fiscal imbalance (HFI) will arise when there are significant differences in income and thus public resources among sub-national governments³⁴. Resolving this imbalance may also mean better addressing citizen's rights to their services, but it is much harder to solve than VFI. In particular because an increase of sub-national taxation systems will normally make HFI more obvious (richer regions also have higher taxing capacity). Both VFI and HFI have been present in the debates about the Communities' fiscal responsibility, which have become one of the main issues in the relationship between the State and the Communities. Since early on, the transfer of at least *some* taxation powers to such sub-national tiers of government, so that they have fiscal responsibility "at the margin"³⁵, has been considered essential in order to reinforce a certain level of political autonomy.

2. As stated above, one feature of the Spanish fiscal decentralization model is the radical asymmetry that exists between two groups of Communities. On the one hand, the financing systems applicable to the two *foral* Communities are known as *Concierto* (Basque Country) and *Convenio* (Navarra) systems³⁶. The main characteristic of this kind of system is that it entails a maximum level of taxation autonomy, which means these two Communities have powers to pass legislation, with only few limitations³⁷, on two of the main taxes of the Spanish fiscal system. Because the Central Government is still responsible for the provision of some public functions or services within the territory of these two Communities, it is entitled to receive a certain sum of money from them, known as the "*cupo*" (quota).

In contrast, the so-called 'common system', which applies to the other fifteen Communities, is the opposite of the *cupo*. The main difference lies in the fact that, under the common system, the Communities have more limited taxation powers, which results in a greater financial dependence upon the Central Government. Hence, (still) most of their revenues are provided by the Central Government, in the form of transfers³⁸.

³⁴ See Boadway, R. W.; Shah, A.: *Fiscal Federalism: Principles and Practice of Multiorder Governance*. Cambridge, 2009; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada...cit.* pp. 30-32.

³⁵ Heald, D.; Geaughan, N.: 'Financing a Scottish Parliament', in S. Tindale (ed), *The State and the Nations*. London: Institute for Public Policy Research, 1996, pp.167-83. Boadway, R.: "Intergovernmental Fiscal Relations: The Facilitator of Fiscal Decentralization", *Constitutional Political Economy*, vol. 12, no. 2, 2001, pp. 93-121.

³⁶ Both these terms (*concierto* and *convenio*) translate into English as 'agreement'.

³⁷ Such limitations are established in the laws regulating the *Convenio* and *Concierto*, and basically refer to the need to maintain a certain level of harmonization with the State's tax system. They are, however, established in quite broad terms, which for example allow the Basque Country to establish corporation tax credits that differ broadly from those of the State. See: Ruiz Almendral, V.: "The Asymmetric Distribution of Taxation Powers in the Spanish State of Autonomies: the Common System and the *Foral* Tax Regimes". *Regional and Federal Studies*, (Editorial: Routledge, Frank Cass Journal, Vol. 13, no. 4, Winter 2003 (pp. 41-66); Monasterio Escudero, C.; Zubiri Oria, I.: "Dos ensayos sobre financiación autonómica". Fundación de las Cajas de Ahorro, 2009.

³⁸ Ruiz Almendral, V. *Impuestos Cedidos y Corresponsabilidad Fiscal*. Tirant lo blanch, 2004.

The mere existence of such asymmetries has been, and still is, the cause of much political discussion. The Constitution in its first supplementary provision states that “the Constitution protects and respects the historical rights of the *foral* territories”. However, it is unclear whether this provision actually calls for totally different financing rules. It has also been argued that it is not feasible to maintain such asymmetry in the long term as this will have a negative impact on the efficiency of the system. It would lead to increasingly divergent tax systems³⁹. Furthermore, and more worryingly, this system ends up entailing that they do not share the full cost of the centrally provided services, which also implies their citizens are enjoying higher per capita public spending than the rest of the country⁴⁰.

In fact, it is not the legal design but the way it has been implemented which has resulted in a situation where the current Basque Country and Navarra do not fully cover the central governments costs (both within the territory and as a pro rata share of other costs) relative to them. In that regard, C. Monasterio has pointed out that “As a way of decentralizing the Public Sector, the Foral System is a clear example of Asymmetrical Federalism, since Foral Finance can apply tax measures which the rest of Spanish Autonomous Communities cannot use. From the perspective of Fiscal Federalism, the Foral System gives great tax autonomy to Sub-central Finance, but as a result the Central Government has almost no tax devices. Today, this system presents serious problems regarding the contribution to national public goods financing and the cooperation to economic stabilization. In quantitative terms, analyzing financial relations between the Foral System of Basque Country and Central Government as a whole, the paid amount underestimates by more than 2500 million euro a year the appropriate contribution from Foral Finance for period 2002-2006”⁴¹. It is important to underline the relevance of this imbalance that is only sustainable, in economic terms, because Navarra and the Basque Country only represent 8 per cent of the national GDP. Taking into account that the above mentioned 2500 million figure is quite close to reality⁴², it represents about 0.25 per cent of Spanish GDP. Whether this imbalance can survive the current economic situation in Spain is yet to be seen. Furthermore, the Cupo regime has created certain tensions with European Union Law, as a miscalculation of the Cupo, together with sometimes lower rates for corporate income taxes in the Basque country has been deemed by some to be to the benefit of Spain vis-à-vis other EU countries⁴³.

³⁹ García-Milà, T.; McGuire, T. J.: “Fiscal Decentralization in Spain: An Asymmetric Transition to Democracy”. (Bird, R. ed): *Subsidiarity and Solidarity: The Role of Intergovernmental Fiscal Relations in Maintaining an Effective State in Diverse Countries*. Washington: World Bank, 2003.

⁴⁰ See: Ruiz Almendral, V.: “¿Vuelta a la casilla de salida? El concierto económico vasco a la luz del Ordenamiento comunitario”. *Revista Española de Derecho Europeo*, n. 28/2008 (499-528). Castells, A.: “Autonomía y solidaridad en el sistema de financiación autonómica”. *Papeles de Economía Española*, no. 83/2000; Monasterio Escudero, C.; Zubiri Oria, I.: “Dos ensayos sobre financiación autonómica”. Fundación de las Cajas de Ahorro, 2009.

⁴¹ See Monasterio Escudero, C.: “Federalismo fiscal y sistema foral. ¿Un concierto desafinado?”. *Hacienda Pública Española / Revista de Economía Pública*, 192-(1/2010): 59-103. To date, this is the most thorough analysis of the current foral regime, which if not in design, is quite problematic in its practical implementation, and largely unfair.

⁴² High ranking Spanish officials from the Ministry of the Treasury (Hacienda) all coincide in this reality.

⁴³ Ruiz Almendral, V.: “¿Vuelta a la casilla de salida? El concierto económico vasco a la luz del Ordenamiento comunitario”. *Revista Española de Derecho Europeo*, n. 28/2008 (499-528); Palao Taboada, C.: “State Aid and Autonomous Regions: The ECJ’s Ruling in the Basque Country case”. *Bulletin for International Taxation*, may/june 2009.

3.3 Sharing Taxes

1. The Spanish Constitution (sections 133 and 157) bestows taxation powers upon the fifteen Communities⁴⁴. In accordance with the recognition of autonomy, or, stated more accurately, the recognition of the right to be autonomous, the Spanish Constitution grants Communities “financial autonomy for the development and execution of their authority” (art. 156)⁴⁵. Apart from stating this principle of financial autonomy, the Constitution establishes a list of resources that will constitute the Communities’ income. This list includes almost all kinds of possible existing resources. Thus, they may obtain revenues from: ceded taxes; surtaxes on existing Central Government taxes; their own taxes; public debt; and transfers (section 157.1).

However, it also allows the Centre to approve a special “organic” law (*ley orgánica*) regulating both how the resources listed in section 157.1 will be distributed among Communities and the limits on the exercise of their financial power on the resources (i.e. whether and to what extent they may create new taxes, etc)⁴⁶. This implies that the Central Government is given the power to both limit and control the financial autonomy of the Communities. In fact, soon after the Constitution was ratified, the *Special Law for the Financing of the Autonomous Communities*, Law 8/1980 (*Ley Orgánica de Financiación de las Comunidades Autónomas* – hereafter, the LOFCA) was approved. The role of the LOFCA is central in the system of financing Autonomous Communities. Some authors have in fact spoken of a “de-constitutionalization” of the system, since the LOFCA replaces the Constitution in

⁴⁴ See Rodríguez Bereijo, A.: “Constitución Española y Financiación Autonómica”, at *La financiación Autonómica*. AELPA, Tecnos, 2010, pp. 25 et seq.

Section 133

1. *The primary power to raise taxes is vested exclusively in the State by means of law.*
2. *Self-governing Communities and local Corporations may impose and levy taxes, in accordance with the Constitution and the laws.*
3. *Any fiscal benefit affecting State taxes must be established by virtue of law.*
4. *Public Administrations may only contract financial liabilities and incur expenditures in accordance with the law.*

⁴⁵ Section 156

1. *The Self-governing Communities shall enjoy financial autonomy for the development and exercise of their powers, in conformity with the principles of coordination with the State Treasury and solidarity among all Spaniards.*
2. *The Self-governing Communities may act as delegates or agents of the State for the collection, management and assessment of the latter's tax resources, in conformity with the law and their Statutes.*

⁴⁶ Section 157

1. *The resources of the Self-governing Communities shall consist of:*
 - a) *Taxes wholly or partially made over to them by the State; surcharges on State taxes and other shares in State revenue.*
 - b) *Their own taxes, rates and special levies.*
 - c) *Transfers from an inter-territorial compensation fund and other allocations to be charged to the State Budget.*
 - d) *Revenues accruing from their property and private law income.*
 - e) *Interest from loan operations.*
2. *The Self-governing Communities may under no circumstances introduce measures to raise taxes on property located outside their territory or likely to hinder the free movement of goods or services.*
3. *Exercise of the financial powers set out in subsection 1 above, rules for settling the conflicts which may arise, and possible forms of financial cooperation between the Selfgoverning Communities and the State may be laid down by an organic act.*

designing the main structure of the financing of the Autonomous Communities⁴⁷. The Constitutional Court has also stressed this role of the LOFCA (Opinions 179/1985, 68/1996, 183/1988, among others) even if it has also underlined the relevance of the Statutes of Autonomy in the definition of the financing system (Opinion 31/2010) *within the framework of the LOFCA*⁴⁸.

The LOFCA imposes severe limits on Communities' capacity to create new taxes. The most important limitation is the prohibition of double taxation (article 6.2 and 3), which prevents AC taxes from being similar to taxes created by the Central Government and the Municipalities. However, this limitation has been largely offset by the sharing taxes system, put into place in 1997, so that in practice, Communities have substantial taxing powers.

The original limitation of their tax powers has an obvious explanation; when the Constitution (1978) and the LOFCA (1980) were approved, both Municipalities and the Central Government had already established taxes on most of the possible sources of revenues, which has left little tax room for Communities. In fact, some of the attempts of Communities to establish their own taxes were declared unconstitutional by the Constitutional Court, on the basis of sections 6.2 and 6.3 of the LOFCA⁴⁹. A recent reform of article 6.3 of the LOFCA has considerably eased the limit⁵⁰. But so far Communities have not created any new taxes. It is not always clear whether it is the limitations on establishing new taxes or the unwillingness to withstand the political consequences of increasing the tax burden that has deterred Communities from creating new taxes, but the traditional existence of such limits underlines the importance of intergovernmental transfers in Spain. When the level of tax autonomy is so low, the possibilities for Communities to obtain their own resources are scarce, hence the need for transfers from the Centre. This situation also explains the substantial imbalance between the common-system Communities spending autonomy – which has been strongly supported by the Constitutional Court (case 13/1992, among other) – and their limited power to raise their own revenues.

2. There is a widespread view that to achieve a fundamental decentralization of powers, the sub-national tiers of government must be able to raise revenues in addition to the Central Government transfers they receive. That view holds that the transfer of at least some taxation powers to sub-national tiers of government is essential in order to achieve a certain level of political autonomy. This inspired the reforms undertaken

⁴⁷ This idea at: Palao Taboada, C.: "La distribución del poder tributario en España". *Crónica Tributaria*, n. 52/1985, p. 184; Medina Guerrero, M.: *La incidencia del sistema de financiación en el ejercicio de las competencias de las Comunidades Autónomas*. Madrid: CEC, 1992, p. 342.

On the other hand, when the Constitution was approved there were no Autonomous Communities, so it would have been difficult to perfectly outline their financing system.

⁴⁸ The relationship between the LOFCA and the Statutes cannot be fully established ex ante. It depends on what type of authority the LOFCA and the Statutes are dealing with. For example, in the case of limits to taxes, the Constitution does bestow the LOFCA the authority to establish the limits within which autonomous Communities may operate.

⁴⁹ Organic laws, such as the LOFCA, that refer to how authority is distributed in Spain have a particular status in the process before the Constitutional Court in the sense that they serve as an element to determine the constitutionality of a given measure. This explains that a law passed by an Autonomous Community establishing a given tax will be deemed unconstitutional if it is contrary to the LOFCA.

⁵⁰ Article 6.3 was modified in 2009 (via this law: *Ley Orgánica 3/2009, de 18 de diciembre, de modificación de la Ley Orgánica 8/1980, de 22 de septiembre, de Financiación de las Comunidades Autónomas*) in order to make it easier for Communities to establish their own taxes.

in 1996, when there was a fundamental change in the financing system of Communities along these lines. Some taxes traditionally belonging to the Centre, and including the personal income tax, were transformed into shared taxes (ceded taxes or *impuestos cedidos*) in 1997, substantially increasing the taxing powers of Communities. Subsequent reforms in 2002 and 2009 have further increased Communities' powers over these taxes⁵¹.

The main goal of these reforms was to make Communities more involved in the establishment of taxes and thus more directly accountable to their taxpayers for the monies they spend. Simply put, the reforms consist of the sharing of some tax room that until then had been occupied solely by the Centre. This has been done through a type of resource called a 'ceded tax'. Until 1997, ceded taxes were Central Government taxes whose yield was granted to Communities according to the taxes paid within each AC's territory (derivation principle). Due to powers delegated by the Centre, Communities had also taken on the responsibility for administering and collecting these taxes. Ceded taxes were, therefore, virtually a kind of transfer, by which some of the taxes 'owned' and until 1997 regulated exclusively by the Centre accrued to, and were administered by, the Communities. They differ from transfers in that the Communities may receive a 'bonus' in some cases. Thus, if the actual yield of the tax is greater than what had been forecasted by the central government, the AC receives the difference. If the yield is less than the forecast, the Community still receives the initially forecasted amount. However, an increase of the yield may or may not be a consequence of better tax administration; for example, it may be merely due to economic conditions⁵². Therefore, this bonus only partially serves as an incentive for Communities to administer ceded taxes more efficiently. On the other hand, the Communities' decision-making powers over these kinds of taxes were, previously, almost non-existent.

⁵¹ The latest reform, which entered into force on January 1st 2010 (although most of its provisions actually extended their effects retroactively, to 1 January 2009) is regulated in the Law 22/2009 (Ley 22/2009, de 18 de diciembre, por la que se regula el sistema de financiación de las Comunidades Autónomas de régimen común y Ciudades con Estatuto de Autonomía y se modifican determinadas normas tributarias) For a general outline (in English) of how the system works and the different outcomes see, by the author: Ruiz Almendral, V.: "Fiscal Federalism in Spain: the Assignment of Taxation Powers to the Autonomous Communities". International Bureau of Fiscal Documentation. European Taxation, vol. 42, no. 11, November, 2002. Ruiz Almendral, V.: "The Asymmetric Distribution of Taxation Powers in the Spanish State of Autonomies: the Common System and the *Foral* Tax Regimes". Regional and Federal Studies, (Editorial: Routledge, Frank Cass Journal, Vol. 13, no. 4, Winter 2003 (pp. 41-66).

More recently, see: Bosch, N. y Durán, J.M.: "The financing system of Spanish regions: Main features, weak points, and possible reforms", en Bosch, N. y Durán, J.M. (Eds.): *Fiscal Federalism and Political Decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 3-24 Gimeno, J.: "Tax assignment and regional co-responsibility in Spain", at Bosch, N. y Durán, J.M. (Eds.): *Fiscal Federalism and Political Decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 74-106. López-Laborda, J., Martínez-Vázquez, J. y Monasterio, C. (2007): "The practice of fiscal federalism in Spain", en A. Shah (Ed.), *The Practice of Fiscal Federalism: Comparative Perspectives*, Quebec: The Forum of Federations McGill-Queen's University Press, pp. 287-316. Martínez-Vázquez, J.: "Revenue assignments in the practice of fiscal decentralization", en Bosch, N. y Durán, J.M. (Eds.): *Fiscal federalism and political decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 27-55. See a thorough outline of the current system at: Zabalza, A. and J. López-Laborda (2010), "El Nuevo Sistema de Financiación Autonómica: Descripción, Estimación Empírica y Evaluación", *Working Paper* No. 530. Madrid: FUNCAS. (<http://www.funcas.es/Publicaciones/InformacionArticulos/Publicaciones.asp?ID=1593>).

⁵² See a critic at Monasterio Escudero, C.; Zubiri Oria, I.: "Dos ensayos sobre financiación autonómica...cit.

Ceded taxes thus changed substantially following the 1996 reform (which entered into force in 1997). The reassignment of taxation powers resulting from the shared taxes mechanisms constitutes the most important tax reform since the State of Autonomies became a reality. Under the new system, common-system Communities have substantially increased their taxation powers. Although the gap between the powers of the *foral* and common-system Communities remains quite large, it has certainly been reduced by the reform. If the tendency continues, the possibility that the two systems end up converging should not be completely ruled out. Such convergence derives mainly from the common-system Communities' newly acquired taxation powers.

Until 1997, only *foral* Communities could pass legislation and control some of the main taxes of the system (such as the personal income or the corporate income taxes). Since then, common-system Communities have gradually gained access to most important tax bases (and rates), excluding corporate income taxes. Although the gap is still wide, considering that common-system Communities can only regulate certain aspects of some of these taxes while *foral* Communities may regulate most elements of the said taxes except for certain aspects, the tendency is towards a degree of convergence. However, when we compare the powers that the common-system and *foral* Communities hold on the main taxes of the taxation system, it is clear from the following table that a profound asymmetry prevails.

Communities may now regulate certain aspects of the personal income tax, the wealth tax, the death and gift taxes, stamp duty and gambling taxes. The use of those powers by Communities is entirely another story. In fact, because Communities do not actually use their powers, at least not extensively, I submit that ceded taxes often work, *in practice*, as a type of transfer. Technically of course, in budgetary terms, they are classified as Communities own taxes. It is the lack of fiscal responsibility, or generally the lack of interest shown by Communities to actually employ their taxing powers to increase their revenues that make them similar to a transfer.

Until 2009, if an AC failed to do so or decided not to exercise such powers, there would be no consequences; the Central Government would continue to regulate every aspect of these taxes in that AC, so it would not lose any revenue by failing to legislate. If an AC were to decide to pass legislation modifying the above-mentioned authorized aspects over any ceded tax, it could do so by enacting legislation which would then substitute for Central Government law, in those areas where the AC has the authority to legislate.

The way that this option was structured – and the fact that the Central Government still guarantees to Communities lump-sum grants allocated on the basis of historical shares in its transfers, *regardless of whether they exercise their powers or not* – served to create a strong disincentive for Communities to use their new taxation powers.

Starting in 2011 the Central Government does not regulate the *ceded* part of the tax any longer. Hence “lazy” Communities will lose their revenue if they fail to legislate. This was a central government's initiative, as no Community has asked for this. It is supposed to reinforce fiscal responsibility, if only by *forcing* Communities to exercise their powers. However, most Communities have (even with the current crisis) merely

used their powers to copy the Central Government's legislation in the same exact terms, which is why I submit that ceded taxes remain a form of transfer.

Table 2: Autonomous Communities powers on ceded taxes (2009)

Ceded Taxes	AC share (%)	Administration	Legislative Powers that Communities <i>must</i> assume
Personal income tax	50	State	Tax rates (must have same number of tax brackets as the State tax) Tax credits, under certain conditions Personal deductions
<i>Wealth tax (repealed in 2009, reestablished in 2011)</i>	<i>100</i>	<i>Communities</i>	<i>Tax rates</i> <i>Minimum threshold</i> <i>Tax credits</i>
Succession and gift taxes	100	Communities	Deductions (mainly, for family circumstances) Tax rates Deductions and tax credits Tax administration regulations
Taxes on transfers and official documents	100	Communities	Tax rates Tax credits Tax administration regulations
Gambling taxes	100	Communities	Exemptions Taxable base Tax rates Tax credits Tax administration regulations
Value added tax	50	State	None
Excise duties	58	State	None
Tax on wine	58	State	None
Tax on electricity	100	State	None
Tax on vehicles	100	Communities	Tax rates (under certain limits)
Special tax on gas	100	Communities	Tax rates (under certain limits) Tax administration regulations

3.4 The Functioning of the System: Transfers and Ceded Taxes

To a large extent, the financing of common-system Communities is based upon need, not purely fiscal capacity⁵³. Thus, it can be argued that their enhanced tax room on ceded taxes is not sufficiently taken into account in the sense that no penalization is envisaged when Communities decide not to exercise their powers or not to increase their tax pressure when they need extra revenue (as opposed to incurring extra debt). In fact, the Communities have mostly used their powers on ceded taxes to create new

⁵³ A recent, an thorough, outline of the Spanish system of intergovernmental transfers can be found at: Zabalza, A.; López-Laborda, J.: "The new Spanish System of intergovernmental transfers". International Studies Program Working Paper 11-03 February 2011, Andrew Young School, Georgia University (at <http://aysps.gsu.edu/isp/files/ispwp1103.pdf> (accessed 27.12.2011)).

fiscal benefits⁵⁴. This is bound to change with the new debt and deficit limits, as explained below.

Table 3: Comparison of legislative powers of common-system and *foral* Communities

Main Taxes in Spain	Legislative Powers that <i>foral</i> Communities may assume	Legislative Powers that common-system Communities must assume
Personal income tax	Total regulation of the tax	Tax rates (must have same number of tax brackets as the State tax) Tax credits, under certain conditions
Corporation income tax	Total regulation of the tax	None
Tax on income of non-residents	Regulation of the tax only in the case of permanent establishment in the <i>foral</i> territory	None
Wealth tax	Total regulation of the tax	Tax rates Minimum threshold Tax credits
Death and gift taxes	Total regulation of the tax	Deductions (mainly, for family circumstances) Tax rates Deductions and tax credits Tax administration regulations
Taxes on transfers and official documents	Total regulation of the tax	Tax rates Tax credits Tax administration regulations
Gambling taxes	Total regulation of these taxes	Exemptions Taxable base Tax rates Tax credits Tax administration regulations
Value added tax	None	None
Excise duties	None	None

The transfers received by the Communities have traditionally been based upon need. In the early 1980s, and according to the LOFCA, the cost of the devolved powers would be calculated and a given amount would then be transferred to the Communities. In reality, the cost was calculated, but transfers were also the subject of intense negotiations which took place in bilateral commissions (between the Centre and each AC). These would meet behind closed doors and agree on a certain amount. The reason for this is that the then existing accounting systems of the Central Government were inadequate for such calculations, so the actual cost of the transferred services was never actually determined. This continuous negotiation was also the subject of sharp criticism. Apart from the lack of democracy argument, seen above, from a financial perspective it was deemed to create inequalities as, eventually,

⁵⁴ On the personal income tax, see: Ruiz Almendral, V.; Vaillancourt, F.: "Choosing to be different (or not): personal income taxes at the sub-national level in Canada and Spain". *Papel de Trabajo del Instituto de Estudios Fiscales*, n. 29/2006, pp. 1-37.

those Communities whose bargaining position was weaker would get less money to exercise the powers that fall within their scope of authority⁵⁵.

The new financing system for Autonomous Communities that entered into force in 2009⁵⁶ was approved at a difficult economic conjuncture for Spain. With the end of the housing bubble and the abrupt end of construction activity, national unemployment hit 20 per cent (July 2011 data), and according to official reports, there is no real hope for recovery before two or three years⁵⁷.

The 2009 system follows the traditional formula applied since 1997, by which the total financing that a Community needs (or is entitled to) is calculated and then different resources are added to arrive at the figure. Roughly put, there are two general sources of revenue that stem directly from the financing system established by the central government. These two sources are a mix of transfers and revenue from ceded taxes – both taxes administered by the Centre and the Communities. Other revenues that Communities may have, such as those deriving from own taxes, are not part of the formula. This is, or should be, an advantage, to the extent that Communities may increase their own revenues by establishing new taxes. However, the political cost of such a measure has generally prevented own taxes from being a significant source of revenue.

The said two sources are the following⁵⁸: revenues that are received on an annual basis and revenues that are received periodically, and adjusted once all the data is known. The first group is formed by ceded taxes which are administered by Communities. The second, much larger, type of source is a mix of ceded taxes revenue (which are administered by the central government) and transfers that intend to equalize revenues on the basis of different needs criteria (population, age of population, etc). The second source may be negative or positive, that is, a Community may be forced to return part of the revenue obtained from the Central Government from the lump sums (*Fondo de Garantía* and *Fondo de Suficiencia Global*) of transfer schemes that are designed to equalize the fiscal capacity of Autonomous Communities. In July 2011 the Consejo de Política Fiscal y Financiera and the Ministry of Economy publicly announced the final data of tax revenues for 2009 (the first year this new system was applied). Because of the crisis, tax revenues, in particular in income taxes, have considerably decreased, which has resulted in the need for many Communities to pay back to the Central Government part of the transfers they received as an advance.

The financing formula first determines the amount that each Autonomous Community is entitled to receive in a given fiscal year. That needed amount or “total financing” (the law calls it “*Necesidades Globales de Financiación*” -NGF) is established for each Community (see below, Table 4).

⁵⁵ León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autònoms, 2007.

⁵⁶ The system was established by two laws: Organic Law 3/2009, which reformed the LOFCA and the above mentioned Law 22/2009.

⁵⁷ See the latest report from the Ministry of Finance in Spain, at:
<http://serviciosweb.meh.es/apps/dgpe/TEXTOS/SIE/siepub.pdf>.

⁵⁸ Santiuste Vicario, A.: “La aplicación práctica del sistema de financiación de las Comunidades Autónomas de régimen común regulado en la Ley 22/2009, de 18 de diciembre”. *Presupuesto y Gasto Público*, 62/2011, pp. 101-117.

The figure will depend on a number of factors, a main one being what the Community had been receiving before (what revealingly is called “total Status Quo”, Table 4), but also other elements such as how scattered the population is or whether the Community has an own language that deserves to be protected (Catalonia, Galicia, Valencia and Balearic Islands fall in this group). The goal is that all the services that are now rendered by the Communities (and in particular the most expensive, Health and Education, which in 2001 became almost entirely the Communities’ responsibility) can continue to be rendered with roughly the same standards as before, as well as with a minimum across the country.

This is actually a consequence of article 149.1.1^a of the Spanish Constitution, which mandates the Central Government to regulate “*basic conditions guaranteeing the equality of all Spaniards in the exercise of their rights and in the fulfillment of their constitutional duties*”. Furthermore, the Constitution also mandates that certain equality (not uniformity) must be achieved and that the Central Government is in charge of guaranteeing that equality at least at the margin. While Section 137 establishes that “*The State is organized territorially into municipalities, provinces and the Self-governing Communities that may be constituted. All these bodies shall enjoy self-government for the management of their respective interests*”, Section 138.1 establishes that “*The State guarantees the effective implementation of the principle of solidarity proclaimed in section 2 of the Constitution, by endeavoring to establish a fair and adequate economic balance between the different areas of the Spanish territory and taking into special consideration the circumstances pertaining to those which are islands*”. Furthermore: article 138.2 states that “*Differences between Statutes of the different Self-governing Communities may in no case imply economic or social privileges*”. According to section 139 “*All Spaniards have the same rights and obligations in any part of the State territory*”. The financial consequences of these provisions are contemplated in article 158 of the Constitution, which establishes that “*1. An allocation may be made in the State Budget to the Self-governing Communities in proportion to the amount of State services and activities for which they have assumed responsibility and to guarantee a minimum level of basic public services throughout Spanish territory*” and that “*2. With the aim of redressing interterritorial economic imbalances and implementing the principle of solidarity, a compensation fund shall be set up for investment expenditure, the resources of which shall be distributed by the Cortes Generales among the Self governing Communities and provinces, as the case may be*”.

These constitutional mandates are reflected in the different types of transfers designed into the system⁵⁹. I will dedicate the following lines to the general outline of the system, leaving out the specifics of the different funds, as well as the special equalization scheme that results from article 158.2, which is regulated in a specific law⁶⁰.

⁵⁹ See, in detail: Zabalza, A. and J. López Laborda, “The new Spanish system of intergovernmental transfers”, *International Tax and Public Finance* (2011) 18: 750-786.

⁶⁰ The “Compensation Funds” are regulated in the Law 22/2001, (*Ley reguladora de los Fondos de Compensación Interterritorial*).

Table 4: Global financing needs (*Necesidades Globales de Financiación*)

Community	Total “Status Quo”	Resources to keep the Welfare State	Scattering of Population	Low density of population	Special language (Catalan, Galisian...)	Total additional resources	Global financing needs
	(1)	(2)	(3)	(4)	(5)	(6)=(2)+(3)+(4)+(5)	(7)=(1)+(6)
Cataluña	15.214.740,10	951.399,58	0,00	0,00	97.957,56	1.049.357,14	16.264.097,24
Galicia	5.729.107,75	163.004,20	34.093,79	0,00	45.956,43	243.054,42	5.972.162,17
Andalucía	14.904.227,64	778.962,05	0,00	0,00	0,00	778.962,05	15.683.189,69
Principado de Asturias	2.273.533,55	46.396,98	7.864,75	0,00	0,00	54.261,73	2.327.795,29
Cantabria	1.401.128,34	54.157,82	1.052,33	0,00	0,00	55.210,15	1.456.338,49
La Rioja	703.737,89	42.875,18	0,00	2.073,69	0,00	44.948,87	748.686,76
Región de Murcia	2.392.718,45	211.455,96	0,00	0,00	0,00	211.455,96	2.604.174,41
C. Valenciana	8.288.774,94	717.237,29	0,00	0,00	61.642,56	778.879,85	9.067.654,79
Aragón	2.855.957,50	136.777,65	0,00	9.006,07	0,00	145.783,72	3.001.741,22
Castilla-La Mancha	3.924.816,60	245.155,03	0,00	13.986,25	0,00	259.141,28	4.183.957,88
Canarias	3.466.475,27	302.230,38	0,00	0,00	0,00	302.230,38	3.768.705,64
Extremadura	2.322.230,82	48.591,86	0,00	7.436,00	0,00	56.027,86	2.378.258,68
Illes Balears	1.718.400,14	173.418,91	0,00	0,00	31.297,08	204.715,99	1.923.116,14
Madrid	12.106.808,68	878.796,65	0,00	0,00	0,00	878.796,65	12.985.605,33
Castilla y León	5.411.011,21	149.540,45	6.989,13	17.497,99	0,00	174.027,56	5.585.038,77
Total CC.AA.	82.713.668,89	4.900.000,00	50.000,00	50.000,00	236.853,63	5.236.853,63	87.950.522,52
Melilla	8.317,03	6.550,00	0,00	0,00	0,00	6.550,00	14.867,03
Ceuta	9.416,99	9.150,00	0,00	0,00	0,00	9.150,00	18.566,99
Total Ciudades	17.734,02	15.700,00	0,00	0,00	0,00	15.700,00	33.434,02

Going back to the “Global Financing Needs” (GFN), the 2009 system added new elements to the formula, making it a very expensive system⁶¹. Before then, only an updated “status quo” would be taken into account. The new system attempts to link the GFN to different criteria that may significantly make the provision of services, in particular Health and Education, more or less expensive. With that purpose, new specific funds have been added to the formula. These funds are to be distributed unevenly among Communities, depending on how much they need. That specific need is assessed through a mix of criteria. Thus, elements such as population, its age distribution, the total surface of the Community and how scattered the population are taken into account just to determine the GFN or amount every Community should achieve. These new funds are revealingly named “Resources to keep the Welfare State”.

⁶¹ As pointed out at Zabalza, A.; López-Laborda, J.: “The new Spanish System of intergovernmental transfers...cit.

The distribution of the GFN among Communities can be seen in Table 4⁶²:

A second step of the system is to define what types of resources will form part of the Global Sufficiency Fund (see Table 5).

Table 5: Global sufficiency fund for 2009

Autonomous Community	Global Financing Needs 2009	Taxing Capacity 2009 (ceded taxes)	Transfers from a Guarantee Fund 2009 (Health, mainly)	Global Sufficiency Fund 2009
	(1)	(2)	(3)	(4)=(1)-(2)-(3)
Cataluña	16.264.097,24	15.672.639,50	-1.455.227,31	2.046.685,05
Galicia	5.972.162,17	4.342.099,98	880.601,61	749.460,57
Andalucía	15.683.189,69	11.645.015,53	2.659.014,15	1.379.160,01
Principado de Asturias	2.327.795,29	1.973.957,92	88.428,98	265.408,38
Cantabria	1.456.338,49	1.167.410,33	-55.714,21	344.642,37
La Rioja	748.686,76	577.042,01	21.555,66	150.089,10
Región de Murcia	2.604.174,41	2.146.073,99	365.363,65	92.736,77
C. Valenciana	9.067.654,79	8.308.737,90	739.427,70	19.489,20
Aragón	3.001.741,22	2.680.403,38	-37.110,51	358.448,35
Castilla-La Mancha	4.183.957,88	3.120.427,22	724.008,93	339.521,73
Canarias	3.768.705,64	1.712.326,07	1.752.613,99	303.765,58
Extremadura	2.378.258,68	1.430.744,00	556.138,29	391.376,39
Illes Balears	1.923.116,14	2.341.634,13	-230.154,58	-188.363,42
Madrid	12.985.605,33	15.416.043,39	-3.180.398,76	749.960,70
Castilla y León	5.585.038,77	4.462.342,12	486.978,91	635.717,75
Total CC.AA.	87.950.522,52	76.996.897,49	3.315.526,50	7.638.098,53
Melilla	14.867,03	0,00	0,00	14.867,03
Ceuta	18.566,99	0,00	0,00	18.566,99
Total Ciudades	33.434,02	0,00	0,00	33.434,02
Total General	87.983.956,54	76.996.897,49	3.315.526,50	7.671.532,55

The current system establishes that those resources will be formed by two large groups: first, the yield of ceded taxes (*Tributos cedidos* -TC) and an equalization transfer (Fund to guarantee essential public services or *Fondo de Garantía de Servicios Públicos Fundamentales* –FGSPF).

A second type of transfer will cover a possible gap when TC + FGSPF does not cover the Global needs. So there are two possible outcomes (as can be seen in the following table):

⁶² Source for all the following tables: Ministerio de Economía y Hacienda (July 2011); document named “Liquidación de los recursos del sistema de financiación de las comunidades autónomas de régimen común y ciudades con estatuto de autonomía y de las participaciones en los fondos de convergencia autonómica, regulados en la ley 22/2009, de 18 de diciembre, correspondientes al ejercicio 2009” and in particular de Annex Tables. All available at:

<http://www.meh.es/esS/Estadistica%20e%20Informes/Estadisticas%20territoriales/Paginas/Informes%20financiacion%20comunidades%20autonomas2.aspx>.

Table 6: Communities with per capita GDP lower than 90 per cent of the average (thousands of euro)

Autonomous Community	GDP 2007 (thousands of euro)	GDP 2008 (thousands of euro)	GDP 2009 (thousands of euro)	Population 2007	Population 2008	Population 2009	Average GDP per capita Last 3 years	Communities that will benefit
	(1)	(2)	(3)	(4)	(5)	(6)	(7)=[(1)+(2)+(3)]/[(4)+(5)+(6)]	
Cataluña	197.166.994	202.695.024	195.644.827	7.166.031	7.270.468	7.288.071	27.411,67	
Galicia	54.107.607	56.220.304	54.857.447	2.728.772	2.738.098	2.737.034	20.134,97	<90% average
Andalucía	144.949.006	148.915.411	142.994.677	7.989.013	8.105.608	8.177.351	17.998,50	<90% average
Principado de Asturias	22.936.864	23.736.703	22.725.577	1.058.743	1.059.089	1.057.145	21.858,16	
Cantabria	13.347.745	13.888.906	13.346.291	567.088	573.758	577.885	23.612,15	
La Rioja	7.762.984	8.037.214	7.843.401	309.360	313.772	316.341	25.166,87	
Región de Murcia	27.100.446	28.164.464	27.182.448	1.392.368	1.430.986	1.452.150	19.283,66	<90% average
C.Valenciana	102.478.051	105.833.509	101.793.151	4.824.568	4.950.566	5.019.138	20.961,13	
Aragón	32.906.696	34.071.768	32.497.506	1.286.285	1.306.631	1.318.923	25.429,46	
Castilla-La Mancha	35.729.134	36.857.370	35.784.888	1.951.388	2.001.643	2.037.756	18.089,68	<90% average
Canarias	41.734.525	42.907.188	41.258.418	2.019.299	2.061.499	2.085.980	20.415,87	<90% average
Extremadura	17.502.561	18.176.031	17.922.048	1.076.695	1.079.725	1.081.012	16.556,53	<90% average
Illes Balears	26.142.863	27.196.542	26.404.893	1.028.635	1.058.668	1.074.949	25.217,57	
Madrid	186.500.419	193.049.514	189.782.158	6.112.078	6.245.883	6.300.460	30.513,41	
Castilla y León	56.620.354	58.128.174	56.388.618	2.492.034	2.506.454	2.510.631	22.790,58	
Total	966.986.249	997.878.122	966.426.348	42.002.357	42.702.848	43.034.826		

A first outcome is when the total amount that a Community needs is smaller than the sum of TC and FGSPF. In this scenario, the Autonomous Community will need to return part of the revenue received. This will normally happen to the richest Communities. This has happened in 2009 to Catalonia, Cantabria, Aragon, Balearic Islands and Madrid (respectively, they have had to return 1,455; 55; 37; 230 and 3,180 million euro). The reason is the high yield of their ceded taxes, which is explained because these are the richest Communities (which means richer taxpayers).

A second possibility is that the Community is not able to cover all its needs by TC and FGSPF. In this case, the second fund –Global Sufficiency Fund/*Fondo de suficiencia global*– will be applied. This has happened to the rest of Communities, with Andalusia receiving 2,659 million euro and, on the other end, La Rioja receiving 21 million euro (column 3)⁶³. The Global Sufficiency Fund therefore only applies as a “closing element” of the system.

⁶³ See complete data at Table 2.11, “Anexo numérico 2009”, at <http://www.meh.es/es-ES/Estadistica%20e%20Informes/Estadisticas%20territoriales/Paginas/Informes%20financiacion%20comunidades%20autonomas2.aspx>

This means that, to a certain extent, the system also provides for inter-regional equalization, with richer Communities partly financing poorer Communities. This is also often contested. Of course any tax system –and the current financing model is largely based on taxes– as well as any redistribution or equalization scheme will produce that result. Whether or not it should be accepted is another matter, and the ultimate answer, largely ideological⁶⁴.

In 2009, new specific balancing transfer systems were introduced. The new types of transfers were intended to equalize AC public revenues and guarantee the provision of “essential public services”, or services related to Education, Health and other Social Services (support for the elderly, etc.). The cost of these transfers has considerably increased, especially in Communities where immigration growth has been quantitatively relevant (such as Madrid and Catalonia, among others).

This final set of transfers is designed to further equalize resources between Communities, not on the basis of the authority that they have but on the basis of a number of elements that set them at a disadvantage. These two “Convergence Funds” (*Fondos de convergencia*) are the “Cooperation Fund” (*Fondo de cooperación*) and the “Competitiveness and Compensation Fund” (*Fondo de competitividad y convergencia*). The criteria that set the relevant amounts revolve around the per capita income, scarcity of population, growth of population and per capita tax capacity (which is a criterion not unrelated to income).

As can be seen in Table 6, taking the most revealing indicator, the per capita income⁶⁵, six Communities have benefited from the “Cooperation Fund”, as they had a per capita income “less than 90 per cent of the average”; see following table (Galicia, with a per capita income of 20,134 euro, Andalusia, 17,998, Murcia, 19,283, Castilla La Mancha, 18,089, Canary Islands, 20,415 and Extremadura, 16,556. By contrast, the richest Communities, in terms of per capita income, are Madrid (30,513), Catalonia (27,411), La Rioja (25,166), Aragón (25,429) and the Balearic Islands (25,217).

When the final results of the system for 2009 were revealed last July 28th, 2011, as all the final data on the yield of the different taxes was ready, it turned out that all Communities will need to return to the Central Government part of what they had been receiving during 2009, 2010 and part of 2011. Simply put, the explanation mainly lies in the way taxation revenues have plummeted and that some of the needs were overestimated. This resulted in ACs receiving an overestimation of tax revenues which is why the following table (Table 7) shows tax revenues as “negative”.

⁶⁴ Furthermore, it is debatable whether financing the poorer is not in fact in the richer Communities’ self interest, since the poorer may then be in a better position to grow and contribute to the general growth.

⁶⁵ The per capita income taken into account for the purpose of this fund is the average of three years: 2007, 2008 and 2009.

Table 7: Final results of the financing system (2009)

ACs	1.PIT revenues	2.VAT revenues	3.Excise revenues	4.Transfer from the Guarantee Fund	5.Global Sufficiency Fund	6.Final results 2009 resources	7.Global convergence funds	6 + 7	9.Advanced funds received by ACs	10. Compensation Wealth Tax	Final result
	(1)	(2)	(3)	(4)	(5)	(6)=(1)+...+(5)	(7)	(8)=(6)+(7)	(9)	(10)	(11)=(8)-(9)-(10)
Cataluña	-893.434,26	-1.252.917	-62.527,67	559.214,78	732.953,94	-916.710,42	936.740,46	20.030,04	2.495.631,41	2.507,09	-2.478.108,45
Galicia	-74.686,46	-450.323	9.511,17	224.634,78	-1.198.572,99	-1.489.436,53	242.788,07	-1.246.648	353.747,09	196,60	-1.600.592,15
Andalucía	-474.622,75	-1.116.762	-59.865,36	618.589,43	-2.957.522,80	-3.990.184,08	308.562,00	-3.681.622	954.397,49	1.419,96	-4.637.439,54
Principado de Asturias	-57.508,81	-197.606	806,89	85.185,86	-394.516,81	-563.639,52	90.926,32	-472.713	115.202,07	149,34	-588.064,62
Cantabria	-34.312,35	-103.245	378,08	44.514,75	-231.059,88	-323.724,70	16.195,79	-307.528,91	56.670,90	26,72	-364.226,53
La Rioja	-37.606,11	-50.394	193,45	24.668,98	-104.864,74	-168.002,52	0,00	-168.002,52	34.898,30	74,09	-202.974,92
Región de Murcia	-109.948,10	-167.616	-17.370,48	107.231,47	-271.285,98	-458.989,74	150.976,89	-308.012,84	273.846,83	114,96	-581.974,63
C. Valenciana	-604.899,09	-696.362	-73.448,17	378.500,84	-441.114,18	-1.437.323,24	634.026,61	-803.296,63	903.460,44	462,35	-1.707.219,43
Aragón	-128.233,02	-225.540	-9.155,82	107.137,69	-345.096,80	-600.888,79	32.645,72	-568.243,07	153.316,97	86,68	-721.646,72
Castilla-La Mancha	-61.184,16	-217.909	-14.652	166.382,78	-714.515,05	-841.878,59	76.320,53	-765.558,06	267.840,91	295,85	-1.033.694
Canarias	-123.715,29	0,00	3.809,67	164.891,21	-959.090,40	-914.104,81	69.199,92	-844.904,89	256.961,54	490,53	-1.102.356,96
Extremadura	-10.744,51	-140.370	9.585,45	88.459,88	-694.966,16	-748.035,81	102.503,83	-645.531,99	118.777,70	68,62	-764.378,31
Illes Balears	-96.634,97	-360.201	-26.651	82.860,53	224.054,50	-176.573,70	327.163,05	150.589,35	328.571,13	396,03	-178.377,81
Madrid	-834.258,59	-1.174.106	-10.912	455.094,54	601.420,14	-962.762,58	762.328,68	-200.433,89	1.130.029	5.759,87	-1.336.223,38
Castilla y León	-111.930,37	-388.110	-7.158	208.158,95	-1.066.230,60	-1.365.270	210.485,55	-1.154.785	284.270,78	125,02	-1.439.181,09
Total CC.AA.	-3.653.718	-6.541.468	-257.457	3.315.526	-7.820.407	-14.957.525	3.960.863	-10.996.662	7.727.623	12.173,70	-18.736.459
Melilla	0,00	0,00	0,00	0,00	1.762,77	1.762,77	5.250,00	7.012,77	8.260,00	0,00	-1.247,23
Ceuta	0,00	0,00	0,00	0,00	3.810,86	3.810,86	5.850,00	9.660,86	10.500,00	0,00	-839,14
Total Ciudades	0,00	0,00	0,00	0,00	5.573,63	5.573,63	11.100,00	16.673,63	18.760,00	0,00	-2.086,37
Total General	-3.653.718,83	-6.541.468	-257.457	3.315.526,50	-7.814.834,18	-14.951.952	3.971.963	-10.979.988	7.746.383,17	12.173,70	-18.738.545

4. SHARING THE DEFICIT

4.1 Economic Situation and Growth of Deficit and In-Debtment

The current economic crisis has forced Spain to adopt a number of measures that should prevent the need for a European bail-out⁶⁶. With a 20 per cent unemployment rate and a total deficit larger than the agreed ratio to GDP in the European framework, to name just two indicators, further measures may be needed.

Even if Spain does not have a debt / deficit problem greater than other EU members, there is a strong credibility problem, which is the main reason why the system should be reformed.

A mild reason for optimism is that foreign direct investment (FDI)⁶⁷ is slowly beginning to grow again, after falling sharply in 2009. In fact, in 2010 there was an increase of 41.5 per cent, with a total volume of €23,415 million. However, it is

⁶⁶ Among the most controversial, a decrease of public servants salaries of between 5 and 15 per cent and the increase of the general rate of the Value Added Tax from 16 to 18 per cent.

⁶⁷ See latest official data at: "Note on 2010 inward FDI data – Investment Registry, March 2011", available at:

<http://www.investinspain.org/icex/cma/contentTypes/common/records/viewDocument/0,,,00.bin?doc=4469127> (access on 27.June.2011).

important to note that the main element behind that FDI increase was operations in the Spanish holding regime (“*Entidades de Tenencia de Valores Extranjeros*” or ETVE), which increased by 174 per cent and were worth €1,778 million⁶⁸.

The current main indicators of the Spanish Economy⁶⁹ can be found below:

Table 8: Annual data and forecast for Spain (2 June 2011)

	2006 ^a	2007 ^a	2008 ^a	2009 ^a	2010 ^a	2011 ^b	2012 ^b
GDP							
Nominal GDP (US\$ bn)	1,235.90	1,444.00	1,600.20	1,468.40	1,409.90	1,529.40	1,454.80
Nominal GDP (€bn)	984	1,054	1,088	1,054	1,063	1,119	1,152
Real GDP growth (%)	4	3.6	0.9	-3.7	-0.1	0.9	1.3
Expenditure on GDP (% real change)							
Private consumption	3.8	3.7	-0.6	-4.3	1.2	0.7	1.3
Government consumption	4.6	5.5	5.8	3.2	-0.7	-1	-1.6
Gross fixed investment	7.2	4.5	-4.8	-16	-7.6	-1.9	2.8
Exports of goods & services	6.7	6.7	-1.1	-11.6	10.3	8.6	3.7
Imports of goods & services	10.2	8	-5.3	-17.8	5.4	4.3	2.7
Origin of GDP (% real change)							
Agriculture	5.4	5.4	-2	-0.6	-1.2	0.3	0.3
Industry	2.9	1.3	-1.5	-9.8	-1.4	1	1.5
Services	4.4	4.4	2	-1.4	0.3	0.9	1.2
Population and income							
Population (m)	44.7	45.2	45.5	45.8 ^c	45.9 ^c	46.1	46.3
GDP per head (US\$ at PPP)	29,213	31,266	31,488	30,643 ^c	30,782 ^c	31,446	32,610
Recorded unemployment (av; %)	8.5	8.3	11.4	18	20.1	20.6	19.7
Fiscal indicators (% of GDP)							
General government budget revenue	40.4	41.1	37.1	34.7	35.7 ^c	35.9	36.3
General government budget expenditure	38.4	39.2	41.3	45.8	45.0 ^c	42.7	42
General government budget balance	2	1.9	-4.2	-11.1	-9.2 ^c	-6.8	-5.6
Public debt	39.6	36.1	39.8	53.2	60.1 ^c	67.1	69

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.

Source: The Economist, Intelligence Unit⁷⁰

4.2 The Stability and Growth Pact and the Spanish “internal” Pact

1. Naturally, and particularly since 2008, the debate about the deficit limits and the debt ceiling has grown exponentially. Although Spain implemented severe deficit restrictions in 1997 and 2001, following the European Stability and Growth Pact, the

⁶⁸ This regime is a preferential tax treatment regime, bestowed to non-residents. It is currently regulated in articles 116-119 of the LCIT, it was introduced in the nineties, reformed in 2003 and then again by the Law 35/2006, of 28 November with the obvious purpose of capturing foreign capital.

⁶⁹ The main investors in Spain in 2010 were: The Netherlands (21.4% of the total), France (18.5%) and the United Kingdom (16.5%), which together accounted for 56.4% of total investment. Practically all foreign investment in 2010 came from OECD countries (95.1%). The two main areas of FDI in 2010 were Transport (€1,983 million) and Real Estate (€1,980 million), both these sectors accounted for 17% of the total FDI. By Autonomous Community, the three leading regions by inward FDI were Madrid, Catalonia and Andalusia (€4,986, 3,952 and 1,140 million respectively), or 42.8%, 34% and 9.8% of total gross inward FDI.

⁷⁰ Source:

<http://country.eiu.com/article.aspx?articleid=1568148141&Country=Spain&topic=Economy&subtopic=Charts+and+tables&subsubtopic=Data+and+charts%3a+Annual+data+and+forecast>, accessed on 27.June. 2011).

The Economist uses a number of different sources: OECD, Main Economic Indicators; Banco de España, Boletín Estadístico; Instituto Nacional de Estadística (INE); IMF, International Financial Statistics.

economic crisis has brought to the political forefront a debate that was almost non-existent outside expert circles.

In 1992 the Treaty of Maastricht made the limitations on debt (60 per cent) and deficit (3 per cent) a prerequisite to enter the “third phase” of the common currency. The 1997 “Stability and Growth Pact” (SGP) and several Rulings by the Commission set strict rules, which until 2005 included sanctions, for those Member States that did not comply with the limitations. The Pact reflected a widespread consensus, consolidated during the late 1980s and 1990s, on the wisdom of curbing excessive deficits. While the tendency towards excessive deficits is almost a structural feature of democratic governments, when they occur, a number of disadvantageous economic consequences are bound to ensue, such as higher interest rates or a higher debt burden that will have to be passed onto future generations by means of higher taxes, social security fees, etc. On the other hand, public expenditures tend to consolidate and to grow, while a sometimes organized resistance to pay higher taxes curtails the possibilities of revenue growth⁷¹. Of course, the main problem is also part of the solution, which is that the best way to secure compliance in policy is a genuine belief from policy-makers. But even if governments and decision-makers share this conviction, the question at stake is why would governments comply if the costs of failing to do so can be transferred to the whole EU. This explains the codification of the Pact.

The Stability and Growth Pact addressed the concerns about budgetary discipline in the Economic Monetary Union (EMU). Such concerns were originally expressed by the “stronger” European economies, thus reflecting a certain distrust of the poorer, southern, economies (namely, Spain, Portugal, Ireland and Greece). The need for rules to ensure Member States’ budget stability has been considered essential for the attainment of an EMU, but it is also generally regarded as a sound principle, or guideline, for a growing economy⁷².

It is, however, not a neutral position, for it reflects a consensus on how economic policy should be established⁷³. The consensus seems to point to the reduction of public spending as the main way to reduce the deficit. However, it has been soundly argued that it is not public spending, but the growing limitation in increasing taxes (taxing capacity) that causes problematic deficit⁷⁴.

⁷¹ Rotte, R.: “The political economy of EMU and the EU Stability Pact”, en: Baimbridge, M.; Whyman, P. (Eds): *Fiscal Federalism and European Economic Integration*. London: Routledge, 2004, pp. 50 et seq.

⁷² Buti, M.; Franco, D.: *Fiscal Policy in Economic and Monetary Union. Theory, Evidence and Institutions*. Cheltenham/Northampton: Edward Elgar, 2005, pp. 8.

⁷³ Cameron, D. R.: “On the Limits of the Public Economy”. *Annals of the American Academy of Political and Social Science*. Vol. 459, Government and Economic Performance, 1982, pp. 47 et seq. Specifically on the EMU see: Snyder, F.: “EMU Revisited: Are We Making a Constitution? What Constitution Are We Making?”, at: AA.VV. (Eds.: Craig, P.; Bùrca, G. De.): *The evolution of EU Law*. Oxford: Oxford University Press, 1999, p. 418.

⁷⁴ Cameron, D. R.: “Taxes, Spending and Deficits: Does Government Cause Inflation?”. Lindberg, L. & Maier, C. (Eds): *The Politics of Inflation and Recession*. Washington D. C.: Brookings Institution, 1985, pp. 234 a 239, y pp. 252 a 259. See a critic at: WOLFE, D. A.: “Politics, the Deficit and Tax Reform”. *Osgoode Hal Law Journal*, vol. 26, n. 2/1988, pp. 351 et seq.

On the other hand, there is a strong case to avoid a democratic deficit, which would ensue when future generations are forced to foot the bill of present spending⁷⁵. This “intergenerational equity” argument is present in all Stability reports presented by the Commission.

Furthermore, there is still, and will continue to be for years to come, the fundamental and unresolved question of the bifurcation of monetary policy and economic policy⁷⁶.

2. In 1997, Spain introduced what has been informally labeled “internal stability pact”⁷⁷ by establishing strict deficit limitations in budgetary policy. In practice, this radically changed how the Central Government’s budget was designed and applied and the question of in-debtment slowly began to creep into financing agreements with Autonomous Communities⁷⁸. But the economic growth that ensued did not help the debate, after all there was not much deficit and in-debtment was low. Hard times spurred the debate and shaped it. In fact, the 2009 reform of the financing system did partially revolve around the deficit issues, even if no significant measure or sanction was implemented.

This has partially changed recently. On July 6th (2011) and by Royal Decree (*Real Decreto-ley*)⁷⁹, the Central Government substantially limited the deficit that the Centre and municipalities may incur, actually establishing a ceiling for public spending; that is, a total maximum spending, related to their deficit limits. On July 27th, all Autonomous Communities agreed to pass laws to limit public spending, which should mirror the said Royal Decree. In the same meeting, it was approved to set the stability objective for Autonomous Communities (that is, the allowed deficit) a 1.3 per cent for 2012, 1.1 per cent for 2013 and 1 per cent for 2014. Finally, the Communities of Andalusia, Extremadura, Balearic Islands and Valencia presented “rebalancing plans”, which were accepted by the Ministry of Economy⁸⁰.

⁷⁵ This argument, among other, at Elliott, E. D.: “Constitutional Conventions and the Deficit”. *Duke Law Journal*, n. 6 (december), 1985, pp. 1089-1090.

⁷⁶ Joerges, C.: “States without a Market? Comments on the German Constitutional Court’s Maastricht-Judgement and a Plea for Interdisciplinary Course”. *European Integration Online Papers* (EioP), Vol. 1, n. 020/1997 (disponible en: <http://eiop.or.at/eiop/texte/1997-01920htm>), pp. 8 y 9. By the same author, see: “The Market without a State? The “Economic Constitution” of the European Community and the Rebirth of Regulatory Politics”. *European Integration Online Papers* (EioP), Vol. 1, n. 019/1997.

⁷⁷ The laws that contain the “internal pact” are: *Ley Orgánica 5/2001, de 13 de diciembre, complementaria a la Ley de Estabilidad Presupuestaria* and *Real Decreto Legislativo 2/2007, de 28 de diciembre, por el que se aprueba el texto refundido de la Ley General de Estabilidad Presupuestaria*. The European “Pact” was approved by a Resolution of the European Counsel (17 June 1997).

The Stability laws were highly contested and it was challenged before the Constitutional Court that decided on this issue in its opinion of 20 July (STC 134/2011), declaring them consistent with the Constitution. Of course after the reform of art. 135 CE this is now clear too.

⁷⁸ See Ruiz Almendral, V.: *Estabilidad presupuestaria y gasto público en España*. La Ley-Wolters Kluwer, 2008.

⁷⁹ *Real Decreto-ley 8/2011, de 1 de julio, de medidas de apoyo a los deudores hipotecarios, de control del gasto público y cancelación de deudas con empresas y autónomos contraídas por las entidades locales, de fomento de la actividad empresarial e impulso de la rehabilitación y de simplificación administrativa*.

⁸⁰ We have left out of this paper the analysis of the situation of municipalities. In fact, their current debt represents 3.3 % of the GDP. See data for municipalities at: www.eell.meh.es.

Table 9: Stability objectives (deficit projections) for 2012-2014

	2010	2011	2012	2013	2014
Central Government	-5.7	-4.8	-3.2	-2.1	-1.5
Autonomous Communities	-2.8	-1.3	-1.3	-1.1	-1.0
Municipalities	-0.5	-0.3	-0.3	-0.2	0.0
Social Security	-0.2	+0.4	+0.4	+0.4	+0.4
Total deficit	-9.2	-6.0	-4.4	-3.0	-2.1

4.3 The Reform of Article 135 of the Spanish Constitution: Possible Consequences for Fiscal Federalism in Spain

1. On August 23rd, 2011, President Zapatero announced before Parliament a possible reform of the Constitution in order to include a deficit limit. This came as a surprise to virtually everyone, but since the other large party (People's Party –*Partido popular*) also agreed, on August 26th a formal proposal was presented before Congress. According to the Spanish Constitution, because this article does not touch any of the main elements of the text (fundamental rights, the Crown, the outline of the State of Autonomies)⁸¹ its reform may be undertaken by special (60 per cent) majority of the Parliament and without referendum. On September 2nd, barely two weeks after it was first announced, the article was modified.

The new article 135 of the Constitution does several things:

First, it refers to the principle of stability as regulated in the Treaty for the Functioning of the European Union (TFUE), to which the article also refers. Section 135.1 establishes that “*all public administrations will follow the principle of budget stability*”. Section 135.2 states that “*The Central Government and the Autonomous Communities may not incur a structural deficit higher than that established by European Union. An Organic law [that is, a law that needs absolute majority for its approval] will establish the maximum structural deficit permitted to the Central Government and the Autonomous Communities. Local entities [mainly municipalities] must have totally balanced budgets*”.

The inclusion of the principle of stability is not a radical change or an innovation of our law system, at least to the extent that it was already mentioned in the TFUE, which is part of Spanish law. But it does ease the coordination between Spanish budgetary principles and European ones, which has been highly contested. It also makes it easier

⁸¹ This reform will follow article 167 of the Spanish Constitution:
Section 167

1. Bills on constitutional amendments must be approved by a majority of three-fifths of members of each House. If there is no agreement between the Houses, an effort to reach it shall be made by setting up a Joint Committee of an equal number of Members of Congress and Senators which shall submit a text to be voted on by the Congress and the Senate.
2. If approval is not obtained by means of the procedure outlined in the foregoing subsection, and provided that the text has been passed by the overall majority of the members of the Senate, the Congress may pass the amendment by a two-thirds vote in favour.
3. Once the amendment has been passed by the Cortes Generales, it shall be submitted to ratification by referendum, if so requested by one tenth of the members of either House within fifteen days after its passage.

to impose these limits to sub-national entities without the constant claim that it may limit their autonomy.

Second, the reform also limits debt, not just the deficit. Thus, section 135.3 establishes that the total in-debtment may never be higher than that established in European law. Again, not a radical reform but good news that it is now enshrined in the Constitution.

Third, the reform does have elements of flexibility:

A first element is that the numbers will be established in an Organic Law, which is easier to change than the Constitution. It has been announced that this law will be approved before the June 30th, 2012, and that there is already agreement (between the two main political parties) on its content. According to press releases (as reliable as they can be) the new Organic Law, to be approved before next 30 June 2012 will establish a maximum deficit of 0.4 per cent for the total public Administrations (that is, not only Central Government but also Communities and Municipalities) in the year 2020 (the German reform, which is being closely followed, set a deficit ceiling of 0.35 per cent for 2015).

A second element of flexibility also follows closely the German constitutional reform. Thus, the new section 135.4 establishes that the deficit and debt limits may only be infringed in cases of “*natural catastrophes, economic recession or situations of extraordinary emergency that are beyond the central Governments control*” such circumstances will need to be assessed and the breach of the deficit/debt limits approved by an absolute majority of Congress.

Third, the new section 135.5 establishes the minimum content that the future organic law is to have. Such law will need to develop the principle of stability as well as establish how Autonomous Communities and Municipalities may participate in the process of distributing the deficit and debt threshold among the different entities. The law will then set how the “pie” of total deficit and debt is distributed among the entities, as well as set the method by which such limits will be calculated. Finally, the law will need to establish the possible sanctions to be applied to those entities that do not comply with the limits.

Fourth, the new section 135.6 is directed to Autonomous Communities that must adopt the pertinent legislation, or modify the existing legislation if that is the case, in order to comply with the new article 135.

2. At this stage, and without knowing what the organic law will actually look like (it will not be approved before June 30th 2012), the following reflections can be made:

First and foremost, the article is a substantial change in comparison to the old article 135⁸², which merely established the obligation to always repay the interest and capital

⁸² The old text stated:

Section 135

1. The Government must be authorized by law in order to issue Public Debt bonds or to contract loans.
2. Loans to meet payment on the interest and capital of the State's Public Debt shall always be deemed to be included in budget expenditure and may not be subject to amendment or modification as long as they conform to the terms of issue.

of the State's Public Debt, a matter that was then, and still is, for that part has not been modified, completely outside the democratic debate. Even if both the Government and the Parliament "forgot" to include the necessary credits to repay the public debt in the budgetary document, they would still be automatically included.

It is remarkable, in my view, that article 136 has not been amended. This article refers to the Auditing Court (*Tribunal de Cuentas*), a totally independent body, accountable only before Parliament that is in charge of "*with auditing the State's accounts and financial management, as well as those of the public sector*" (136.1)⁸³. It should have been further empowered to also control the new debt and deficit limitations.

Second, from a political perspective, the decision has been harshly criticized because it seems to have been dictated by Germany. Indeed, opposition leader Mr. Mariano Rajoy proposed a similar measure a year ago, which was rejected by the ruling party without further discussion. The fact that it has been proposed in the last month before the Parliament was dissolved⁸⁴ also sends a message of hastiness that is not a good precedent.

Third, it could be argued that the content of the new article is not so new taking into account that the stability principle already exists in the TFEU and that the "internal stability pact" already established the deficit limits for all public entities. However, even if the final text of the Organic Law does not differ greatly from the existing laws, there is a fundamental difference in the importance that the principle acquires.

Fourth, a classical argument employed by those who oppose the stability principle has been that it runs counter to the principle of equity in the distribution of public moneys, as established by article 31.2 of the Spanish Constitution ("*2. Public expenditure shall make an equitable allocation of public resources, and its programming and execution shall comply with criteria of efficiency and economy*")⁸⁵. Already many political commentators have expressed that worry, and the new government the People's Party (PP), in power after 20 November 2011, has publicly stated that the new article must mean less public spending. This is one view; another one is that the reform does not

⁸³ Section 136

1. The Auditing Court is the supreme body charged with auditing the State's accounts and financial management, as well as those of the public sector.

It shall be directly accountable to the Cortes Generales and shall discharge its duties by delegation of the same when examining and verifying the General State Accounts.

2. The State Accounts and those of the State's public sector shall be submitted to the Auditing Court and shall be audited by the latter.

The Auditing Court, without prejudice to its own jurisdiction, shall send an annual report to the Cortes Generales informing them, where applicable, of any infringements that may, in its opinion, have been committed, or any liabilities that may have been incurred.

3. Members of the Auditing Court shall enjoy the same independence and fixity of tenure and shall be subject to the same incompatibilities as judges.

4. An organic act shall make provision for membership, organization and duties of the Auditing Court.

⁸⁴ Parliament will be dissolved on September 26th. General Elections will take place on November 20th.

⁸⁵ Many Spanish commentators have made this point, that the stability notion both limits public spending and that it makes its distribution less equitable; among others: Aliaga Agulló, E.: "El proceso de asignación de los recursos públicos en la futura Ley General Presupuestaria". *Revista Española de Derecho Financiero*, n. 120/2003, p. 655; Martínez Giner, L. A.: "El principio de justicia en materia de gasto público y la estabilidad presupuestaria". *Revista Española de Derecho Financiero*, n. 115/2002, p. 471. I have maintained the opposite view in: Ruiz Almendral, V.: *Estabilidad presupuestaria y gasto público en España*. La Ley-Wolters Kluwer, 2008, pp. 153-162.

necessarily diminish public spending, but then the tax revenues must be raised. Spain currently has substantially lower tax pressure than most other European countries from the “euro-area”, more so if the fact that the welfare state is well extended and implemented (with free and universal Health care and Education, among others) is taken into account.

**Table 10: Total tax revenue as percentage of GDP
(Euro countries)**

	1965	1975	1985	1995	2000	2007	2008
Austria	33,9	36,6	40,8	41,4	43,2	42,1	42,7
Belgium	31,1	39,5	44,3	43,5	44,7	43,8	44,2
Denmark	30,0	38,4	46,1	48,8	49,4	49,0	48,2
Finland	30,4	36,6	39,8	45,7	47,2	43,0	43,1
France	34,1	35,4	42,8	42,9	44,4	43,5	43,2
Germany	31,6	34,3	36,1	37,2	37,2	36,0	37,0
Greece	17,8	19,4	25,5	28,9	34,0	32,3	32,6
Ireland	24,9	28,8	34,7	32,5	31,3	30,9	28,8
Italy	25,5	25,4	33,6	40,1	42,2	43,4	43,3
Luxembourg	27,7	32,8	39,4	37,1	39,1	35,7	35,5
Netherlands	32,8	40,7	42,4	41,5	39,6	38,7	39,1
Portugal	15,9	19,1	24,5	30,9	32,8	35,2	35,2
Slovak Republic					34,1	29,4	29,3
Slovenia				39,2	37,5	37,8	37,2
Spain	14,7	18,4	27,6	32,1	34,2	37,3	33,3

Source: OECD Tax databases⁸⁶

Fifth, this reform will surely shape the debate and future reforms of the financing of public entities (Autonomous Communities and Municipalities). Just last July (2011), the Constitutional Court decided on the first of many cases on the Stability Laws, that many Communities claimed, limited their fiscal autonomy in a way that was contrary to the Constitution. In its decision 134/2011, of July 20th, 2011, the Court clearly states both that the Central Government has the authority to impose debt and deficit limitations to Communities and Municipalities, and that those limits are a consequence of the European legal framework. I submit that that ruling has paved the way for the current reform of article 135.

A possible outcome is that Communities may start to exercise their tax powers on ceded taxes in a more substantial way. This may mean more fiscal responsibility but also larger levels of regional differences. All that in a country where, even though officially decentralized, there is a generalized sentiment among citizens by which certain things –such as the provision of fundamental services but also tax pressure - must remain the same or similar in all the territories⁸⁷.

⁸⁶ Source, OECD database (free access:

http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html).

⁸⁷ Often, differences in salaries of public servants among Communities, or tax pressure, attract press attention and more often than not, angered comments by politicians contrary to such differences.

5. CONCLUSIONS

The decentralization process in Spain has been remarkably swift and, generally speaking, quite successful. Authority has been devolved to Communities in an orderly fashion and this new tier of government has been well accepted by citizens.

Nonetheless, far too many issues remain unresolved. Among others, the level of fiscal responsibility is insufficient. Despite the significant reallocation of taxation powers, the system is still largely based on the assessment of need by the Central Government and the allocation of funds according to that need. Furthermore, and to a large extent the basic formula of the system guarantees funds to Communities without sufficiently taking into account their fiscal responsibility, whether they decide to establish new taxes or increase tax pressure in order to obtain more funds, and regardless of whether they control their indebtedness and deficits. Indeed, the law prescribes that all Communities shall receive an amount sufficient to finance their authority. If a Community decides to increase or decrease the tax burden of its ceded taxes, this will be reflected in the total budget received from the Centre, which will then vary accordingly. However, there is no effective mechanism to incentivize Communities to exercise their taxation powers, as they still obtain the revenue of ceded taxes, even when they do not actually regulate any aspect of them. That is, the financial incentive for Communities to use their powers over those ceded taxes that they control is weaker than the political incentive not to increase the tax burden on their citizens. In fact, a substantial amount of revenue is already guaranteed from ceded taxes they do not control. This partially explains why most of them have preferred to establish tax credits and tax benefits, as opposed to increasing the tax burden. They have, so far, only increased taxes in the cases of gambling taxes, capital transfers tax and stamp duty.

Furthermore, the financing system does not sufficiently take into account the EU Stability Pact constraints. Although Spain has adopted a kind of “internal stability pact”, the sanctions are not credible enough and Communities are able to run large deficits while reducing their tax burdens. It seems as if the financing of Communities was designed (still) without fully taking into account the European context. Of course the new article 135 of the Constitution may serve to change that, but it is too early to tell.

If a crisis can be viewed as an opportunity, the current one may bring about two theoretically opposite results: a larger decentralization of revenues, in the form of greater fiscal responsibility and a re-centralization of services, as a result of severe spending cuts by Autonomous Communities.

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The way forward on state tax reform: an AFTSR perspective

Greg Smith¹

Abstract

This paper reviews recommendations in the 2009 Report to the Treasurer on Australia's Future Tax System Review (AFTSR) relating to the future of state taxes in Australia. The Report proposes greater centralisation of tax collection, abolition of many state taxes, and reforms to others including land, resource and road-related taxes.

1. INTRODUCTION

The Australian Government established a review of Australia's Future Tax System ('the AFTS Review') in 2008, conducted by a five member panel chaired by the then Secretary to the Treasury, Ken Henry. The Review considered taxes at each level of government, including those levied by the States and Territories². This paper provides a survey of the main findings of the AFTS Review on State taxes and a discussion of the issues and prospects for reform in coming years.

2. FISCAL IMBALANCE

The Australian States have long collected a number of relatively small and narrowly based taxes which together fund only about one half of their expenditures. The gap between own-source revenues and expenditures, or vertical fiscal imbalance, has been met by fiscal transfers from the Commonwealth so that State services rely in large part on funding from national tax revenues.

The AFTS Review sought to determine the best structure of taxes for Australia as a whole on the broad premise that the resulting revenues could be allocated between the levels of government under mutually agreed arrangements. The majority of existing state taxes were found to perform relatively very poorly in terms of allocative efficiency. The Review proposed that they be abolished. In general, the preferred replacement taxes were those imposed on large bases collected at the national level. Accordingly, adoption of the AFTS Review recommendations would lead towards greater vertical fiscal imbalance than under the existing arrangements.

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² References in this paper to the States refer to the States and the two self-governing Territories.

The implications for the States of the AFTS Review recommendations extend beyond the replacement of inefficient state taxes. In addition, recommendations were made that would:

- change the ways that some state functions are funded, including in ways that would alter the relative fiscal positions of the Commonwealth and the States; and
- change the design and scope of remaining state taxes and charges.

The AFTS Review did not undertake a formal assessment of fiscal federalism. In particular it did not consider issues associated with horizontal fiscal imbalances (variations in the fiscal capacities of the States to provide public services) or its amelioration. As to vertical fiscal imbalance, the preferred outcome depends on a number of factors including the allocation of spending functions between each level of government, the desired degree of policy experimentation and competition between the States, and (in contrast) the desired level and nature of coordination and harmonisation between the States and between the levels of government.

The Review found that the States with their current roles should have access to their own revenues “...to finance significant marginal expenditure decisions”³. The emphasis on ‘marginal’ is intended to imply that it is satisfactory for most revenue to be obtained through transfers from central government. Australian States have some degree of policy autonomy and hence diversity in at least some areas of continuing policy responsibility, but this is limited and declining. The Review envisaged that much of the funding would take the form of tax base sharing using centrally collected taxes – with the States themselves being likely to mainly collect revenues only from relatively immobile tax bases.

A key issue with the sharing of centrally collected taxes is whether states have any autonomy on the tax base or rate. Currently, the States receive 100 percent of the net revenues of the Goods and Services Tax, which as a Commonwealth tax is constitutionally required to have a common base and rate⁴. States could potentially exercise autonomy if instead they were to share an income tax base. However, the AFTS Review did not proceed to the point of recommendations on these issues, essentially because it considered a review of broader federal financial relations would be required first. It is possible to conceive a large range of possibilities for the ways in which public services are funded with significant implications for the ways that federal funding arrangements are conducted. These possibilities have not yet been systematically assessed across all areas of policy in Australia – recent proposals for a national disability insurance scheme however provide one illustration of the major changes that are possible. That proposal functionally separates funding arrangements and service delivery and would reduce state revenue requirements.⁵

3. THE REFORM FRAMEWORK

The AFTS Review was informed by the well-established analytical tools of the tax axioms (equity, efficiency, simplicity etc.) including recent empirical evidence on some of the key issues, and international comparisons. Perhaps more so than earlier

³ AFTS Review Part 2 (2010), p.672

⁴ The Constitution reserves excises for the Commonwealth and prohibits discrimination between the States under revenue laws (s.99).

⁵ See Productivity Commission, Disability Care and Support, 2011

policy reviews, it was also heavily influenced by an assessment of strategic developments in such fields as the global economy, demography, technology and social and environmental sustainability.

The broad conclusions for the future Australian tax architecture were:

- Revenue collection should be concentrated on four efficient bases – immobile rents, consumption, individual income and business income.
- Other narrow and inefficient taxes should be abolished (except those efficiently addressing market failure or other clear social purposes)
- To maximise economic growth, the relative weight of the major taxes should shift over time in accord with base mobility – more tax on immobile rents (land and natural resources) and consumption and less on personal and (particularly) business income.
- Existing major tax bases could be more neutral; the transfer system better targeted, more adequate, and less adverse for workforce participation; and some user charges and other fiscal arrangements could be reformed to improve social outcomes.

In broad terms the Review was conducted under a revenue neutrality assumption because its terms of reference specified that “...recommendations should not presume a smaller general government sector and should be consistent with the Government’s tax to GDP commitments.”⁶ Clearly then, the Review framework requires that revenue losses from the abolition of taxes be offset by higher collections from the large efficient bases.

Several large tax base issues were addressed in very general and sometimes provisional terms, such as those relating to business income and the taxation of dividends. Because the Review was precluded by terms of reference from recommending increases in the GST rate or base, it was also guarded in the way it approached the key idea of increasing the overall weight of consumption taxes or using these to facilitate reform (often abolition) of State taxes.

The key recommendation in this regard is Recommendation 55 dealing with replacing state taxes with a destination cash flow tax, but this is worded essentially as a finding. There is no specific recommendation for the actual introduction of a new cash flow tax and the only recommendation in the chapter on State tax reform relates to general principles for inter-governmental coordination processes. Recommendation 55 states that:

*Over time, a broad-based cash flow tax – applied on a destination basis – could be used to finance the abolition of other taxes, including payroll tax and inefficient State consumption taxes, such as insurance taxes. Such a tax would also provide a sustainable revenue base to finance future spending needs.*⁷

A destination cash flow tax would have much the same economic base as a value added tax (the GST). In the context of modern business technologies, it may be simpler than the GST because the invoice VAT was originally designed for mid-20th century paper based business technologies. It could offer an opportunity for a broader

⁶ Terms of Reference are reproduced in AFTS Review Part 1 (2010) pp vii-ix

⁷ AFTS Review, Part 1 (2010) p 91

and more neutral base and for greater integration of tax administration and collection across more than one base. However, the Review essentially leaves most of these issues for further study in the future.

4. ABOLISH AND REPLACE STATE TAXES

The AFTS Review proposed that a number of state taxes be abolished and replaced by other more efficient sources of tax revenue (or user charges). A destination cash flow tax is potentially only one of these. Clearly, an increase in the rate or base of the GST itself, whether or not it is reformed in other ways, is also an alternative source of revenues if political conditions change under some future government.

The taxes proposed to be abolished were identified by the AFTS Review essentially on the basis of theoretical expectations and empirical estimates of their excess burden or ‘deadweight economic loss’ (the loss of social welfare arising from behavioural change arising from the tax)⁸. While this is only one criterion for the analysis of taxes, the Review had in any event decided to recommend that revenue collections be concentrated on four large and relatively more efficient tax bases. It did not support retaining in the long run any other tax whose justification was purely revenue. Some taxes may be retained where there are specific additional economic or social purposes and it can be shown these are met efficiently by taxes. The proposals for the main state taxes are summarised in Table 1.

Table 1: AFTS Proposals for State Taxes

Tax	Revenues 2009-10 \$b	Proposal	Possible Replacement
Payroll	16.8	abolish	Consumption
Insurance	4.6	abolish	Consumption
Property transfers	12.3	abolish	Land tax
Land tax	5.8	Retain and reform	Modified base
Resource Royalties	6.6	abolish	Resource rent tax
Motor Vehicle revenues	7.0	Possibly abolish tax component	Road user charges
Gambling	5.0	Retain and reform	na

Source for revenues: Taxes, ABS Taxation Revenue Australia, 2009-10, Cat. 5506.0: Royalties, Commonwealth Grants Commission website (note significant royalty revenue increases are expected in coming years)

As Table 1 shows, the AFTS proposals potentially would require additional consumption tax revenues of about \$21 billion (in 2009-10 terms) to replace mainly payroll and insurance taxes. This would broadly be equivalent to a destination cash flow tax at a rate of 3-4 percent: the narrower base of the existing GST might require increasing the rate from 10 to 14 or 15 percent (base broadening aside). Of course, whether or when Australian political conditions would ever support such a reform (and under what if any broader change strategy) is difficult to judge: it is ruled out by current policy on both sides of politics.

For practical and constitutional reasons (noting a destination tax is imposed on imports) a cash flow tax would need to be a uniform national tax, just as the GST and

⁸ AFTS Review, Part 1 (2010) p 13

any changes to it requires Commonwealth legislative action that does not discriminate between states.

The abolition of state taxes would change the assessment of the fiscal capacities of the States and so would affect the distribution of Commonwealth general revenue payments to them. As with the introduction of the 10 percent GST in 2000, these issues likely would need to be the subject of a comprehensive intergovernmental agreement, possibly including guarantee provisions ensuring no state is made worse off by the changes.

In principle a greater use of the consumption tax base might also be used to replace other inefficient taxes. However, as indicated in Table 1, the analysis in the AFTS Review points to different approaches for these other taxes. Land tax, if imposed on a broad and neutral base, is particularly efficient, even more so than consumption, and the immobility of its base renders it very suitable as a state (or local) tax. Unlike consumption tax there is also no constitutional difficulty for States imposing the tax at rates of their choosing. The AFTS Review therefore envisaged that land taxes, which currently generate revenue both through an asset base and a transaction base, should be reformed without any net reduction in land revenues. The abolition (or reduction) in property transfer taxes would therefore be funded by land tax.

Similar considerations apply to resource royalties – the most efficient replacement for these is resource rent taxes. The AFTS Review recommended that royalties be replaced in this way and that the Australian and State governments negotiate an appropriate allocation of the revenue and risks. Subsequent announced policy, applying to a more limited range of resources, was developed without this consultation on revenue sharing. It provides for the retention of both forms of tax, with the States retaining royalty revenue and the Commonwealth taking rent tax (with a credit for royalties). Some States have already announced higher royalties in order to secure higher shares of revenue, but the retention of royalties has compromised for now the potential efficiency benefits of these reforms.

In the case of the motor taxes (which at the state level mainly comprise registration charges and stamp duties on purchases of motor vehicles), the initial recommendation is to make these explicit and link them to recovery of costs related to road provision. In the long term these could be replaced if efficient road pricing is introduced, but this is a highly contingent proposal.

While taxes on bequests are generally considered politically unattainable in Australia, the AFTS Review did survey the issues because such taxes are clearly relatively efficient. In practice they could contribute to state revenues, to tax system progressivity and to encouraging philanthropy (assuming such bequests are exempted). The recommended course, however, was no more than to encourage further study and community discussion of the options.

5. REFORMING CONTINUING STATE TAXES

The AFTS Review provided few substantive recommendations for the reform of specific state taxes except for land tax. Land and gambling taxes would be the only substantial state taxes continuing to exist if the Review recommendations were fully adopted.

5.1 Land Tax

The potential efficiency of land as a tax base has long been recognised. The AFTS Review included land among its four preferred tax bases (including it with natural resources as the main immobile economic rent bases). In Australia, however, taxes based on land take three main forms with only one, the local government rate, coming close (in most cases) to an efficient design. Much less efficient are state land taxes (because they apply on an aggregate landholding basis and only to certain land uses) and property transfer taxes which share the efficiency costs of many other transaction taxes.

The Review proposed a single, comprehensive land tax base (essentially shared between local and state government). It proposed that the rate of tax be set by reference to the unit value of land (that is, the value per square metre rather than the aggregate value of total landholdings of each taxpayer). Low unit value land such as most rural land would fall below a threshold value for tax, but in general there would be no exemptions based on the use of land. As the unit value of land rises, generally in or near population centres, the rate of tax would also rise. The highest rate would apply to the most valuable land per square metre, although implicit in the recommendations is that the rate of tax would never be so high as to confiscate a very high share of rents. Of course, it is to be expected that such a tax structure would through capitalisation of the tax result in some reduction in land prices and amelioration of the land price gradient.

Given its implications for land values and hence for existing wealth-holding, this reform, if it is to have any prospects, likely would be phased in over a potentially long time frame along with the reduction and perhaps even ultimate abolition of property transfer tax. Clearly, however, this is still politically challenging, both in relation to its different transitional effects on taxpayers and as it involves a tax base shared by two levels of government. Recognising this, the Review suggested consideration of some more incremental steps, including:

- Applying land tax to each holding rather than aggregate holdings (potentially removing disincentives for the expansion of holdings of residential investment properties by institutional investors); and
- Applying the reform only to commercial and industrial property.

The main problem with comprehensive reform in this area is the difficulty in seeing who would champion it. The performance of land markets in Australia is mainly of concern because prices are often high relative to incomes. The reasons for this are controversial. The implications are also unclear and contested, although there is growing concern about housing affordability particularly for the new generations of potential first homebuyers. It is in this concern that land tax reform has its most obvious potential prospects, along with other tax reforms (such as the taxation of investment properties) and for regulatory reform beyond the tax agenda.

However, set against this are strong interests benefiting from existing outcomes, not least existing landowners. It is unlikely that there will be much change unless and until a much clearer consensus emerges about market performance, its causes, and opportunities for improvement. Even then, there may need to be other gains packaged with this reform. The future role of local government may also play an important part, given the fundamental place that property and land use plays in that role and its funding.

5.2 Gambling Taxes

Gambling taxes are controversial in Australia as elsewhere given differing perspectives on how the social costs of problem gambling should be addressed. As for alcohol, the AFTS Review tended to the presumption that responsible gambling consumption was welfare improving in keeping with the standard consumer sovereignty framework of mainstream economics. The role of taxation was therefore seen mainly as collecting monopoly rents arising from government regulation of gambling. Attention focused also on ensuring that outcomes were neutral, in particular not serving one supplier interest (such as clubs) over others.

5.3 Reforming other taxes

The AFTS Review put its faith in abolishing the most inefficient state taxes rather than reforming them. While these taxes continue, there may be scope for their reform to improve efficiency and other outcomes. The Review observes that thresholds and exemptions create distortions and increase the welfare cost of the payroll tax, but this analysis is not taken further to detailed recommendations about payroll tax design.

The Review also proposes that minor state taxes and charges be reviewed against the principles enunciated in its Report – it would follow logically that this apply to other major taxes as well, but the Review itself did not attempt to do so.

The Review also recommended (Rec. 138) that uniform state reporting of state tax expenditures should be introduced through agreement reached under the umbrella of the Council of Australian Governments (COAG)⁹. It envisaged that the standards for the reporting of tax expenditures by both the Commonwealth and the States would be set by an independent body. While these are not the type of recommendations that usually attract much attention, the publication of tax expenditures can facilitate longer term reform efforts as the opportunity costs of inefficient taxes are made more transparent.

6. OTHER FISCAL REFORMS

The recommendations of the AFTS Review extend beyond specific state taxes themselves to measures that would affect the fiscal position of the States in other ways. Overall, the effect of many of these may be to reduce the tax revenue needs of the States. Some would affect tax administration or revenues and others state spending needs, or the ways that Commonwealth programs directly or indirectly fund those programs. These are briefly illustrated here.

⁹ COAG is a formal structure for meetings of heads of Commonwealth and State governments and is the principal body for the negotiation of intergovernmental agreements within the Australian federation.

6.1 Road congestion

The Review proposes that governments investigate the possible introduction of variable congestion pricing and potentially wider road pricing reforms if new technologies prove cost effective. Ultimately, such a reform has the potential to remove the requirement for a large part of Commonwealth and State funding of roads from tax sources. These approaches to road pricing carry with them requirements for major institutional and market reform in the roads sector. The reform task here is complex and challenging with major implications for all levels of government, with tax arrangements playing only one of many parts. Roads are the last major economic infrastructure to resist substantive microeconomic reform. For the foreseeable future progress on this issue will depend on broader road reform (and technology related) developments.

6.2 Local Government

The Review proposes greater revenue autonomy for local government but also eventual integration of land based state and local government taxes. The roads and housing reforms also have implications for local government. Each of these would rely on high quality coordination between state and local authorities, although the potential also exists for pursuing greater fiscal autonomy for local government if that is considered desirable, with reduced reliance on intergovernmental transfers.

6.3 Housing policy

At present rental housing assistance is provided both by the Commonwealth in the private rental market and the States in the public housing sector. The Review proposes that the Commonwealth provide a common (and higher) level of assistance across both sectors, with potential implications for the future funding models (and respective roles of government) in public sector housing. Potentially, the Commonwealth could replace the States as the source of all housing assistance funding, while the States may continue to manage public (or other community) housing supply. Attempting to contribute to ameliorating the broader problem of housing affordability, the Review's housing-related recommendations included economic reform of the basis for setting developer charges.

6.4 Social policy programs

The Review made a range of recommendations that would potentially alter state financial responsibilities in relation to some social support programs. These included a recommendation that the provision of concessions tied to goods and services be reviewed, particularly as some deliver benefits on a regressive basis and value for money is uncertain. More fundamentally it recommended a review of the models for funding social programs – anticipating the Productivity Commission work on client-centred funding for disability care and aged care. These potentially involve models where the States remain as regulators and service providers but not as ultimate funders of programs. Such models could extend to many areas and have profound implications for federal financial relations.

7. REVIEW TIMETABLE

The AFTS Review was commissioned by the Government in May 2008. It followed a business-inspired call for a tax review at the so-called 2020 summit, a gathering of diverse individuals aimed at discussing Australia's future course. At that time Australia appeared to be facing benign economic and fiscal conditions, so the main focus was on how to make best use of our luck. This included expectations of continuing future budget surpluses, and no doubt many saw an opportunity to benefit from them. However, within a few months, the Global Financial Crisis was triggered and fiscal surpluses soon disappeared. The AFTS Review reported in a very different environment from the one in which it commenced.

This fundamental change in conditions reinforced the long term focus of the Review. In its Report, the Review discussed at length why it did not propose timetables or packages of reforms¹⁰. These included:

- The need to assess critical links to other areas of public policy, including taking into account overall developments affecting income distribution.
- The need to assess the right balance over time between competing policy objectives and to link appropriately to fiscal and macroeconomic circumstances (these were influenced by the prevailing GFC problem and its uncertain course).
- The need to obtain intergovernmental agreement.

In making these and other observations, the Review sought a robust *approach* to reform rather than immediate *results*. Its goal was to produce a reference document for future reform efforts. This positioning, of course, is not easily understood or managed in contemporary political settings. The Government did not release the Report for nearly six months, and then only after making many policy decisions for announcement at the same time. Some further decisions have followed in a small number of areas.

Only in October 2011 was a formal community discussion of tax reform organised. It resulted in very limited intergovernmental agreement on tax reform¹¹. Some States have indicated an interest in reviewing their own taxes, and some processes along these lines have been commenced, but at this stage it appears unlikely that these will lead to any major push for major structural reform. Australia in 2011-12 is undergoing a period of considerable political change and uncertainty which may not be conducive to early major action.

8. PROSPECTS FOR REFORM

The prospects for further tax reform are constrained by several key issues.

Firstly, the tax reform policy agenda is already quite heavy, at least in political terms. The immediate agenda is dominated by two main measures – introduction of a carbon pollution price and a minerals resource rent tax. Although the gross tax receipts of each of these is less than 2 percent of total tax revenues, they have proven highly controversial, arguably consuming the political space for tax reform for some time. Beyond this, governments face difficult reform agendas relating to aged care and

¹⁰ AFTS Review Part 1 (2010) Pathway to reform, pp xxiv-xxvi

¹¹ See the Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, "Closing Remarks for the Tax Forum" 5 October 2011 (at www.treasurer.gov.au/speeches)

disability care and support, each affecting both major levels of government and the subject of Productivity Commission Inquiries. A major challenge now arises in integrating responses to these issues with the quite high fiscal cost decisions already taken on retirement income policy.

Second, the fiscal situation facing Australia is one of very limited policy room. Projected national budget surpluses in each of the three years to 2014-15 are very small (reaching only \$3.1 billion in the final year). In the context of strong bi-partisan commitment to budget surpluses, this largely rules out for some time the tactic used in most past tax reforms of providing net tax cuts with reform packages. These were previously possible in large part because significant bracket creep revenues (that is, higher revenues as average rates of tax increase under an unindexed progressive tax scale) were returned to give the impression of net gains.

Third, the policy settings in coming years will likely act as a brake on the growth rate of disposable household income which limits the political appetite for reforms that have any real or apparent household cost. The elements of this include bracket creep for a number of years, the introduction of an additional 3 percent superannuation guarantee obligation, and the possible costs of the aged care and disability care reforms. In combination, these will limit the rate of growth of real household disposable income – arguably at a time when widespread expectations for continuing rapid income growth remain unrealistically high.

This is not to say that the prospects for reform will necessarily be dominated by negative factors. For the States in particular, other economic developments may raise interest in reform issues. The mining boom in Australia is having profound effects on the relative fiscal positions of the States, and these effects could continue to grow. These effects include:

- A large increase in revenue disparities between the main mining States (mainly WA and Queensland) and the other States
- In consequence, an offsetting redistribution of GST payments under Australia's horizontal fiscal equalisation system: already underlying controversies in this regard have led to the establishment of a Review of the GST distribution arrangements¹²;
- Weak growth in the GST pool: this partly reflects the two-speed economy problem but in future may also be influenced by the effects of other policies on the rate of growth in household disposable income (and hence consumer spending).

It is also possible that the very high terms of trade enjoyed by Australia will undergo a correction. If this occurs, some of the effects noted above may ameliorate but only at the expense of other developments associated with weakening national income. Renewed concerns about trade competitiveness and employment growth could emerge and with that revitalised interest in the adverse economic effects associated with inefficient taxes.

If Australia in a future period undergoes a protracted period of relatively high unemployment (as it did throughout most of the years of tax reform in the past) there may be greater interest in particular in abolishing the payroll tax. While this interest

¹² The GST Distribution Review, commissioned in March 2011 and due to make a final report by August/September 2012: refer www.gstdistributionreview.gov.au

may often be based in part on misunderstanding of the actual economic incidence of this tax, a switch from that tax base to consumption would be expected to support growth.

Overall it is not clear what will develop, but there is certainly early evidence of considerable concern among the States at their fiscal circumstances and the ways that these developments and existing policy affects them. This could generate interest in a broader solution to their revenue and spending pressures.

In the current setting, it seems that those interested in further reform may need to focus on furthering the analysis and understanding of the key issues for some time. The AFTS Review made a number of recommendations that would further this type of work (see Recommendations 113, 131 and 134 which each propose arrangements for ongoing review, coordination and independent policy research).

Developing a renewed understanding and vision for the federation may need to be added to that agenda. Disputes over the role of state royalties and national resource rent taxation illustrate the ongoing difficulties in the federal relationship. The likely coexistence of these taxes now raises a clear reform opportunity if a revenue sharing (or even full tax reassignment) agreement could be reached so that interests can be aligned favouring a more efficient structure.

9. CONCLUDING COMMENTS

The AFTS Review provided a broad vision for the future Australian Tax System rather than a detailed design or roadmap for change. For the States the vision is ultimately one of greater revenue base sharing and hence continued financial dependency on the Commonwealth. There is some risk that this fact alone will be an impediment to tax reform because for the States it comes at the price of losing even more of the little remaining revenue autonomy they enjoy.

This observation supports a conclusion that tax reform at this level will depend on reform of the federal fiscal relationship. This relationship raises a complex set of questions that requires considerably more research work and stakeholder discussion before it will progress far. That work and discussion is not properly or sustainably one for the Commonwealth and the States alone, represented by their ephemeral executive governments. The stakeholders extend to all in the Australian community.

Efforts to date to achieve better relations between the Commonwealth and the States have brought some results but as quickly as gains are made new setbacks emerge. With widespread areas of policy responsibility now entangled by shared responsibility, the political costs and drain on leadership time and attention of these problems suggest that there should be incentive for more concerted action.

On the tax front, the immediate prospects for major structural reform along the AFTS lines are not strong. As the next few years unfold, much will depend on the way economic conditions unfold. Core questions ultimately will include whether there is enough force to the argument that a higher general consumption tax should replace the payroll tax (and some smaller inefficient state taxes) and whether, once the dust settles, the benefits of one rent-based tax on resources can better serve the States as well as the Commonwealth.

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Solidarity and the design of equalization: setting out the issues

Bernard Dafflon¹

Abstract

Inter-jurisdictional differences originate in choices or situation disparities. Equalization refers to the latter only. Recent policies separate disparities of revenue potential from expenditure needs in various formula-based vertical or/and horizontal financial transfers. Whereas the RTS method (for “Representative Tax System”) is common for revenue equalization, different concepts have been used to express disparities associated with decentralized public expenditures. Needs or costs disparities and expenditure disabilities are usually given as rationale for equalization. The paper explores four issues in the two types of equalization: funding, measures of disparities, formulas and possible additional policy variables. It also questions the rationale of vertical versus horizontal equalization transfers. The objective of the paper is to organize the core questions around these issues in a coherent – and if necessary iterative – sequence of reasoning with the aim of producing guidelines for policy implementation.

INTRODUCTION ²

In most federal or decentralized countries, the reduction of fiscal disparities between sub-national governments (SNGs thereafter) is an acknowledged aim of intergovernmental fiscal policy. Even if it is far from undisputed on economic grounds (Oates, 1999: 1127), fiscal equalization transfers are in many countries an important instrument to pursue interregional solidarity. For practitioners, the theory of fiscal equalization is elusive. There is no core program; it is mainly derived from the theory of grants-in-aid. There are several ways to consider SNGs' capacity. The distinction between expenditures/costs/needs equalization is blurred. This is not surprising. Equalization is first and foremost a question of redistributive justice among SNGs. How much the "rich" jurisdictions should contribute to equalization and "how much" the "poor" can claim, the estimation of the degree of capacity - financial, fiscal or tax capacity - together with the evaluation of the amount to be paid or received are closely - though not exclusively - related to the concept of "solidarity", a concept that opens up a variety of opinions. Equalization policies are pervaded with value judgments that cannot be seized by theory. And since equalizing formulas are embedded in many ad

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² This paper is a compilation of recent studies by the author on the institutional and political economy of equalization, most of them centered on the logic and coherence of implementation. See Dafflon and Vaillancourt (2003), Dafflon and Mischler (2008), Dafflon (2007) and two papers in progress: Dafflon and Vaillancourt (2009), Dafflon (2010).

hoc systems, generalization and policy guidance are difficult.³

This paper is divided into four sections. Section one explores the rationale of fiscal equalization: what are the possible origins of fiscal differences in the relevant literature? Section two presents in graphical form revenue equalization in addressing four fundamental questions: the measurement of the revenue differentials, equalization formulas, how much equalization, and possible further adjustments. Section three turns to equalization schemes that incorporate expenditure needs/costs differentials: how to determine "standardized" expenditures; to measure disparities in needs or in costs? It also looks at the available methods for estimating expenditure needs/costs disparities. Section four concludes.

1 THE RATIONALE FOR EQUALIZATION

Most federal and decentralized States have experienced fiscal imbalance, vertical and horizontal, and have found the necessity to correct both over time. In a decentralized budget, vertical imbalance results from the fact that in most cases, major buoyant taxes are held by the federal government, while labour intensive functions, such as health, education and social services have usually been assigned to SNGs for reasons of proximity and preferences (Watts, 2008: 103). Vertical imbalance should be solved by re-assigning taxation or through additional financial transfers from the center to the SNGs.

The origin of horizontal imbalance is different. First, no matter how carefully functions and revenues are decentralized with the objective of matching expenditures and taxation, their paths differ over time causing disparities in decentralized budgets of SNG units. Second, since no federal or decentralized country is perfectly homogenous, the different levels of taxation by SNGs do not necessarily mirror differences in the demand for local public services. Sub-national financial capacities depend on both the tax bases accessible to SNGs and the territorial distribution of those bases. Needs vary according to the particular preferences of the local residents; but they also depend on geographic, demographic, and socio-economic factors. They are further determined by legal (but not only) requirements as to the type of mandatory public services that SNGs must provide.

Equalization is the usual answer to horizontal imbalance. It refers to attempts made at the reduction of fiscal differences among SNGs by monetary transfers. Two initial questions arise with respect to implementing equalization schemes. (i) What sort of "solidarity" among SNGs is accepted and acceptable and who decides on this? More solidarity would clearly mark a trend towards standardization in the delivery of core local public services, instead of promoting the provision of local-specific services at comparable tax levels. (ii) Where to draw the line between local preferences and mandatory local public services? As Boex and Martinez-Vazquez (2007: 293) put it, without a clear demarcation line separating specific standards of services from an

³ Recent publications on intergovernmental transfers and equalization summarize the various theoretical facets of equalization, the pros and cons, and confront theories to practices. This is not surprising in view of the dissatisfaction that arose from the equalization systems dating from the seventies and the urge for changes. See Färber and Otter (eds), 2003; Boadway and Shah (eds), 2007; Martinez-Vazquez and Searle (eds), 2007; Kim and Lotz (eds), 2008.

overall envelope of expenditures, perceptions of what may be a need can easily escalate to completely unaffordable expenditure levels.

In a first attempt to delineate what should or should not be included in equalization, Box 1 reviews the possible origins of fiscal differences in the relevant literature. The logic behind this classification into five categories is twofold:

- (i) Those items that are within the scope of decision and the fiscal management of SNGs should not be taken into consideration for equalization. They belong to the sphere of local autonomy and responsibility.⁴
- (ii) "External" items that are outside their scope of decision should be compensated, at least partly, if they result in a significant spread in the relative fiscal position of SNG units. Generally speaking, involuntary or non-chosen differences are referred to as fiscal disparities.

Category A concerns resource equalization: taxable resources depend strongly on the geographic position of government units in the national territory (periphery or proximity of urban areas and economic centers), on the kind of economic activities or clusters, and on communication networks. Within an open market economy, SNGs cannot influence these characteristics, thus they must be treated as exogenous variables.⁵

Category B refers to the provision of local public goods and services at standard levels that are fixed by higher government tiers – the mandated functions. It raises the issue of correspondence between decision makers, beneficiaries and payers (Oates, 1972: 34): with the motto "he who decides should also pay", cost differentials are paid by the government layer that determines the standards. When this is not the case, the issue of needs equalization comes to the heart of the political agenda.

Category C deserves careful consideration of the possible origin of expenditure needs/ costs disparities. Cost disparities in input factors very often fall outside the SNGs' decision-making competence and should thus be taken into consideration for equalization. Considering needs disparities is more delicate because it may be problematic to link needs directly to the sheer increase in the volume of production or the number of beneficiaries.

⁴ This is also the position of the Expert Panel on the reform of Equalization in Canada: "Expenditure needs should only take into account differences that are not under the control of governments". However, the Expert Panel concluded that "this is very hard to establish with precision and can vary from province to province", one of the arguments that led them to abstain from considering expenditure needs (Vaillancourt, 2007: 48).

⁵ In the long term, one can argue that SNGs can increase their attractiveness for activities and newcomers through targeted fiscal operations. One could consider that a marketing of this sort is a choice variable in SNGs' hands and therefore falls outside equalization. However, if on the expenditure side local attractiveness depends on the SNGs' ability to provide specific services, on the tax side, this raises the controversial question of tax competition. Whereas the decision to reduce local taxation lies in local hands, the final result depends in fact on the relative position of each SNG compared to its rivals – a situation that is outside the control of a single local jurisdiction. The relation between equalization and tax competition is presently a disputed issue.

Box 1 Sources of fiscal disparities

- A. Differences in the access to resources (Oakland, 1994). It takes two forms: (i) differences in the income and wealth of community residents, or (ii) differences in communal property and/or natural resource endowment.

Also: differences in SNGs' taxable resources (Dafflon, 1995); tax bases (Gilbert, 1996); taxable resources per head (King, 1997); economic position and opportunity (Dafflon and Vaillancourt, 2003); territorial distribution of the unequal tax bases (Bird and Vaillancourt, 2007: 260).

- B. The amount of mandatory public goods that the SNGs must provide for exogenous reasons (Gilbert, 1996); needs per head (King, 1997).

Also: differences in the number of units of standardized service required per capita owing to demographic reasons: age structure, different participation rates in social programs by persons of different ages (Bird and Vaillancourt, 2007: 265).

Cost differences per unit of mandatory public goods (Dafflon, 1995; King, 1997; Dafflon and Vaillancourt, 2003).

- C. Cost differences due to input-output relationship (Break, 1980, cited in Shah, 1996: 102). Also: (i) differences in input costs, or (ii) the fact that some populations are more costly to serve than others (Oakland, 1994).

(i) Cost differences per unit of standardized public service (due to climatic or geographic features, density or distance factors, or (ii) differences in labour cost across regions (on the basis of real private sector wages) (Bird and Vaillancourt, 2007: 265);

Cost differences due to the natural conditions of service areas and the composition of the population (Break, 1980).

Differences (i) in the quantity and composition of input that is necessary for producing the public service, (ii) in factor or input prices, (iii) in physical characteristics (environmental factors), and (iv) in the socio-demographic composition of the SNGs' residents (Reschovsky, 2007: 402).

Economies of scale in the service provision (Dafflon, 1995; Dafflon and Vaillancourt, 2003).

- D. Differences due to specific tastes of residents in the various SNGs or to policy decisions at the local level (Break, 1980);

Local preferences either for optional services or for quantities or quality above the minimum standard level in the provision of mandatory services (Dafflon, 1995; Gilbert, 1996; Dafflon and Vaillancourt, 2003).

- E. Differentials attributable to SNGs' with respect to federal transfer payments (Break, 1980);

Local preferences among different forms of taxes and between taxation and user (Inman and Rubinfeld, 1996).

Differences under D and E result from local preferences and hence they need not be compensated by any kind of equalization or transfer payment.

If this rationale for equalization is accepted, the next and immediate question is whether revenue and expenditure needs equalization should be distinct. Equalization policies introduced in the seventies or before usually combined revenue and expenditure disabilities in one measurement formula. Today the trend is for separation. With different evolutions in taxation and decentralized functions, the political economy of equalisation is nowadays faced with four situations: SNG units with high tax potential could also have higher expenditure needs; but also high potential low needs; low potential high needs; and low potential low needs. A unique formula combining tax potential and expenditure needs cannot answer the four situations. The separation of revenue equalization from expenditure needs equalization must be observed.

2 REVENUE EQUALIZATION

Over the last twenty years, revenue equalization has taken such a wide variety of arrangements that organizing a coherent comparison is a challenge. In practice, the level of redistribution achieved depends on the equalization formula, but also on the effects of the ceiling and floor provisions, the generic solution and, more fundamentally, on the definitions of tax bases used to calculate the entitlements (Smart, 2004: 197). In this section, we present a schematized approach to revenue equalization with the help of a graphical tool that allows most of the specific schemes on this topic to be represented and thus easily compared with one another (Dafflon and Vaillancourt, 2003). There are four issues to be addressed, illustrated in Figure 1: measuring the fiscal capacity of SNGs, designing and calculating the equalization formula, funding the equalization policy and determining the target level of equalization. The objective here is to organize the theoretical arguments in order to sequence the fundamentals in a coherent way.

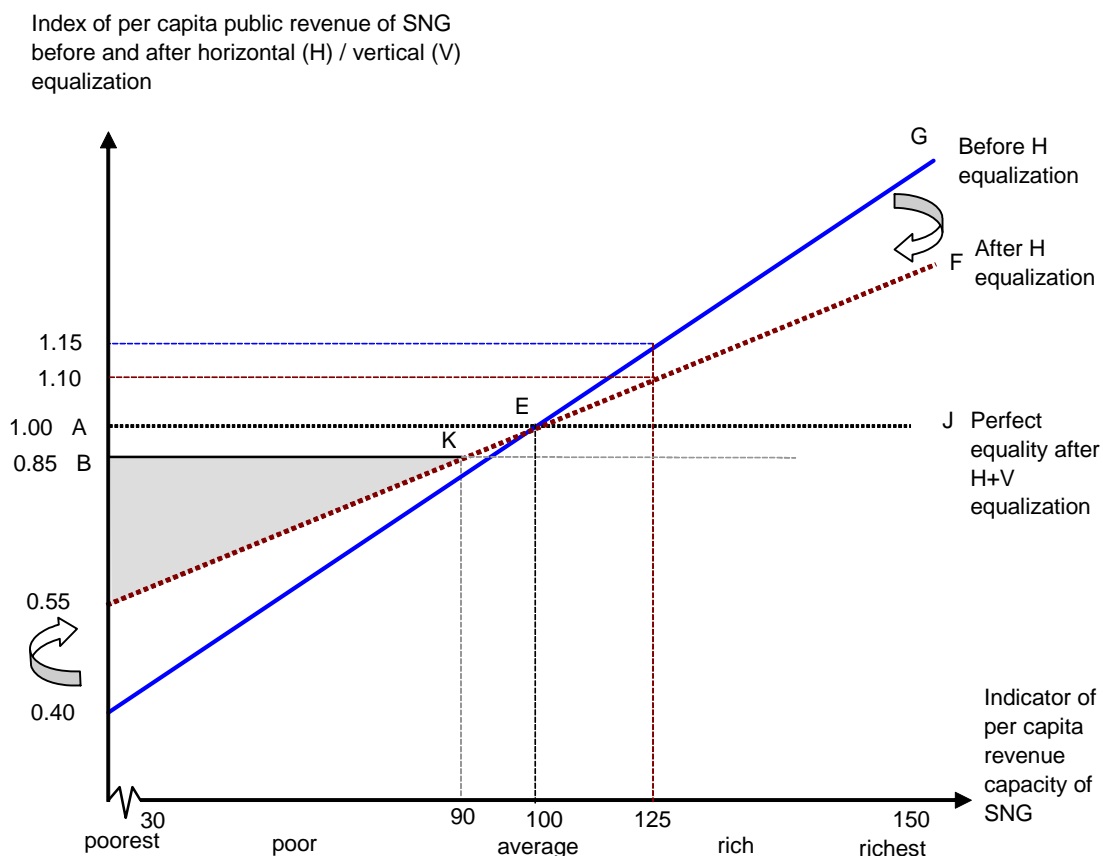
2.1 Measuring fiscal capacity

Measuring the fiscal disparities between SNGs, or setting out a benchmark indicator of their revenue capacities, along the horizontal axis on Figure 1, is the first problem. Measurement is not easily separable from the objective, and the indicator components often directly influence the calculation of the equalization entitlements. The basic concept is thus formulated: "jurisdictions with higher-than-average capacity should receive less (pay more); jurisdictions with lower-than-average capacity should receive more (pay less)". In Figure 1, average capacity, however defined, is given a value of 100. For simplification, the "poorest" jurisdiction is given a value of 30.

Of course, the concept is easier to explain than to implement. An overview of the theoretical literature indicates that there is no proper answer to this technical and politically sensible question. While a comparison of best practices shows that they are numerous, each one can claim good reasons to be the best, depending on whether "best" reflects the judgment of public finance economists, macroeconomic analysts, politicians, the winning or the losing jurisdiction(s). However, despite the present fuzzy situation, there is a general agreement between scholars and politicians that the data series used for measuring capacity should have the following characteristics:

- precise and stable over a range of several years;
- not susceptible to manipulation by decision-makers;
- easily verifiable by all government units and parties involved in the equalization process.

Figure 1 A stylized representation of a revenue equalization scheme



Source: Dafflon and Vaillancourt, 2003: 401

In order to implement equalization programs, policymakers require accurate measures of the fiscal condition of SNGs. Such measures are needed to determine whether disparities justify action and to design the appropriate equalizing formula (Ladd, 1999: 37). There are two schools of measuring the capacity of government units. One is based on macroeconomic figures, such as the GDP or the national revenue, calculated per government unit and per capita. The other is derived from the tax system with two alternatives: total taxable resources (TTR), or the use of a representative tax system (RTS) for an approximation of taxable capacity.

Box 2 Introducing RTS

[1] Selection of the SNGs' taxes which will serve for the calculation of tax capacity.

Which taxes and sometimes other revenue sources shall be taken into consideration? Using several taxes is usual but requires technical adjustments since tax bases from different tax sources cannot be simply added (Gilbert and Guengant, 2001: 65). Too many taxes create complexity, are costly to manage, lack transparency, cause iterative and endless negotiation on the range of taxes to be included in the calculation and the weight attributed to them (Bird and Slack, 1990; Wilson 2007: 350-352).)

[2] Calculation of the per capita yield of each tax, with reference to a standard tax rate (t^*).

A "representative" result is obtained with the use of a standard tax rate schedule t^* and not the rates applied in individual SNG. With t^* and the same adjusted tax base, the calculation takes into account the potential tax resources of each SNG. There is no need to bother about the combination of taxes established at the sub-national level according to specific circumstances or preferences or political bargaining, nor about the question of benefit versus non-benefit taxation.

[3] Decision on the number of years to which the calculation applies.

The annual yield of a single SNG's taxes, even at t^* , can be irregular depending on which sources of taxation are considered. Discontinuity in tax capacity indicators results in the variation of the annual amounts received or contributed. This "disturbing" effect brings uncertainty in SNGs' budgeting and planning. Continuity and predictability in the relative position of individual SNGs is essential. A longer period of calculation can smooth annual variations.

[4] For each tax source, calculate the "tax index" (TI) of local government "i" for tax "T".

Compare the results obtained for each SNG to the reference tax yield, normally the average value obtained for all SNGs. This comparison is at the core of the system. It permits the ranking of SNGs above or below average for a particular tax, thus giving the relative position of each government unit. The average tax yield, which corresponds to [average tax base $B^* \times t^*$, pc], can be given the reference value of 100 points (E in Figure 1).

[5] Calculate the weighted indicator of tax potential (ITP) for each SNG by combining the series.

With several tax sources and as many series of SNGs' tax indices, the arithmetic for combining the series into one is not straightforward. The obvious step is to consider each of them in proportion to the total potential yield. But in practice "tax index" series are sometimes given weights that combine this with criteria such as volatility and risk. For example, the real property tax and the tax on motor vehicles have a reputation of delivering a reliable yield. On the contrary, taxes on mobile factors (such as the corporate profit) involve more risk (delocalization, tax competition, external shock, recession). The alternative view is that those tax yields are returns on investment resulting from SNGs' own efforts to enhance their local attractiveness. This category should weigh less in the average calculation, it is argued, as a reward (or an incentive and a mutual insurance) for SNG policies in a "more risky" environment.⁶

⁶ The theoretical relation between risk-sharing arrangements and equalization belongs to the second-generation theory of fiscal federalism (Oates, 2005: 364). One important issue is whether risk sharing should be a federal or a SNG program if the regions differ in terms of incomes or exposure to external shocks. Under such circumstances, Persson and Tabellini (1996) show that vertical programs tend to oversupply, while horizontal programs tend to undersupply insurances. For an overview of the question, see Von Hagen (2003: 382) and Oates (2005:364-366).

For Barro (1986) and Boothe (1998), macro type indicators such as GDP per capita, national revenue calculated per government unit and per capita are more adequate methods than RTS and less susceptible to distortion which occurs when SNGs continuously adjust their tax system for competition, redistribution or to attract equalization benefits. The system is simpler and less costly (Wilson, 2007: 339). But for Aubut and Vaillancourt (2001) macro indicators serve an objective of redistribution rather than equalization: instead of equalizing the capacity to provide comparable levels of public services at comparable levels of taxation - to use the Canadian definition - they attempt to level per capita national income in the SNGs. Pros and cons of macro formulas for equalization versus RTS are examined in Wilson (2007). Switzerland is an interesting case in this respect because the 2008 new equalization system abandoned a macro indicator (national revenue per government unit per capita) for a RTS measure for two reasons. (1) Differences in the cantons' indices of financial capacity are too important according to whether the calculation is based on GDP or the national income (per government unit, per capita). Each data series mirrors the openness of the cantons' economies and mobility in a completely different manner.⁷ Macro indicators are not sufficiently reliable as most economic parameters are characterized by geographical externalities. (2) The conceptual argument is that the measure of the cantons' capacity should reflect their ability to generate tax revenues only and not the state of their economy in a broader sense. If one considers some recent European experience in revenue equalization (Färber and Otter, 2003) one can find that recent references are almost exclusively to RTS for very similar reasons.

2.2 Equalization formulas

Designing the equalization formula is the second issue. In Figure 1, the line DEG "before equalization" represents SNGs' per capita tax yields according to the origin principle. Any equalization formula would have to give more to "poor" jurisdictions than they would receive following the origin principle and "rich" jurisdictions would receive less, something along the CEF line. The equalizing performance is represented by the distance between lines DE and CE for beneficiaries, and between EG and EF for the contributing jurisdictions. Thus, for example, for the poorest SNG with a fiscal capacity of 30, equalization increases public revenue per capita from 0.40 (D) to 0.55 (C), but for a rich SNG unit with a capacity of 125, equalization reduces its available revenues from 1.15 to 1.10. A balanced solution with horizontal (H) equalization requires that the amounts received (represented by CDE) and contributed (EFG) coincide. The importance of equalization depends on the formula, which gives the position of the slope CF around the central point E. Several formulas are possible, each with different consequences in terms of distributing the burden or the benefits of equalization between SNG units in each group.

⁷ Remember that in Switzerland, the cantons are very small SNGs in surface (km²) in international comparison. Distance from one cantonal capital city to another is on average less than 50 kilometers. Thus, residence in one canton and daily commuting towards another canton for work is frequent. The territorial distribution of income is very different for the geographic origins of the domestic product.

Box 3 Possible revenue equalization formulas

Revenue equalization formulas always integrate the measures of capacity and thus give the extent of solidarity. How much "high capacity" jurisdictions have to contribute and how much "low capacity" jurisdictions can claim is not a question of economic objective only. Policymakers seek to understand the equalizing mechanism in order to be able to choose between a sophisticated but not very readable formula and a simpler and more accessible but perhaps less precise one.

In horizontal equalization, a possible formula for the calculation of equalizing transfers (contributed or received) takes the following form:

$$(1) \quad TC_i = \frac{(P_i \times [ITP_i - 100]^\alpha)}{\sum_{i=1}^{n-m} (P_i \times [ITP_i - 100]^\alpha)} \times M \times K \quad \text{for contributing SNGs and}$$

$$(2) \quad TB_i = \frac{(P_i \times [100 - ITP_i]^\alpha)}{\sum_{i=1}^m (P_i \times [100 - ITP_i]^\alpha)} \times M \times K \quad \text{for beneficiary SNGs}$$

There are N SNGs of which m have an indicator of tax potential (ITP) lower than average (at 100 points) and (N-m) have ITP indicators equal or higher than average. M (money) is the total available amount in the equalization fund. In equation (1), SNGs with $[ITP_i > 100]$ contribute in proportion to their population (P_i) multiplied by the difference between their own ITP and the average; the higher their financial capacity, the more they contribute. The inverse is verified for beneficiary SNGs in equation (2). K is a coefficient that permits to balance the contributions from high-capacity SNGs to low-capacity SNGs over the reference period. The formula is "proportional" if $\alpha = 1$. Increasing α reinforces the equalizing effect. Within the group of SNGs with $[ITP > 100]$, the higher α , the more top-capacity SNGs will have to contribute to the equalization fund. Within the group of SNGs with $[ITP < 100]$, the lower the SNGs in the ranking, the more they receive. α in equations (1) and (2) need not be the same. Other formulas are studied in Dafflon, 2007: 386 Dafflon and Mischler (2007: 73-84).

2.3 Funding equalization

The third issue concerns the source and the importance of revenues that are to be shared and redistributed. Since beneficiary jurisdictions are different in size and population, the redistribution must take into account the population (size) of each jurisdiction and thus is calculated in relative terms. This is accounted for on the vertical axis by using the variable of per capita revenue. Along the line AEJ, the beneficiary jurisdiction receives exactly the average amount of public revenue per resident, represented by the value 1.0 point. The basic questions are which revenue (tax) sources are to be shared and according to which decision procedure? Note that the starting point can also refer to the initial assignment of revenue sources to SNGs: in this case, the basic questions are whether block grants or revenue sharing should be added to local own resources if the latter are insufficient, and if yes, in which form? The initial effective per capita resources of SNGs before equalization is represented by the line DEG. The "poorest" government unit obtains, say, only forty percent of the per capita national average at D; the "richest" get a per capita amount that corresponds to G, well above the average index of 1.0 point. The fundamental question of the first

issue is: does the unit-by-unit initial per capita endowment along line DEG need a correction because it results in too large fiscal disparities? In the affirmative, the second question is how to finance equalization. Several answers are possible, each with pros and cons. Three of them are discussed below.

(1) The amount is financed out of the general resources of the paying unit(s) and established in their annual budget. This is a very flexible solution. Yet it has three main defects: (i) recipient governments are not sure that they will receive a comparable amount (in real value) from one year to another, which renders any medium term planning and policy-making very difficult; (ii) budgetary debates are subject to ad hoc political arrangements, with unstable contours by definition; (iii) the amount of equalization is at the mercy of the "high capacity" government units which will probably attempt to revise downwards their contributions.

(2) The method of calculating the equalization amount is explicitly stated in the constitution or in a law in the form of revenue sharing from at least one but preferably several specific tax sources used at the central level (vertical) or attributed to SNGs (horizontal). The advantages of this solution are: (i) with a specific legal foundation, the political debate on "how much equalization" takes place when the constitution is amended or the law is passed, and not on an annual basis when the budgets are decided; (ii) it avoids important variations in the available amounts if the tax sources are sufficiently diversified and chosen in such a way that macroeconomic cycles are partly alleviated. The drawbacks: (i) revenue sharing from specific taxes might be subject to the fluctuation of the economy, following ups and downs with perhaps procyclical results; (ii) using only one tax source for sharing purposes may result in the government units not collecting it as vigorously as if it was their exclusive source of revenue since collection efforts reward in part other government units through the equalizing transfers.

(3) It is possible to solve these problems by establishing an equalization fund fed by the revenues of several tax sources and anchored in the constitution or the law. The fund serves as the source of yearly equalization payments but also contains a "rainy-day" element. Such a system holds not only the two advantages described above but also a third one: it can smooth equalization payments through leaving in the funds a part of the contributions in good years and tap this reserve in bad ones. This inter-temporal stabilization is the added value of this option.

The three solutions above do not separate vertical and horizontal funding. They have to be revisited to allow for this distinction. Solution (1) is not suitable for horizontal equalization because it requires annual budgetary negotiation between those SNGs which contribute to equalization and the beneficiary SNGs. In case of conflict, some form of arbitrage by a higher tier is necessary, a situation which brings verticality in the process. Solutions (2) and (3) can be truly horizontal but require the prior intervention of a higher government tier in order to write in the constitution or the law the obligation for SNGs to participate in some horizontal equalization scheme and the criteria for receiving equalization transfers. Of course, this top-down process need not be imposed on the lower tier. SNGs should be involved in the design of the horizontal equalization policy: after all, it is the SNG units that will later support the burden or enjoy the benefits of this policy. If co-participation in the design and decision process is not promoted, then the equalization policy becomes a merit good that is

implemented top-down. Solution (3) is very attractive from the point of view of macroeconomic stability. With the pressure of globalization and tax competition, SNGs with higher financial bases have no longer the security to remain in an advantageous fiscal position for years. They would use their budget surpluses for the consolidation of their own position or for feeding their own rainy-day fund rather than to contribute to horizontal equalization. Theoretically, an equalization system can also serve this purpose. But the two processes do not have the same insurance characteristics. A SNG owned rainy-day fund is analogous to a system of capitalization, whereas a rainy-day element within the equalization scheme, as in solution 3, corresponds to a system of mutual insurance: SNGs exposed to adverse revenue shocks in the short run would see their relative position modified in their favor relative to other SNGs facing better fiscal conditions (Smart, 2004). Yet the argument of "risk-sharing" or "risk-pooling" against external macroeconomic shocks (von Hagen, 2000: 273) is disputed (Usher, 1995: 94; Buettner, 2002) and could not convince "high capacity" SNGs to foster fiscal solidarity. This question is without doubt the principal challenge that horizontal resource equalization will face in the next years.

2.4 Does equalization need additional limits?

The fourth issue is whether further limits to the redistribution formula should be introduced. In Figure 1, E represents an exactly neutral position: with an average financial capacity and average *per capita* tax revenues, a jurisdiction at this point would neither pay nor receive any equalizing amount. But the central point need not be at E. Other equalization targets are possible, and often controversial. Two specific points must be noted.

First, it can be debated whether jurisdictions with just below average financial capacity should benefit from equalization. One could argue on financial, political and equity grounds that only jurisdictions below a certain level (e.g. $ITP < 90$) should qualify. Financial considerations could be one argument: at 90, the triangle CDE would be smaller, which means smaller contributions by richer SNGs. But more crucial are political considerations; at what value does fragmentation of the nation into poor and rich jurisdictions endanger national coherence. Or, put differently, how much poorer is too poor?

A second related question is illustrated with the triangle BCK. The resources available after applying the horizontal equalization formula are those corresponding to line CE (above DE): the poorer a jurisdiction, the more it receives. But the horizontal equalizing payments in the example can be argued to be far from giving poor jurisdictions sufficient resources, increasing the resources for the poorest SNG from (in our example) 40% to 55% of the national average. Should they be augmented, what would be the appropriate limit? The example in Figure 1 ensures that poor jurisdictions receive equalizing payments so that their revenue endowment reaches at least 85% of the national average, along line BK. Since "rich" SNGs already pay EFG to cover CDE (equal by construction), financial resources for paying BCK come from the center through a vertical equalization scheme. Is 85% a proper level? Fragmentation, equity and incentives must be considered. In Figure 1, beneficiary jurisdictions have no incentive to take initiative for their development if they are satisfied with public spending compatible with 85% of the national average per capita

public revenues, and if they have no preference for autonomous revenues rather than transfers. In practice, the difficulty is to design an equalization formula that gives sufficient and significant solidarity funding without disincentive for economic or more specifically revenue base growth (Zimmermann, 1999: 168).⁸

3 EXPENDITURE NEEDS EQUALIZATION

Currently, there is a strong debate both in theory and practice about expenditure needs equalization (Färber and Otter, 2003; Kim and Lotz, 2007). The discussion is about (i) its necessity; (ii) the functions to be considered, (iii) the disparities that have to be taken into account: needs, expenditures or costs; (iv) the method for measuring needs, and (v) the consequences of the equalization policy in terms of efficiency, allocative neutrality, incentives, and equity. The distinction between differences in needs, costs, expenditures or need-capacity gap is far from evident and presents a great deal of conceptual and technical difficulties.⁹

This section deals with four selected problems. First, we present a stylized scheme that informs in a coherent manner the four issues parallel to those in revenue equalization. Second, we question whether cost disparities are genuine or result from SNGs' own choices, in which case they should not count for equalization. The third issue develops the argument that expenditure needs equalization should be vertical only. Fourth, we deal with the methods of need assessment.

⁸ The common reference to Zimmermann cannot easily serve since it is related to the very specific German case issued from the re-unification. Careful investigation in textbook analysis and case studies shows that the question of disincentive with too high equalization payments is not a core issue. To the best of our knowledge, we could not find substantial evidence on this issue for another country. Thanks to Alan Fenna, Curtin University for raising our attention on this point.

For revenue sharing, the disincentive problem is very debatable. Take the Swiss case. Art. 6 of the federal law of October 2, 2003, indicates that after resource equalization, the cantons' tax revenues + equalization transfers should aim at 85% of the national average. The explicative Message of the Federal Government to Parliament gives 85% as a reference but NOT the fixed target and also warns that this percentage will not necessarily be attained. Yet the Message does not contain a single line on a possible disincentive effect (Federal Parliament, Feuille Fédérale, 2002: 2245 and 2337).

This can be understood when one introduces the time lag in the calculation process. For example, for the 2011 revenue equalization transfer system, the fiscal years that serve as reference are 2005, 2006 and 2007. This means that if a canton would behave strategically to influence the revenue equalization system, a cantonal Parliament would have to start making strategic tax choices in autumn 2004, when preparing the budget 2005, yet without knowing the fiscal choices and strategies of any of the other 25 cantons. In addition, the exercise should be repeated for three years. It means at the time of the first decision $25 \times 3 = 75 + 2$ (the canton's budget for 2006 and 2007 is not yet known) unknown variables. I take it for a certainty that no politician (risk adverse or not) will engage in such strategic speculation with this time horizon. If one considers the result, and not the anticipation, the time horizon creates the same problem. Admit that the 2011 equalization already influences the 2012 fiscal position of a canton. The first time that 2012 will be referred to in the equalizing formula will be 2018 (the time lag is six years with the actual system, based on a three years average). Again, I doubt that disincentive effects can be evidenced and measured with this span of time.

⁹ See Shaw (1996) for a discussion of this distinction in theory and practice. One important difficulty faced in most countries is the scarcity of databases accounting for cost factors. This is a recurrent observation in Färber and Otter (2003) for the case studies in European countries.

3.1 Four issues in a stylised scheme

Figure 2 presents a stylised expenditure equalization scheme. As with Figure 1, four issues are questioned.

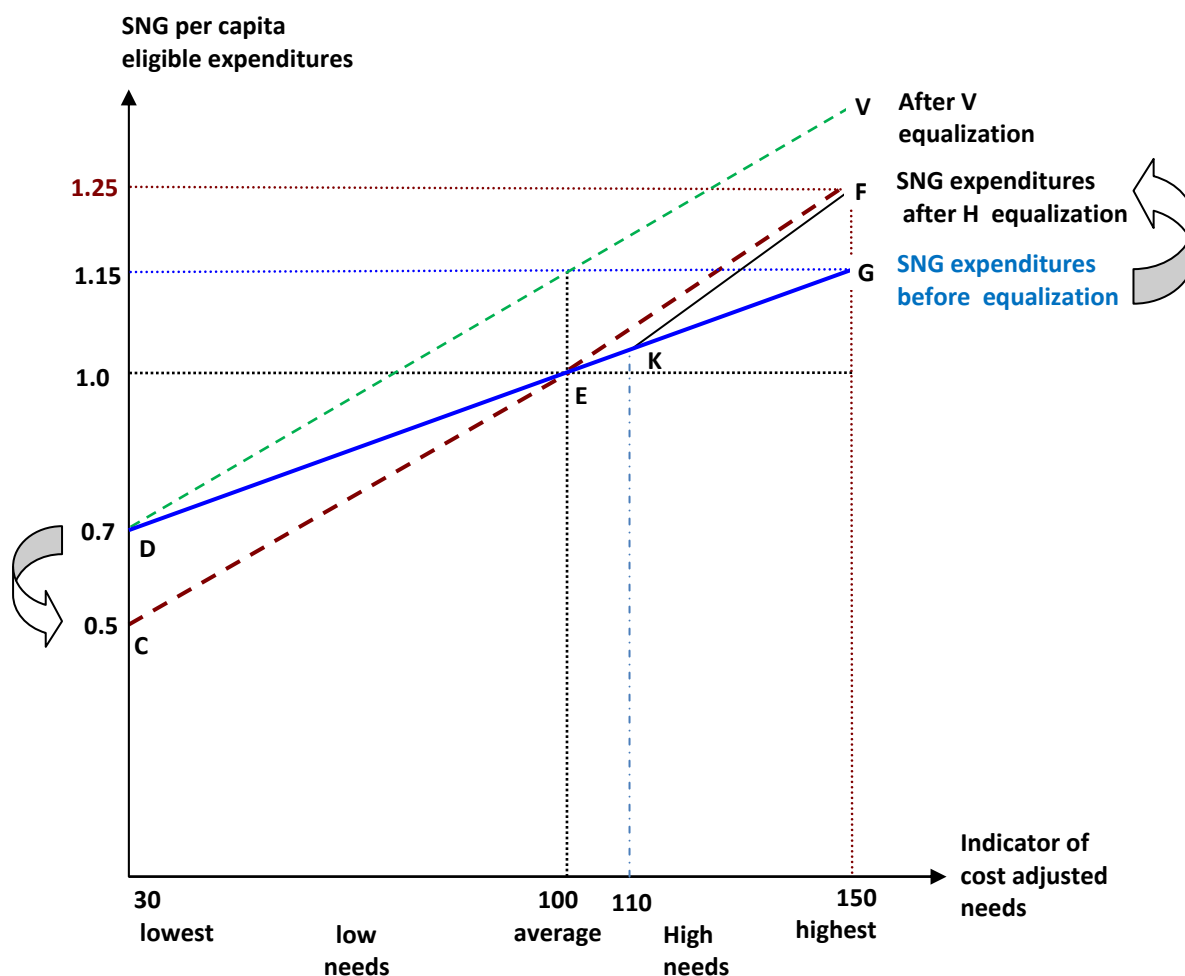
[1] First, which SNGs' functions are considered for equalization? If not all, then the vertical Y-axis would be drawn only for eligible expenditures. As in Figure 1, the monetary measure is in *per capita* terms.

[2] Second, how should we rank SNGs for expenditure equalization? In answering this question recall that average *per capita* expenditure differences in providing a public service reflect two factors: need differences (Box 1, B above) and cost differences (Box 1, C).

Plausible factors related to needs differences are socio-demographic: the share in the total population of various age groups such as infants (post-natal care), elders (health care) and school age children, special needs, either temporary i.e. new immigrants (language skills acquisition, integration into society) or not e.g. aboriginal population. The relevance of many of these indicators depends on the role SNGs play in delivering specific public services and their share of expenditure thereof.

Various factors determine cost differences. Some are natural ones that vary with geography such as climate (snowfall, heavy rain), frequency of natural disasters (floods, earthquakes), topography (mountainous or desertic regions) and distance (remoteness from providers of inputs into public services). Others are demographic such as population density/urbanization. The difficulty is to estimate in monetary units the impact of such factors on costs. For many public services, labour is an important factor of production. Labour costs should be calculated using private sector wages for equivalent inputs and not on the basis of public sector wages which may reflect such political factors as the government's political philosophy or the relative strength of workers' unions (Courchene, 1998; Reschovsky, 2007: 402). But if e.g. snow removal is done only by public maintenance crews, then how does one distinguish between true differences in costs and the relative strength of unions in the SNGs, assuming that each sets its own wages (not set centrally)?

On the horizontal X-axis, we use a cost adjusted needs index. What does this mean? Let us assume that we have two regions with identical revenue capacity, one (A) with a proportion in its population of 10% of older individuals in need of specific health services and the other (B) with 30%. In terms of needs, (B) has higher needs. If the cost per % point of older population is 1 monetary unit, then (B) should receive 20 more units of resources than (A) to be able to provide the required services without having to levy more taxes than (A). But if (A) is more mountainous than (B) and because of this the cost of getting the services to the older residents is higher, say 1.5 point in (A) and still 1.0 in (B), then the difference in cost adjusted needs is only 15 $[(30 \times 1) - (10 \times 1.5)]$. Adjusting for costs changes the relative position of SNGs on the X-axis in Figure 2.

Figure 2 A stylised representation of an expenditure

Source: adapted from Yilmaz S., Vaillancourt and Dafflon (2012: 123)

[3] The third issue is the equalization formula. Without equalization “needier” jurisdictions to the right of E spend less per capita than with equalization and “un-needy” ones to the left of E more. Note that per capita expenditures are for the population as a whole and not for the specific populations (older, immigrants...) that may be deemed to have specific needs. Horizontal equalization in this context means that un-needy SNGs spend less overall for their residents after equalization and pay for residents of other jurisdictions. Thanks to the equalizing grant, needier jurisdictions can now spend more to better satisfy the needs of their residents without additional tax effort. Thus, for example, for the neediest jurisdiction with a cost adjusted needs indicator of 150, equalization increases expenditures per capita from 1.15 to 1.25, but for an un-needy region with a needs indicator of 30, equalization with its diversion of revenues reduces public expenditures it can finance from 0.7 to 0.5. A balanced solution with horizontal (H) equalization requires that benefits and costs coincide. The importance of equalization depends on the equalization formula, which

gives the positions of the lines CE and EF around the central point E. It is conceivable that the slopes of these two lines are not the same.

[4] The fourth issue is whether an equalization policy would introduce further limits to the redistribution formula. In Figure 2, E represents an exactly neutral position; a jurisdiction at this point would neither pay nor receive any equalizing amount. But the central point need not be at E. Other equalization targets are possible. It can be debated whether jurisdictions with just above average needs should benefit from equalization; one could argue that this would be a disincentive to become more productive¹⁰ or that measurement errors of needs are upward biased and thus that a cushion of say 10 % (e.g. 110, KF instead of EF in Figure 2) should be used. The equalization budget is also lower ($KGF < EGF$).

3.2 Genuine cost disparities versus political choices

We noted earlier in Box 1 that differences resulting from local choices (D and E) should be ignored. Figure 3 illustrates the difficulty of drawing the border line between genuine disparities and local preferences or management abilities that result in expenditure or cost differences (Reschovsky, 2007: 401-404). Scenario 1 relates to economies of scale and the related size of SNGs. Scenario 2 illustrates the difficulty of distinguishing between genuine higher production costs and X-inefficiencies.

Scenario 1: Impossible economies of scale or reluctance to cooperate

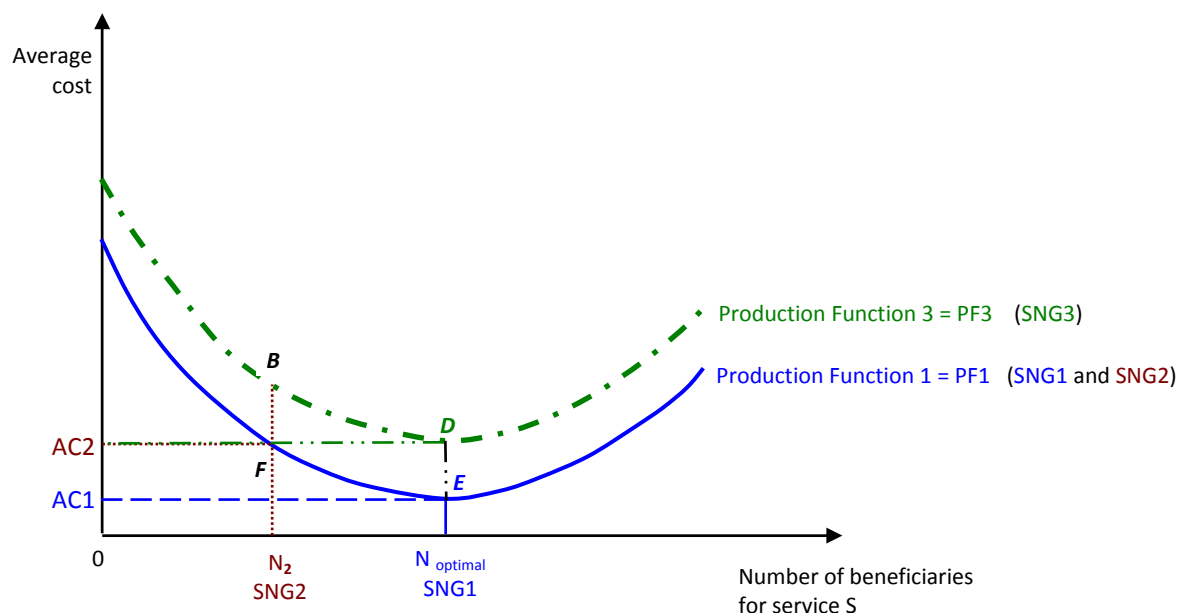
The jurisdictions face the usual simplified U-shaped production function for a local public good S (Reschovsky, 2007: 403). Start with the production function PF1 for SNG1. Resident beneficiaries pay for the service on a quid pro quo basis (for simplification: one resident, one unit of local service S, one tax unit - no spillover). The efficient solution is at E for a total of N_{optimal} residents served. The E solution shows two key results: the minimal average cost at AC_1 and the total local public expenditure ($0N_{\text{optimal}}EAC1$) at the optimal level for PF1.

Consider SNG2: assume it has an identical production function PF1, but only N_2 residents. Average cost is AC_2 . Why is this so? There are three plausible answers.

- (1) The number of beneficiaries is low because of socio-demographic characteristics of the resident population in SNG2.
- (2) SNG2 is not in a position (for topographic reasons or distance) to cooperate with neighbouring SNGs in order to increase the number of beneficiaries towards N_{optimal} .
- (3) SNG2 (for reasons of differences in preferences or the desire to remain autonomous) is not willing to cooperate with neighbouring SNGs?

In situations (1) and (2) cost differences should be considered in equalization because differences in unit costs do not result from a local decision. With (3), SNG2 should support the fiscal consequences of its decision. No equalization should make up for the difference in costs.

¹⁰ In this domain also (see footnote 8) it is not easy to gather case study evidence that expenditure needs equalization could result in undesirable incentive (Kim and Lotz, 2008: 16). The OECD (2007) expressed some concerns about this issue related to cost equalization and productive efficiency.

Figure 3 Production functions for a sub-national public expenditure*Scenario 2: Genuine cost disparities versus X-inefficiencies*

Consider a third local unit, SNG3 with production function PF3 characterized by higher production costs. Even with the optimal number of beneficiaries served, SNG3 cannot provide an equal level of service S at the same tax price [$N_{\text{optimal } D} > N_{\text{optimal } E}$]. If the cost difference $AC_1 AC_2$ is a genuine disparity, then the situation suggests some kind of equalization so as to restore the fiscal balance. This would not only reduce the average cost AC_2 of service S that residents in SNG3 face, but it also reduces fiscally induced migration, thereby enhancing efficiency (Bird and Vaillancourt, 2007: 262). But does PF3 represent the real costs or does it hide X-inefficiencies? How can one interpret the difference ED in average costs if SNG1 and SNG3 serve the same number of beneficiaries? Can SNG3 do anything about higher costs?

Figure 3 thus identifies situations that need to be examined if expenditure equalization is on the political agenda. Relative cost differentials have to be clearly traced and identified. This is not simple; it requires information for several SNGs about the number of beneficiaries and the production function of each public service selected for equalization in order to set the standard cost function within a reasonable range. Such information is not always available (Dafflon and Mischler, 2008: 183-185). Take the example of primary education. Suppose SNG1 and SNG3 buy the same number of books for the same number of pupils. If SNG3 faces higher unit costs, is it because it overspends on fancier books, tries harder to keep up with new pedagogical trends, or teaches a different language group? Is SNG3's choice to follow a new pedagogical path an item of laboratory federalism, a decision taken in coordination with other SNGs (in this case, equalization is acceptable), or is its own decision following the specific tastes of the constituency (no equalization)? If language is different, is the higher government concerned with the protection of minorities (equalization is acceptable) or are language differences not an issue (no equalization)? Are mixed

language or mixed religious classes to be mandated either centrally or by SNGs that pay horizontal equalization? Not only is it difficult to isolate variables that affect costs from variables that indicate differences in public good preferences, but the answers and therefore the justification of equalization belong to the realm of politics.

Equality of per capita expenditure, using SNGs' population, is a frequent but not necessarily an adequate measure of causality (Dafflon and Mischler, 2008: 183-185). If one can clearly identify the number of beneficiaries of the service, then the average cost is known. But such information is not always available. The problem of measuring public outcomes is another issue. Take the textbook example of snow removal to guarantee road security. Comprehensive security corresponds to a "no accident" situation, but the link of this measure with public expenditure and average costs is not clear. Road length is an alternative. Yet, this is an input measure, not a target, and a debatable one too. Expenditure needs can be determined in relative terms only if causality is clearly traced and identified - but this is not as simple as it sounds because it requires information about the production function of each local public service selected for equalization and the number of beneficiaries. And for each service, an adequate number of local production functions must be identified in order to fix the standard within a reasonably representative target.

Another challenge is the simultaneous presence of the two scenarios, but then, questions follow questions in a domino-like sequence. Since AC_2 is the same for LG2 (at F) and LG3 (at D), there is no reason to differentiate equalization based on average costs: relative equity is respected. Yet LG2 could realize economies of scale by collaborating or amalgamating with other jurisdictions, whereas LG3 has no possibility to lower its (genuine) costs. Who determines when cooperation or merger between SNGs should be required to lower average production costs?

In sum, there is no practical way to state beyond doubt whether situations F , B and D in Figure 3 represent genuine cost differentials or result from SNGs' own choices. From this perspective, any policy of expenditure-based equalization is a tremendous challenge. Since expenditure needs equalization is complex and cannot be separated from political value judgments, should one renounce, as the Canadian Expert Panel on Equalization recently proposed (Groupe d'experts, 2006: 46; Boothe and Vaillancourt, 2007: 48)? Or, should one try to design expenditure needs equalization as best as one can with imperfect knowledge, information and data (Boex and Martinez-Vazquez, 2007: 291; Reschovsky, 2007)?

3.3 Horizontal versus vertical equalization

We have not yet considered whether equalization should be horizontal or vertical. In Figure 1, surface $CDE = EFG$ implies that equalization is horizontal, between contributing and beneficiary SNG units; CBK, if it exists in total or partially, is vertical. In Figure 2, a balanced solution (around E) with horizontal equalization requires that benefits and contributions coincide. But the solution could also be vertical, centrally funded.

Horizontal revenue equalization is typically a "Robin Hood" solution. This is less conceivable for expenditure needs equalization: three arguments against can be given (Dafflon, 2007: 370-371):

(a) Horizontal expenditure needs/costs equalization would imply that SNGs with relatively low needs/ costs of service provision accept higher tax prices which allow subsidizing of other SNGs with relatively high expenditure needs/ costs. This would distort the relative local tax prices of public services and result in allocative inefficiencies. It penalizes SNG units which cooperate or strive to ban X-inefficiencies.

(b) Horizontal equalization has no rationality for those local public services that are financed through user charges. Pricing those services means that individual beneficiaries pay exactly for what they receive. Any violation of this rule would send a false price signal and disrupt the market-like process. From the point of view of economic efficiency it is both unrealistic and erroneous to imagine that user charges based on the polluter-pays principle (for example: fees for household solid waste collection; waste water treatment) or on the user-pays principle (drinkable water) would support an equalization supplement with the argument that the costs of services vary from one jurisdiction to another. The equity argument also holds: it would be inequitable to make users in a particular service precinct pay a price in excess of their benefits in order to cross-subsidize users in another precinct, whereas the latter would thus pay charges that are below the true costs of the public service they benefit from.

(c) For services that are financed through taxes, there is an information problem. Identifying the real needs and costs that justify equalization is a tremendous challenge (Reschovsky, 2007: 400-404). SNGs' functions are countless and a "perfect mapping"¹¹ does not exist for most of them. In case of differences in the level or quality of services, what would be the "adequate" mandated provision (distinct from choice)? If the causes are X-inefficiencies, new management methods must be imposed (by whom)? In this case, however, the aid should be vertical because only a higher tier of government is able to foster a scheme as much neutral as possible from an allocative point of view.

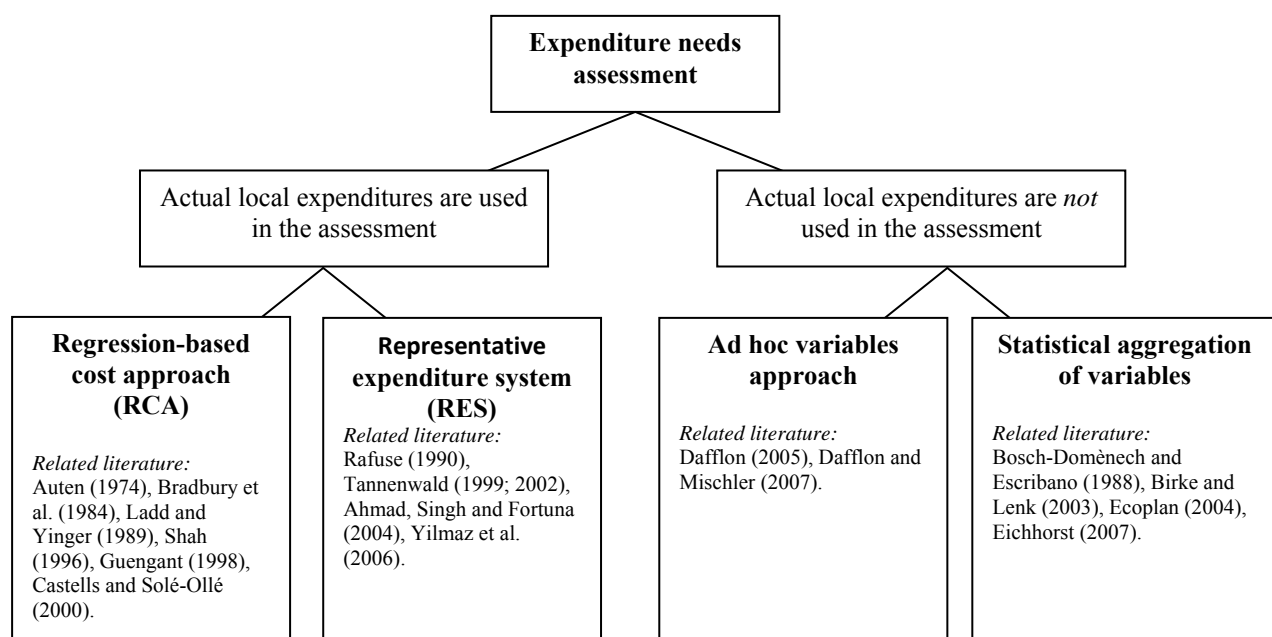
If vertical equalization is selected, what should it be? Figure 2 mirrors three alternatives. [1] With EF, SNGs with needs higher than average (100) will benefit. [2] KF introduces a cushion of 10 points (see subsection 3.1 fourth issue above). [3] The constitutional argument of "equal treatment" for all SNGs can explain the third possibility, represented by the line DV. Each SNG unit has positive expenditure needs, though not of the same importance; all should benefit from equalization the larger or the higher the needs. The three solutions are linear, but need not be so. Economic arguments (budget, incentive) can guide the choice, but are not decisive; political choice is needed.

¹¹ "Perfect mapping" exists when the spatial pattern of the provision of local public goods corresponds exactly to the geographical boundaries of the jurisdictions.

3.4 Methods of needs assessment

In the economic literature, the methods of expenditure needs / costs assessment have been treated in a rather scant manner. Reschovsky (2007: 404-410) mentions “several methodologies” without much detail and groups them in three categories: estimating a cost function, estimating an expenditure equation (both qualified as “statistical analysis”) and reliance on the judgment of experts. Vaillancourt and Bird (2006) proposed two criteria: (i) historical expenditure patterns using regression techniques for designing a representative expenditure system (RES parallel to RTS) or (ii) the center decides which functions and what standards – the judgment of politics instead of experts! But they conclude, joined by Kim and Lotz (2008: 17) that “what is important is not that the formula used is ‘correct’ but the results of applying it are politically viable”! In a seminal contribution, Mischler (2009: 76ss) distinguishes between four methods of needs assessment, distributed in two groups. Figure 4 recapitulates these approaches together with the related references from the economic literature. The first group makes use of the actual local expenditures. Using Ladd's terminology (1994: 29), it is subdivided into the regression-based cost approach (RCA) and the representative expenditure system (RES). The ad hoc variables approach and the statistical aggregation of variables form the second group that does not make use of actual local expenditure data.

Figure 4 Overview of the methods of needs assessment



Source: adapted from Mischler, 2009: 77.

Regression-based Cost Approach

Public expenditure data are used in order to determine structural cost differences by regression analysis. The use of expenditure data requires normally restrictive assumptions about local public goods provision (Ladd and Yinger 1989; Reschovsky 2007): among others, the service responsibilities need to be comparable and

expenditures per quality unit of public services are assumed to be equal. The regression method tries to explain the variation of expenditures per capita. Demand indicators, input prices of public service provision and environmental variables are the explanatory variables. By inserting real values of the structural cost variables and average values for all the other variables into the regression, the model estimates expenditures per capita that vary only because of different costs of public goods provision. The relative expenditure need is calculated as an index using average values of the explanatory variables as a benchmark. The results are standardized for equalization payments.

Besides the problematic aspect of assuming away difficulties with regard to the quality of public services or service responsibilities, the challenge remains how to maintain for the variety of possible influences on local public expenditures. The specification of the regression formula is crucial and often highly dependent on the knowledge about SNGs' characteristics. They add to well-known technical criticisms (multicollinearity, omitted variable bias) about the RCA (Lago-Peñas, 2001 and already OECD, 1981):

The main advantage of this method is its ability to provide an absolute measure of local expenditure needs in monetary units by incorporating an important amount of information about SNGs. However, there are disadvantages, too. Because of technical difficulties of the regression approach, the complexity of this method rises quickly and makes indispensable decisions about equalization policy even more the issue of technicians, although the questions concerning the practical implementation of equalization are highly political.

Representative Expenditure System

A RES assumes standardized expenditures per physical workload factors. This expenditure per workload unit can be determined using average expenditures or normatively defined "necessary" expenditures. The average spending per workload unit is often considered to be the basic benchmark (Rafuse, 1990). The standardized expenditures are determined by multiplying the average spending per workload unit with the observed workloads in the jurisdictions. A SNG unit is considered needy under this approach when it faces higher standardized expenditures per capita than the average jurisdiction. If information is available, the workload factor may be weighted by an input cost index (Tannenwald 1999).

The RES approach seems to be convincing if public expenditure is caused by structural community characteristics. A good example may be the number of pupils as this is linked to expenditures on primary education. If not, the method uses basic intuition or plausibility for the selection of workload factors. Yet, for some expenditure categories a plausible relation to public goods provision through structural indicators cannot easily be established. In some cases normative standards are employed instead of average expenditures. Operational accounting standards may provide useful information about how much money SNGs should spend on specific public services. Expert evaluation to determine normative expenditure standards per workload is also frequently cited. In cases of mandatory functions, corresponding normative benchmarks may also be used.

The RES approach has an intuitive appeal and may lead to reasonable results for some tasks. Yet, the use of average expenditure as the relevant benchmark for the

assessment of needs leads to incentive problems with regard to the distribution of a common pool of expenditures. Normative benchmarks are not discussed here in detail since they do not rely on an attempt to assess objective needs but depend on an *a priori* optimal amount of spending, often based on expert judgments or political decision.

If the equalization policy aims at reforming the system in force, both the RCA and RES approaches face the challenge of controlling for the related expenditures. If the public expenditures in SNGs' accounts already contain elements of the equalization system that must be changed, they cannot be considered without correction – removing the equalizing component from actual accounted expenditures. This obliges to trace causality, a challenging process that does not often succeed in practice (Dafflon and Mischler, 2008: 173-174).

Ad hoc Variables Approach

This approach links expenditure needs directly to particular community characteristics. Differences in needs are to be explained through “plausible” explicative criteria – “plausible” in the sense that there is a relation of causality which is acceptable and reasonable in economic policy terms: socio-demographic characteristics of the school-aged population and the expenditure needs for primary school, for example. Ad hoc variables related to (group) population may be weighted. The main argument is that needs are not in a linear relationship to the relevant ad hoc variable. A well-known example is the population density: [this?] may be associated with needs in different ways according to whether economies of scales are accessible or not (Birke and Lenk, 2003), or should account for scarcely distributed population in remote areas (Dafflon and Mischler, 2007: 197-199). To avoid the selection of the relevant ad hoc variables being driven by political priorities, the plausible relation of causality must be explicitly clarified (Bramley, 1990).

Since the ad hoc variables approach does not refer to actual local expenditures, the absolute value of expenditure needs as a monetary amount cannot be determined. It is only possible to determine SNGs relative expenditure needs. This leads to the open question as to how to evaluate the funding of the equalization program. Also, the advantage of simplicity and intuitive understanding of this method is soon brought into question when more than one variable is necessary to describe the expenditure needs per function; the variables have to be weighted but the method provides no criteria for such an exercise.

Statistical Aggregation of Variables

This approach exploits the information of as many indicators as possible. A principal component analysis can be applied to reduce the information for explaining the most important part of total variation of expenditure needs. But the complexities arising from an increasing number of variables make this interpretation a difficult task. This approach is only possible if the considered variables are strongly correlated (Bosch-Domènech and Escibano, 1988).

By using the standardized scores of the most important components as weights for the considered variables, one can determine the index of relative needs. If more than one component is applied, the question of aggregation of those values is once more open to debate, which is comparable with the situation when ad hoc variables need to be

weighted. Similar to the ad hoc variable approach, the statistical aggregation of variables provides only the relative position of SNG units in expenditure needs, but not how much funds are necessary to compensate expenditure needs disparities.

4 CONCLUSION

With the on-going theoretical debate on the virtues and defaults of equalization, many diverging practices in revenue equalization and limited experiments in expenditure needs/ costs equalization except the Australian case, it would be presumptuous to propose ready-to-wear solid conclusions. But a few points can already serve.

- Equalisation is about solidarity. And solidarity is normative: it is first a matter of ethical and political choices. It is not feasible to solve equalization in practice by quantitative methods only.
- The political economy of equalization offers a methodology for accompanying stakeholders (the “centre” and SNGs) in the process of transforming a concept, "solidarity", into practical policy measures, "equalization", as best as one can. Organizing four questions around the logic and the coherence of revenue equalization and expenditure needs equalization is a first step in this direction.
- The complexities of, the search of efficacy and coherence in equalization policies are not detrimental to transparency, accountability and acceptability. The first step is to agree on the nature of differences in the SNGs' public finances and to which extent they will count. The second step would be considering the separation of revenue equalization from expenditure needs/ costs equalization.
- Revenue equalization cannot be implemented without central and regional politicians taking responsibility for deciding how much, according to which criteria, to what extent and for which target equalization should take place. Of course, the final result will also depend on the financial resources available. With RTS, additional questions are the list of taxes to be considered, their structural quality, the standard rates that should apply for each selected tax and the weight given to each component in assessing the SNGs' tax potential. With several equalizing formula at hand, each design corresponds to a certain concept of solidarity.
- Expenditure needs equalisation is more controversial if only because of the difficulties in separating mandated functions from choices, in assessing needs or costs, in finding the adequate explanatory variables and adopting the adequate method of measurement. These difficulties are topped by political considerations and divergences about which functions should be considered and what are the required standards (access, costs, expenditure?) for those functions? Assessment methods are not of a sort that facilitates the econometric choice.

This paper contributes to a better analysis of equalization by organising the questions in a coherent sequence. It is not conceived as a process which delivers a final report on what-should-be-done, but as a participative step-by-step exposure of the issues and questioning which should be re-appropriated by the stakeholders in their particular country. This is essential when equalization (thus solidarity) is to be legitimated through parliamentary and democratic procedures.

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Fiscal equalisation and State incentive for policy reform

Neil Warren¹

1. FACILITATING STATE POLICY REFORM

Australia's approach to allocating Commonwealth untied grants to States and Territories (the States) has given their equitable allocation precedence over issues such as efficiency, revenue stability, regional asymmetric shocks, accountability and transparency². In recent years, the Commonwealth has left the determination of what is an equitable allocation of untied grants to the Commonwealth Grants Commission (CGC) who advises it on their allocation. An explanation for this approach might be that while ever States cannot agree on an alternative, the Commonwealth is not motivated to impose a different fiscal equalisation methodology to that applied by the CGC. However, there is reason to expect that in the future the Commonwealth might take a different view as evidence grows of pressure for a rethinking of current grant arrangements. This evidence includes:

1. *Recommendation 108 of Australia's Future Tax System (AFTS 2009)* that: 'The Productivity Commission should examine the principles of public service delivery and the mechanisms that are available to governments to deliver public services and their implications for financial arrangements in the federation. The findings of this study should be considered by COAG'. <http://www.taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf>
2. *2010-11 Australian Government Budget Paper No. 3*. (11 May 2010): In the 2010-11 Budget, the Australian Government stated that: 'Horizontal fiscal equalisation does not guarantee that the States will provide a uniform standard of service – its aim is to equalise the capacity of each State to do so, while leaving each State free to determine the standard of service provision.....Under the *National Health and Hospitals Network*, Australian Government funding for public hospitals will be based on the efficient price of public hospital services, determined by an independent pricing authority.' (p7)
3. *The Treasury Incoming Government Brief - Red Book Part 1* (August 2010) statement that 'reforming State taxes also presents an opportunity to deliver[deleted 'y'] a significant increase in long term productivity' and that 'The fiscal

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² See Warren (2010a, 2010b) for an overview of the issue leading to this observation.

equalisation process does not promote reform' (p21).

<<http://www.treasury.gov.au/contentitem.asp?ContentID=1875&NavID>>

4. The holding of the current *Senate Select Committee on the Reform of the Australian Federation*
<http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=reffed_ctte/index.htm>
5. The recently announced (9 February 2011) House of Representatives Joint Committee of Public Accounts and Audit (JCPAA) *Inquiry into National Funding Agreements*
<http://www.aph.gov.au/Parliamentary_Business/Committees/House_of_Representatives_Committees?url=jcpaa/natagree/report.htm>
6. Recent COAG discussion on health funding (13 February 2011) which saw considered a proposal for health specific purpose grants (specific purpose grant) and States own-source funded expenditure to be 'pooled' for redistribution amongst States using an activity based model and agreed levels of servicing
<http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13>
7. Recently tabled (28 February 2011) Private Member's Bill *Auditor-General Amendment Bill 2011* which proposes amending the *Auditor-General Act 1997* to require amongst other things that the Commonwealth Auditor-General audit State agencies in receipt of Commonwealth grants³.
<<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;query=Id%3A%22legislation/billhome/r4527%22>>
8. *Review of GST Distribution* (30 March 2011): When announcing the Review, Prime Minister Julia Gillard stated that 'Instead of States facing penalties for economic growth and rewards for economic underperformance, the GST distribution process should encourage economic reform and better delivery of services, and provide States with certainty.' Also that 'The review will lead to a simpler, fairer, more predictable and more efficient distribution of the GST to States and Territories.'⁴

Current intergovernmental fiscal arrangements are clearly under greater scrutiny by the Commonwealth Government and Parliament. The stimulus for this increased scrutiny appears to have two primary sources. Firstly, a perceived lack of transparency in current arrangements and what this has meant for State accountability for grant funded outcomes and secondly, for the incentive States have to embrace their own reforms or those funded through Commonwealth initiatives and delivered by States.

³ In particular, this is in response to the Auditor-General being 'limited with respect to money allocated to states and territories through national partnership agreements and other means, such as natural disaster payments or Building the Education Revolution payments. The Auditor-General is limited in jurisdiction in following the money trail and making sure that value for money and efficiency are being delivered.', Hansard, House of Representatives, Australian Parliament 28 February 2011, p17
<www.aph.gov.au>

⁴ See <<http://www.gstdistributionreview.gov.au/>>

This paper will examine whether there is an alternative grant design to that applied in Australia which is capable of better reflecting the lessons learnt in other countries with decentralised governments (Section 2). Attention will be focussed on how to design a grant structure which directly acknowledges how different approaches to allocating grants interact (Section 3) and potentially adversely impact on the incentives for States to embrace policy reform (Section 4). Focus will then be given to the policy areas of taxation (Section 5) and health (Section 6) and how a changed untied grant design could improve transparency, accountability and the incentive for States to undertake reforms.

2. LESSONS IN INTERGOVERNMENTAL GRANT DESIGN

In a recent review of fiscal federalism in twelve countries, a number of broad design lessons were identified as applicable to all decentralised governments. In particular, that:⁵

- (1) There be clear assignment of responsibilities;
- (2) Various levels of government have clear and agreed roles and limits on their authority;
- (3) Finance should follow function;
- (4) Governments face the financial consequences of their decisions;
- (5) Intergovernmental transfers strengthen (a) accountability, (b) competitiveness and (c) equity;
- (6) Accountability to citizens be achieved through transparent performance standards and redress mechanisms for citizens;
- (7) Institutional arrangements exist to manage intergovernmental conflicts; and there be
- (8) Periodic joint review of arrangements.

It is generally acknowledged in Australia that assignment of responsibilities across levels of government is unclear and confusing (1). Also accepted is that there is a lack of clarity as to the roles of and limits on the authority of the different levels, this being most apparent in the areas of health, education and the environment (2). With States raising just on 15% of all taxes but responsible for 41% of all government expenditure (in 2008-09), this substantial vertical fiscal imbalance means finance clearly does not follow function (3). The risk is that breaking the link between revenue and expenditure can result in each level of government not having to face the financial consequences of its decisions (4). In practice in Australia, this lesson is learnt as evidenced by the role of the Loan Council, the annual Loan Council Allocation and each State's own policies on budget transparency (Warren 2010b, pp27-28).

Failure to learn lessons (1) (2) and (3) has contributed to States sometimes claiming their inability to deliver the services demanded by the community is due largely to inadequate intergovernmental fiscal transfers. Here blame has been attributed by States to both the level of transfers from the Commonwealth and to their distribution between the States. A consequence is confusion by citizens as to who is accountable (5a) for policy outcomes – the Commonwealth or their State. This is not helped by

⁵ See the concluding lessons observed by the editors from the diverse experiences of the twelve federal countries reviewed in Shah (2007).

unclear performance standards for each level of government and unclear redress mechanisms for dissatisfied citizens (6).

Where Australia performs better is through its focus on achieving equity (5c) and having in place institutional arrangements designed to manage intergovernmental conflicts (7) through the Council of Australian Government (COAG) process. However, a weakness is with the apparent lack of readiness to periodically undertake joint reviews of arrangements (8). Rather, the Commonwealth Grants Commission which advises the Commonwealth on general (untied) grant allocation, is typically left to undertake periodic reviews – usually every five years – but not of a fundamental nature. While Australia appears to have learnt the lessons in (4) (5c) and (7), this could not be said for (1) (2) (3) (5a) (5b) (6) or (8).

The focus of this paper will be on the Australian federation's performance against international lessons (5) and (6) and how current intergovernmental transfer arrangements could be redesigned to provide States with an incentive to undertake policy reforms designed to improve efficiency and accountability.

Understanding how to simultaneously strengthen accountability, efficiency and equity of intergovernmental transfers requires an understanding of the conceptual issues guiding the development of different grant structures. Section 3 outlines how despite the complex grant design applied in Australia, it is in effect equivalent to a grant regime where all grants are pooled and allocated on horizontal fiscal equalisation principles. The effect is to compromise State accountability (5a) and efficiency (5b) as well as to make unclear from where a citizen's redress should be sought (6). As Section 4 will indicate, if Australia is to learn lessons (5) and (6), it must consider a fundamental re-examination of current grant design and distribution arrangements.

3. GRANT DESIGN AND FISCAL EQUALISATION

With decentralised government, it is almost inevitable that gaps will arise in the respective expenditure responsibilities and net revenue capacities both between and across levels of government. Typically, the national government is in a surplus revenue position while sub-national governments are revenue deficient. This arises from sub-national governments having access to often limited, small or weak own-tax bases or being 'crowded out' of a tax base by the actions of the national government. Even if each sub-national government could fund its activities from own-sources (so that there is no vertical fiscal gap⁶), asymmetries might exist between them as a result of their differing economic, social, political and demographic circumstances (resulting in a horizontal fiscal gap).

This could require the national government to make grants designed to ensure sub-national governments are funded in such a way as to provide a similar level of service given a similar tax effort. In this case, the grant would be designed to equalise a sub-national government tax and/or service capacities resulting in an equitable outcome. Such an outcome can also be affected by removing the pressure for low tax capacity

⁶ There is an important distinction to be made between vertical fiscal imbalance (VFI) and vertical fiscal gap (VFG) in the literature. VFI is the difference between VFG and the actual level of funding from other governments designed to fund VFG. In effect, VFI relates to the under funding of VFG. See Shah (2006 p18), and Boadway and Hayashi (2004).

sub-national governments to impose higher tax rates to fund comparable service levels to other governments. Grants can also be designed to address shocks which have asymmetric impacts across sub-national governments due to their widely differing structures.

What is less often clear in practice is just how the different grants which are designed to achieve the objectives of equity, efficiency and stabilisation, can interact and potentially undermine the original intent of each grant. As observed by Bergvall *et al* 2006 (pp112-113): ‘An important cause of inefficiency in many countries is the use of the same grant for various purposes, for instance, subsidisation grants that simultaneously attempt to equalise, or financing grants that simultaneously attempt to subsidise.’ Inefficiencies can also arise when different grants are used to achieve a similar purpose, as with funding health both through specific purpose grants based on a particular objective and general purpose grants distributed on equalisation principles.

What can result is a lack of transparency as to how an objective is being met and with it an erosion of accountability and ultimately a compromising of equity objective in the allocation of all grants (Lesson 5). An important consequence of this lack of transparency might be to erode the willingness of sub-national governments to embrace policy reforms where there are uncertain benefits.

A possible solution is to make explicit the objectives and principles that underpin each type of grant and to identify and acknowledge how any interaction between different grants potentially compromises their respective objectives. Two basic strategies are possible in response: one is to identify and measure these interactions and the other is to prevent them. The difficulty with the former approach is that each grant could interact with and impact on other different grants. Even if in theory their interactions could be identified, in practice information asymmetries may result in advantages to some grant recipients which limits the scope for monitoring grant funded outcomes. The other option for limiting the unintended interaction between the different grants is to directly limit these between grant interactions.

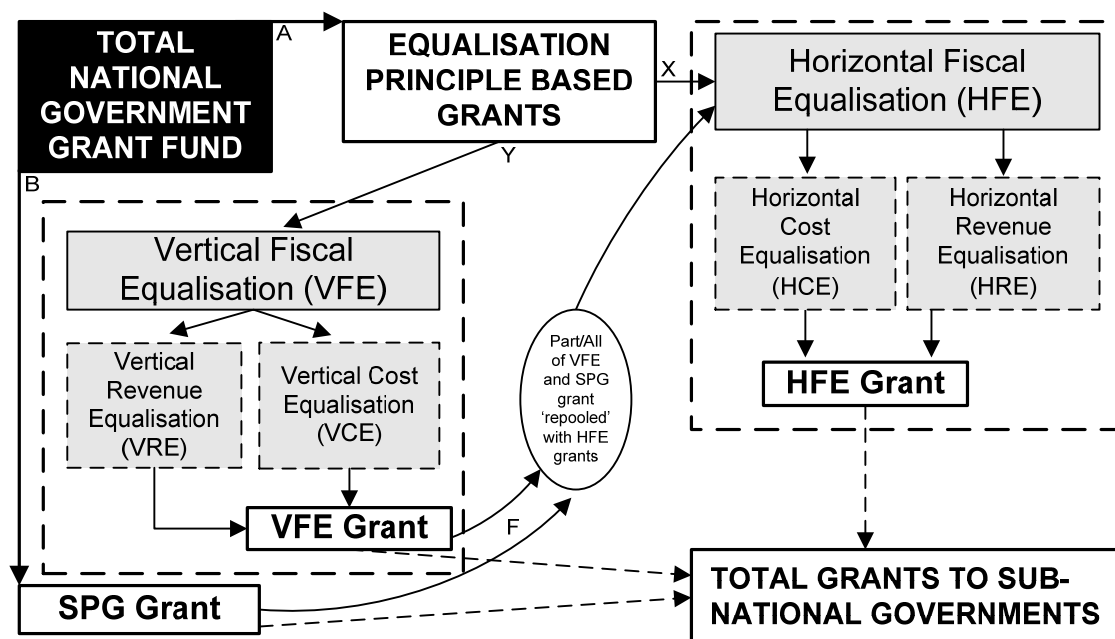
To appreciate the nature of these interactions and how they might be limited in practice, Figure 1 presents schematically a simple *all* grant allocation framework. The schematic assumes that the national government has an available ‘pool’ of resources to address sub-national government funding objectives. This ‘pool’ can then be divided into general purpose grants (A in Figure 1) and specific purpose grants (B). While specific purpose grants are designed to address issues such as spillover effects from sub-national government expenditure or the effects of asymmetric shocks, general purpose grants are most often focussed on the objective addressing vertical fiscal gap and horizontal fiscal gap through applying fiscal equalisation principles.

In practice, however, fiscal equalisation is implemented in many different ways across OECD countries⁷. This gives rise to the second distinction in Figure 1 which centres on how the available general purpose grant is distributed to sub-national governments. A distinction is made here between vertical fiscal equalisation (VFE) and horizontal

⁷ See OECD *Working Papers* 1 to 12 prepared for the OECD *Fiscal Federalism Network* by the OECD Centre for Tax Policy and Administration at http://www.oecd.org/findDocument/0,3770,en_2649_35929024_1_119684_1_1_1,00.html and Warren (2011)

fiscal equalisation (HFE). VFE is designed to allocate the general purpose grant between sub-national governments on criteria such as disparities in expenditure needs or fiscal capacity, to achieve some national government specified desired outcome such as *minimum* expenditure or a guaranteed average fiscal capacity. It is not unusual to have such grants earmarked, matching, or performance related. In contrast, strict HFE is about having sub-national governments with higher-than-average tax capacity and lower cost structures contributing to an equalisation fund from which sub-national governments with lower-than-average tax capacity or higher cost structures can benefit.

Figure 1 Grant Allocation and Fiscal Equalisation



Source: Based on Figure 1 in Warren (2012)

The methodology adopted in determining VFE and HFE grant allocations may in practice be very similar – differing only in how it is applied. For example, vertical revenue equalisation (VRE) and horizontal revenue equalisation (HRE) could both be based on the assessed revenue measured as the average national tax rate applied to their share of the base of a particular tax (defined as revenue from a Representative Tax System). A general purpose grant distributed on VRE principles, for example, could then fund a particular sub-national government to ensure it received at a *minimum*, assessed revenue equal to the average national per capita assessed revenue from various revenue sources. In contrast, HRE would fund those below the average national per capita assessed revenue through a *redistribution* from those sub-national governments with above the average national per capita assessed revenue. Similarly, a particular expenditure could be funded through vertical cost equalisation (VCE) to ensure *minimum* national average per capita assessed expenditure after taking into account cost disabilities in delivering services across sub-national governments. In contrast, horizontal cost equalisation (HCE) would be focussed on those sub-national governments with below national average per capita assessed expenditure *contributing* to those with above national average per capita assessed expenditure.

While Figure 1 is not definitive in terms of all possibilities, it does represent the most common approaches to national governments allocation of the total grant ‘pool’ to sub-national governments. Two facts are clear from this Figure: firstly, that specific purpose grants cannot be considered in isolation from general purpose grants and secondly, that general purpose grants can, like specific purpose grants, be distributed according to a multiplicity of principles. Combined, this might result in the ultimate impact of the allocation of the total grant pool being neither transparent nor able to ensure accountability, let alone result in efficiency and equity improving outcomes.

The remainder of this paper will focus on the Australian grant allocation framework, the implications of such inter-grant interactions and whether any policy disincentives effects which might arise could be minimised by restructuring the current approach.

4. INCENTIVISING STATE POLICY REFORM

In Australia, the CGC, when advising the Commonwealth on how to allocate general purpose grants based on HFE principles, adopts a ‘five pillars’ approach (Warren, 2010a):

Pillar 1 a State’s *financial capacities*, not its performance or outcomes;

Pillar 2 what States collectively do (on average);

Pillar 3 *policy neutrality* or a State’s own policies or choices should not directly influence its grant;

Pillar 4 *practicality*; and

Pillar 5 *contemporaneity*, delivering relativities most appropriate to the application year.

An important outcome of this CGC approach is to effectively pool specific purpose grants and general purpose grants and allocate this pool on HFE principles (Warren 2012, 2010a). This is most simply represented by F in Figure 1, which is the proportion of specific purpose and VFE allocated grants added directly to a State’s fiscal capacity when determining the allocation of general grants distributed on HFE principles.

A direct consequence of this approach is that, through the interaction of these different grants, the original objective of the specific purpose and VFE grants is undermined. So too is any attempt to encourage policy reform through these grants. By treating specific purpose and VFE grants as just another funding source when allocating general grants on HFE principles, any outcomes sought from these grants will be overridden through the allocation of general purpose grants. Complicating this result is the fact that most of the benefit arising from State policy reform will flow through to both other States (through its impact on HFE grants) and to the Commonwealth through increased revenue (Warren 2010a).

A possible strategy to address this outcome is to quarantine specific purpose and VFE grants from general purpose grants allocated using HFE principles (by setting $F=0$ in Figure 1). In effect this would ensure the current CGC approach to ‘repooling’ all Commonwealth grants is replaced with an approach which ensures ‘depooled’ grants are independent (and therefore ‘depooled’) from general grants allocated on HFE principles.

An advantage of quarantining the allocation of different grants in the 'pool' from each other is that it enables one to 'see through' the grant (as an input) directly to the outcome (or output). What results is a simpler and more transparent approach which would improve accountability by ensuring any individual grant in the 'pool' designed to achieve some outcome/output performance conditions can be more readily monitored and assessed. By limiting the interaction between different types of grants, unintended consequences can also be minimised, such as when specific purpose grants or the benefits from reforms are redistributed away from the State because of how general purpose grants are allocated. It could also enable more of the benefits of reform to accrue to the reforming State.

As Blöchliger and Charbit 2008 (p9) observed, 'the amount of equalisation grants a State loses if it increases its own tax revenue varies considerably across countries; however, on average sub-national jurisdictions have to dedicate more than 70% of additional tax revenue to equalisation'. Such high rates are a significant disincentive to government effort to increase their revenue base (Wurzel 2003).

In fact, assuming tax capitalisation, there could arise an incentive for some States to increase their tax rates to reduce their tax base and subsequently obtain higher equalisation grants (for Australia: Dahlby and Warren, 2003; for Canada: Smart, 2007, for Germany: Büttner, 2006). Also, if the grant allocation was based on an equalisation formula which was not comprehensive, States could 'avoid taxes that enter the formula and select taxes that do not, resulting in a distorted sub-national tax structure. Lenient tax effort, especially if tax administration is under sub-national control, may also be a result of high equalisation rates' (Blöchliger and Charbit 2008, p9).

Grant interactions may also result in a development trap for poor regions. Policy reforms designed to grow their economy with any downside-risk would be unattractive since any gains would confront a 100% marginal equalisation tax rate until they pass the floor or some minimum entitlement (Baretti, Huber and Lichtblau 2000, Garnaut and Fitzgerald 2002). One solution proffered is to exclude taxes strongly related to development from the equalisation formula – as with taxes on resources in Canada which are designed to encourage resource development in poorer (Atlantic) provinces. A risk with this approach is that it could result in strategic tax setting by those regions. However, this could be overcome by making some grant entitlements related to policy results such as certain sectoral growth performance, rather than wealth creation. It is also reasonable to expect that the incentive a State has to grow its economy and yield greater benefits to the State will provide an overwhelming incentive to States to continue to grow their economies despite the loss in grants through the equalisation tax (Schneider 2002).

Nonetheless, the benefits from (inefficient) State 'strategic behaviour' designed to maximise its grant share should be minimised. Here, adopting comprehensive approaches to revenue and cost equalisation or by adopting measures which are independent of State actions⁸ is important. However, any adverse consequences of comprehensiveness must be minimised. It is here that the Australian approach to

⁸ For a discussion of these issues see Blöchliger and Charbit (2008) and Bergvall, Charbit, Kraan and Merk (2006).

allocating the total grant pool has come under challenge for failing to ensure that governments face the financial consequences of their decisions (Lesson 4); for weakening not strengthening accountability, competition and equity (Lesson 5); and for undermining accountability through a lack of transparent (and simple) performance standards with redress mechanisms for citizens (Lesson 6).

If history is any lesson, introducing the approach outlined above could confront political resistance across the States. However, the inertia against change can be overstated. As highlighted in Section 1, there is a growing recognition that change is necessary to current intergovernmental fiscal arrangements. This is also clear in the commentary by States such as New South Wales, Victoria and Western Australia in their submissions to various CGC Reviews. It is also clear from inquiries in various States⁹ and recommendations by business groups¹⁰.

In the following two sections, the scope for the framework outlined above to facilitate reform in the areas of income taxation and health will be examined.

5. INCOME TAX BASE SHARING

Despite Australian States having the power to impose income taxes, they have not imposed such taxes since the Commonwealth introduction of the uniform income tax legislation in 1942 as a war measure with States compensated through the provision of grants. Post-war, States proposed reintroducing income taxes but were subsequently threatened with the loss of these grants on a dollar-for-dollar basis for any tax revenue raised. In the late 1970s and 1980s, the Commonwealth moved to allow States to impose surcharges on the Commonwealth personal income tax but opted not to. AFTS(2009)¹¹ supported such an approach on the proviso that the Commonwealth ‘make room’ for States which it would not do when this option was previously available to States.

However, even if the Commonwealth was to ‘make room’ for States, the application of HFE principles by the CGC when allocating general purpose grants would remove any real incentive for States to countenance such a proposal (Warren 2010a). In essence, this is because the marginal equalisation rate is excessively high.

In response, Warren (2010a) proposed five options to remove this HFE ‘trip’ to economically efficient State tax reforms:

- (1) Quarantine additional revenue from selected State tax reforms;
- (2) Quarantine any Australian Government tax reform incentive grants;
- (3) Limit CGC redistribution of any agreed fiscal dividend through backcasting¹²;

⁹ For example, New South Wales Government in IPART (2008), Victoria (2010), and was a motivating factor for Tasmania (2011) and the Garnaut and FitzGerald (2002) Review sponsored by NSW, Victoria and Western Australia.

¹⁰ For example, see Business Council of Australia (2007) and NSW Business Chamber (2008).

¹¹ AFTS 2009, Pt 2, Vol 2, p675.

<http://www.taxreview.treasury.gov.au/content/Content.aspx?doc=html/pubs_reports.htm>

¹² Major changes to methodology, policies and data are responded to by the CGC through using a process described as backcasting, where the changes in any one year are applied *as if* they were in operation in earlier years across which the State relativities are being estimated. The impact of the change occurs on

- (4) Institutionalise compensation; and
- (5) Adopt a flexible Pillar 2 through a partial move to ‘what States ought to do’ rather than ‘what States do’ on taxation.

It is (5) that the UK government is soon to introduce as part of its recently revised funding arrangements with Scotland. Here, ten percentage points of the UK Personal Income Tax basic and higher rates on the Scots is attributed to Scotland whether or not it decides to set that rate above or below ten percentage points (Warren 2010c). In effect, this is an application of VRE principles with ‘average’ and imputed rather than actual rate and where higher (or lower) than the ‘average’ rate is effectively ignored and to the benefit (or cost) of the State. In Canada, VRE is applied through a province’s per capita equalisation entitlement being equal to the amount by which their fiscal capacity is below the average fiscal capacity of all provinces – known as the ‘10 province standard’. Those provinces with above average fiscal capacity receive no equalisation entitlement¹³.

At present in Australia, States with a tax capacity (or tax base) below the per capita national average receive transfers from States with an average per capita above the national average. States are therefore assumed to impose the tax at the national average tax rate. If a State increases its rate above the average, the CGC assumes in Pillar 3 that it will benefit wholly from any revenue above the average. In practice, however, Pillar 3 is not independent of ‘what States do’. While small changes in rates will only infra-marginally impact grant entitlements, this is not so with substantial rate increases or major tax reforms (as noted in Warren 2010a).

If instead an approach was taken which operated on the VRE principle with the average set at ‘what ought to be’, then a State would have no reason not to impose the minimum and every reason to increase their rate above the average – since this would not be subject to equalisation. In Canada, such an arrangement effectively applies to natural resource revenues. Provinces receive a grant equal to the greater of either the amount they would otherwise receive by fully excluding natural resource revenues, or by excluding 50% of natural resource revenues. This adjustment to equalisation ensures that provinces receiving revenue from natural resources receive a net fiscal benefit from their resources equivalent to half the per capita resource revenues of the receiving provinces¹⁴. This is a conceptual approach which Western Australia has long argued for to the CGC in relation to its resource royalties revenue.

With VRE, each State has a clear incentive both to grow its economy (due to a potentially zero marginal equalisation tax rate) and to impose rates greater than ‘what ought to be’. States would then have real and significant discretionary fiscal powers through their access to substantial revenue sources such as through access to a broad based personal income tax.

However, if this new substantial tax and related VRE pool were treated as just another revenue source when determining general purpose grant shares using HFE principles,

a one-off basis with any transitional arrangements relating being excluded from the CGC process through quarantining any one-off compensation. See discussion in Warren(2010, p316).

¹³See <<http://www.fin.gc.ca/fedprov/eqp-eng.asp>> and discussion in <<http://www.eqttf-pfft.ca/english/EQTreasury/annex04-1.asp>>

¹⁴ibid

then these benefits would be undone. For this reason, the VRE pool and related tax would need to be quarantined and accompanied by complementary adjustments to the coverage of expenditure when applying HFE principles.

While it could be argued that a State might have an incentive to retain a tax base disability, this is unlikely to be the case with taxation as far more is to be gained from growing the economy than just the loss of the Commonwealth disability compensation. In this case, VRE would be equitable, efficient and transparent.

VRE need not replace HFE principles when allocating the general purpose grant pool. Rather, VRE principles could be applied to part of the 'pool' with the objective of providing the framework in which incentives are made available to States to encourage their adoption of major tax reforms such as a State income tax. A significant benefit also would be the attention such an approach draws to the benefits of reform and the scope to reduce vertical fiscal gap and minimise the inefficiencies arising from the redistributive effects of addressing horizontal fiscal gap.

6. HEALTH FUNDING REFORMS

While there might not as yet be an active public debate directly on the issue of funding the federation, there is in effect an active debate on the need to improve State public service delivery. It was in fact just this debate which motivated the health reform discussion at the 13 February 2011 COAG meeting. In the eleven-page communiqué following the meeting (*Heads of Agreement – National Health Reform*), 'transparency' was mentioned fourteen times and 'performance' fifteen times¹⁵. The issue is that health is both a State and a Commonwealth priority and funded by States through own-source revenue, and by the Commonwealth through specific purpose grants and by States allocating a proportion of their general purpose grants to health.

In the case of health specific purpose grants, three basic principles find application: equal per capita (EPC); vertical cost equalisation (VCE) and horizontal cost equalisation (HCE). EPC is where grants are based on population shares, VCE is where funding is for those States with *below* some average level of service provision given cost disabilities, and HCE is where funding enables States to achieve some average level of service provision given cost disabilities.

VCE is the most common approach across OECD countries for allocating grants to fund expenditure (Blöchliger and Charbit 2008). In Australia, all three approaches find application. Health specific purpose payments (SPP) are allocated on an EPC basis and national partnership payments (NPP) for health are allocated on a needs/cost basis and reflective of Commonwealth priorities and are in effect allocated on VCE principles. The general purpose grants (equal to the GST revenue) are then allocated on HFE principles which are underpinned in the case of the expenditure side, by HCE principles.

The trade-off with cost equalisation is that it can create inefficiencies (disincentives) through leading States to influence their needs (and disadvantage) with the goal of increasing their equalisation grant. This is possible because the cost of service

¹⁵ See <http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.rtf>

delivery is far more complex than revenue capacity issues and therefore more open to abuse. This complexity can therefore lead to rent seeking and pressure from special interests for particular grants.

One solution has been to earmark cost equalisation grants but this can be inefficient as grant entitlements are most often input rather than output- or outcome-based. As Blöchliger and Charbit (2008, p16) noted:

Earmarking reduces sub-national choice and can lead to distorted sub-national budget allocation, especially if grants cover many small budget items. Moreover, if earmarked grants are matching sub-national spending – so-called matching grants – their equalising effect is likely to be weak or even negligible. If national government is to retain control over the proper use of equalisation funds, it can do better through appropriate public service regulation such as minimum standards or output and performance indicators, while leaving operation and management of fiscal resources at the discretion of local and regional governments.

Earmarking grants also only weakly assists regional disparities. The evidence shows that poor regions are less willing or able to respond to Commonwealth matching grants while wealthy regions tend to reduce their own expenditure when receiving such grants. An alternative to earmarking grants is to link equalisation general purpose grants with regulations such as minimum standards or output and performance indicators.

Inefficiencies can also arise from the interaction between grants. The CGC is, for example, aware (Morris 2002, pp322-23) that by offsetting (unquarantined) Commonwealth specific purpose grants received by each State against that State's 'Total Requirement for Financial Assistance', the CGC methodology effectively undoes the intended specific purpose grant distribution arising from any special negotiations between the Commonwealth and the States. In effect, what the CGC does is add back (or repools) specific purpose grants into the general purpose grant 'pool' ($F=1$ in Figure 1). The key issue is that regardless of how the health specific purpose grant is allocated (EPC, VCE or HCE) or not (when general purpose grant is increased accordingly), if it is assumed that $F=1$ then the final distribution of the total grant 'pool' (general purpose grant and specific purpose grant) will remain unchanged. If, however, the health specific purpose grants are allocated on EPC or VCE principles and then quarantined ($F=0$), the original intent of these grants is maintained. This is because quarantining both the specific purpose grant and the related assessed health expenditure removes them from consideration when determining the relativities applied when allocating general purpose grants.

If it happened that the health assessed expenditure was on an EPC basis, then it would not matter if health specific purpose grants were allocated on an EPC basis. In this case, including or excluding health specific purpose grants and related expenditure would be of no consequence to relativities. However, this is an exceptional case.

As a general rule, only quarantining a specific purpose grant and related expenditure will maintain the original distribution of the specific purpose grant. However, while this ensures States spend their specific purpose grant on the designated expenditure, if the specific purpose grant was without matching conditions, the State could still reduce that States own-source revenue allocated to health expenditure. In this case

there is no reason why States would not change their total level of actual health expenditure and therefore total assessed health expenditure. A remedy is for the Commonwealth to replace its input focussed specific purpose grants with matching conditions or outcomes/outputs performance conditions. In the latter case, States would be indirectly forced to match specific purpose grants so as to achieve Commonwealth specified outcomes/outputs and benefit from any reward regimes (or not be impacted adversely by penalties for non-performance).

A benefit of this particular approach for the Commonwealth is to force actual and assessed State health expenditure to become aligned since 'what States do' would become 'what States ought to do' according to the Commonwealth. With such an outcome, debate over whether to quarantine the health specific purpose grant and related expenditure might be unimportant if the general purpose grant methodology adopted to determine assessed health expenditure aligns with the Commonwealth desired outputs/outcomes. However, if States opt to fund health at levels above 'what ought to be', then a general purpose grant allocation methodology based on 'what is' could act to redistribute the health specific purpose grant. In practice, the simplest and least controversial approach would be to quarantine the health specific purpose grant from the HFE principles-based allocation of general purpose grants, thus removing any scope for the specific purpose grant allocation to impact on the general purpose grant. In essence, that the specific purpose grants be defined as an earmarked matching quarantined grant accompanied by output/outcome performance conditions (such that $F=0$ in Figure 1 and related expenditure removed from consideration in HFE).

The 13 February 2011 Commonwealth-State proposal on health went one step further than this recommendation, effectively defining the specific purpose grant 'pool' as total health expenditure, whether funded from a specific purpose grant, general purpose grant or State own-revenue¹⁶. This health 'pool' was to be determined based on an agreed volume of activity and an efficient price. States would then be funded from this pool to deliver an agreed volume of services at an efficient price. If the State's cost of delivery is below the efficient price, the State can retain the savings. If it is above, they can either increase their funding of health from own-sources or provide less service. An incentive therefore exists to deliver services at the efficient price.

The health funding proposal is therefore conceptually similar to the VCE principle in Figure 1. However, if the proposed VCE grants and associated health expenditure are not quarantined ($F=1$) from inclusion in the CGC HFE methodology, the CGC's advice to the Treasurer on the allocation of general purpose grants amongst States has the potential to undo the original intention of the COAG health proposal, since 'what States ought to do' will differ from 'what States do' (Pillar 2). This is particularly important since the COAG proposal is about outcome and outputs (through performance requirements) whereas the CGC approach is all about expenditure (costs and needs) and therefore inputs. Ensuring the VCE principle is maintained would require the health grant and related expenditure to be removed ($F=0$) from consideration when the CGC estimates how to allocate general purpose grants. This

¹⁶See <http://www.coag.gov.au/coag_meeting_outcomes/2011-02-13/docs/communique_attachmentA-heads_of_agreement-national_health_reform.pdf>

quarantining would also need to extend to any rewards or penalties relating to performance. Not to do so would work to remove any desired behavioural response by individual States (which is why current performance payments under current health NPPs are quarantined as explained previously).

The VCE approach to health also has the advantage of addressing an ongoing criticism of the CGC HFE methodology that Pillar 2 rewards disability, doing nothing to encourage States to reduce it – an accusation most commonly made of States with large indigenous populations¹⁷. If VCE grants fund ‘what States ought to do’, have attached performance conditions, and are quarantined from consideration when allocating general purpose grants, then addressing disability is unavoidable. What results from applying the VCE principle in Figure 1 where $F=0$ is an outcome which aligns with agreed objectives (such as equity and efficiency outcomes) which are transparent (in being readily understood) and ensure accountability (through outcome performance monitoring).

7. CONCLUSION

The objective of this paper has been to highlight how greater attention given to the interaction between the various intergovernmental grants could make clearer the currently blurred roles and responsibilities within the Australian federation. This is especially problematic where there is not only shared funding of programs, but shared delivery. What could result from a better understanding of these interactions is better performance against the desirable criteria of accountability and transparency at the sub-national level of government.

It was also shown that through grant design which explicitly acknowledges the interaction between grants with State policies, major reforms in the area of income tax base sharing and health reforms could become potentially more attractive for sub-national governments. Complementing this knowledge with action to ensure the integrity of any agreed reward/penalty arrangements and to limit any apparent disincentive effects, would do much to encourage States to embrace reform which is in both their and the national interest.

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¹⁷ Warren (2010a) also argues the CGC methodology is best suited to a steady-state evaluation and not well suited to periods of major reform because the fiscal equalisation mechanism can work against change and only with direct Commonwealth involvement (through changing the CGC TOR and supplemental funding for States) can these limitations of fiscal equalisation be overcome.

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